Business and Industry Advisory Committee to the OECD

Comité Consultatif Economique et Industriel Auprès de l' OCDE

June 1999

# A BUSINESS VIEW ON TAX COMPETITION

## Introduction

The multinational business community speaks with a single voice when it puts forth the view that tax competition, generally, is a healthy phenomenon, from the points of view of both government and business. We believe that it is not erroneous to state that it is unwarranted taxation by governments, rather than competition among them in the tax area, that is stifling to economic and business development. After all, countries do compete in other ways to attract business to their territories, so why single out taxation of one relatively limited form of activity as harmful? Tax competition tends to keep tax burdens lower, which creates pressure for less wasteful, and, therefore, more efficient use of public funds. In addition, it fosters increased efficiency in the allocation of scarce resources. Lower tax burdens also translates into lower cost for multinationals operating within the territory and internationally.

## The Fundamental Issue

It is a well accepted notion that each country is free—indeed obligated—to decide its own fiscal destiny, unless, of course, it is a member of a supranational institution, such as the EU. Therefore, each nation should establish its system according to its fiscal needs, i.e., its budget, and collect the required revenue under the tax system of its choice to meet that budget. Such a situation creates the environment wherein tax systems and tax levels vary from country to country, a reality we have to live with and which is not *per se* a bad thing.

Likewise, in a world which generally espouses free cross border trade and investment, multinationals are, in major part, free to structure and operate their business activities as they see fit, generally in a manner that makes the most sense from a business point of view. In analysing the various costs of carrying on a business, whatever the structure or *modus operandi,* tax burden is taken into account when making business decisions. When viewed in this context, tax differentials among countries are not harmful. Such differentials may affect activity location decisions, but this is an expected phenomenon in a world supporting, and in a sense relying on, free trade and cross border investment.

BIAC understands the valid concern of governments to protect their revenues from unwarranted erosion. In this regard, BIAC rejects any form of fraudulent behaviour, and we do not in any way support preferential tax regimes established to promote and facilitate fraudulent practices. Such tax fraud not only distorts competition but is injurious to the general well-being in a market economy. Nevertheless, the target of efforts to combat tax fraud should not be so broad as to attack every nation that has a favourable tax climate which attracts businesses from other states.

## The OECD Report "Harmful Tax Competition"

BIAC has studied with great interest the document "Harmful Tax Competition—An Emerging Global Issue " (Report) which was prepared under the auspices of the OECD's Committee on Fiscal Affairs (CFA) and approved by the OECD Council on 9 April 1998. To our disappointment, BIAC was not consulted during the preparatory phase of this project, as is normally the case with respect to important tax issues under review and study by the CFA and its working parties. We believe that prior consultation of the

business community would have made the Report a more balanced document. Furthermore, two OECD member countries abstained from endorsing the report, indicating in published statements views that are strongly critical of the report's premises. BIAC would urge its involvement in any future work of this nature. In particular, we would add value to any studies (or other activities) to be produced by the Forum on Harmful Tax Competition.

Despite the language in paragraph 84, the Report gives the distinct impression that taxation is **the** major factor taken into account by multinational enterprises when deciding in what country to locate specific business activities. There are many other, non tax, factors that are of an equally high or higher priority in business location decisions. For example, we note such critical non-tax factors as adequate supply of appropriately-trained workers, relative labour costs, a developed and efficient infrastructure to support specific activities (electricity, water, roads, airport capacity and proximity, etc.), proximity to suppliers and markets, and a favourable government attitude toward foreign investment.

The Report describes its principal focus as "financial and other service activities," yet it offers no definition of the term, other than to assert that such activities are "geographically mobile." BIAC expresses disappointment with the lack of clarity created by failing to define this fundamental concept, which we believe is restricted to portfolio investment activity, intra-group financing arrangements of multinational groups, and similar applications. By contrast, we question the implicit notion that capital-intensive, customer-driven financial services that are actively engaged in offering financial goods and services (e.g., commercial banks, securities dealers, insurance underwriters and brokers, or retail finance companies) are inherently more mobile in their geographical situs than are other commercial and industrial firms.

With respect to the geographically mobile activities, the multinational enterprises that utilise the environments offered by the tax havens or countries with preferential tax regimes have **not**, in general, done so primarily for tax saving reasons, but because these locations have developed an expertise in servicing such activities, which, today, are far more significant than tax benefits in attracting business. Such regimes reflect, in effect, the continuation of the trend toward higher degrees of specialisation of labour that started with the industrial revolution. In support of the fact that taxation, although important, is not the crucial factor in this area, we note that business enterprises domiciled in countries that have enacted "controlled foreign corporation" (CFC) legislation continue to utilise countries with preferential tax regimes in which to conduct financially mobile activities despite the fact that the income therefrom may be taxable at home.

We interpret the Report as an attempt to mobilise the OECD nations to adopt a strategy designed to make low tax countries abandon the activities upon which their livelihood has been based for many years and in which they have developed recognised expertise. A result of such a strategy could make these countries economically dependent on other countries.

The theme underlying the Report, which involves taking proposed actions in a concerted way, runs counter to notion of free and unrestricted cross border business activities. It would, if adopted and acted upon, create a cartel-like atmosphere which is in clear conflict with the concept of free trade and investment across national frontiers, and which has never proved successful over a long period of time to the countries involved.

**The OECD Report in Light of Long-Term Trends**

Over the last two and a half decades, the phenomenon known as the "global economy " has evolved out of the many regional and national economies. This evolutionary movement was abetted by the governments of the free world ( most of whom were very supportive and encouraging) primarily by a gradual removal of many of the obstacles and restrictions which would have slowed down, perhaps even prevented, the

development of a truly global economy. In fact, the OECD was clearly in the forefront in supporting and encouraging this trend among its member states as well as non-member countries.

Over the same period, OECD figures demonstrate that the total tax revenues collected by governments have increased steadily and substantially. They show an increase that is in some areas astounding (ever-increasing as a percentage of GDP, even while GDP was increasing).

Competition between countries to attract and win foreign investors is a healthy phenomenon that could sustain reasonable levels of tax burden, and prevent potential excesses. These tax burdens effect all economic units, including: individuals (as workers and shareholders, etc.) and companies, and all of their activities. These large increases have impact across the whole economic community. For the relevant OECD figures, please see attached ANNEX II.

With this by way of background, the tone of the Report seems to run "against the grain", so to speak, giving the impression that the OECD and its sovereign member states are now changing direction in imposing new restrictions or limitations on the freedom of choices offered to multinational enterprises. In our view, multinationals should have the right to structure their international business activities in the most cost effective manner possible, including the minimisation of their global tax costs as one of the cost components incurred in the conduct of their businesses. During the period of growth of the global economy, taxation differentials among countries and subdivisions of countries were the order of the day, and in planning corporate expansion, location decisions were made based on many factors, including tax costs, but, tax costs were only one factor dictating the location decision. The Report's recommendations, if implemented in whole or in part, would constitute the beginning of the rebirth of artificially imposed restrictions on this flexibility, turning the clock back by many years.

**Benefits of Tax Competition**

In the global economy, international tax competition among nations tends to keep the negative effects of taxation limited. Witness the events that transpired following the company ( and personal ) income tax reductions that took place in the United Kingdom and the United States in 1985 and 1986. In considerably less than 10 years, rates of income tax all over the world dropped by up to 50%. Even the emerging countries tended to adopt lower income tax rates to be able to compete with the mature industrialised nations. Low tax rates tends to impose a discipline on the countries levying such taxes to make more efficient use of tax revenues in their spending decisions. The Report does convey an impression that the OECD is advocating a reversal of this trend, thus encouraging higher taxes.

**Distinction between Mobile and Other Activities**

In BIAC'S view, the distinction between mobile activities (as defined in the Report) and other, presumably non-mobile, activities is unwarranted. Admittedly, the so-called mobile activities, generally those related to financial functions, are easier to relocate because of the intangible nature of the assets and liabilities involved. Nonetheless, the prevailing international climate of liberalisation (i.e., removing trade and investment restrictions) and encouragement toward globalisation means that multinational enterprises should be free to carry on their activities where the environment is most conducive. The notion of restricting the placement of these financial functions appears to be an effort by the higher tax burden countries to retain, or recover, tax revenues that would be, or have already been, shifted to the lower tax burden countries.

**Conclusion**

BIAC strongly urges that no new obstacles to cross border trade and investment be promoted by the OECD for its member states as well as important non-member states. The 1998 OECD Report called "Harmful Tax Competition," however, does just that by promoting the introduction of novel restrictions on location

choices in the area of geographically mobile activities; in other words, the Report introduces a negative bias, i.e., discrimination against, such activities.

We believe that the adoption and strict adherence by countries to the OECD Transfer Pricing Guidelines is the most appropriate response to the issues raised in the Report and one which will be understood and accepted by the business community. The Guidelines in conjunction with national tax rules governing outbound transfers of intangibles which we understand many OECD nations impose, should address the fundamental tax issues raised in the Report. In addition, the treaties provide for exchanges of information between tax authorities to add transparency.

Furthermore, the suggestion that the exemption of tax on income from low or lower tax jurisdictions be selectively eliminated by OECD members—however effected—is inappropriate. The exemption system that some countries apply is designed to meet their legitimate objectives of encouraging foreign investment The income does not, by reason of its exemption, change its source. The suggestion therefore goes against longstanding concepts approved by many member countries to afford double taxation relief. In addition, this suggestion contradicts the fundamental notion of fiscal sovereignty and restricts freedom of choice between various fiscal policies. After all, the superiority of the credit system over the exemption system has not been demonstrated.

Should the OECD member countries move ahead to adopt the concept(s) in the Report, what is the next type of income flow to be saddled with similar restrictions? The end result of wholesale adoption of the Report's recommendations (or a majority of them) will be to raise the effective tax rates of the OECD based multinationals, a step in the wrong direction.

**ANNEX I: SPECIFIC COMMENTS to the OECD Report**
**"Harmful Tax competition: An Emerging Global Issue" (1998)**

**Paragraph 4**

The language of this paragraph sets forth the purported evils of harmful tax practices, as carried out by the so-called tax havens and countries offering preferential tax regimes for certain activities. To us, all of the adverse results specified in this language signify the desire of each of the OECD member countries to protect and enhance their tax base. Looking at this proposition from the viewpoint of the international business community, it translates into higher tax burdens for business. We take strong exception to the opinion that the existence of the tax regimes targeted by the Report "undermine taxpayer confidence in the integrity of tax systems."

**Paragraph 12**

In this paragraph, the topic of cross border interest flows was cursorily considered, with the conclusion that the matter should be referred to Working Party # 8, the group that deals with tax evasion and avoidance, to develop appropriate proposals on withholding and information exchanges. At this point, BIAC would like to restate our longstanding position that, in the interest of expediting cross border trade and investment flows, withholding taxes should not apply on interest payments, intra-country or inter-country, between affiliates in a multinational group. Accordingly, BIAC would offer to assist WP # 8 in developing its proposals on this subject.

**Paragraphs 24-25**

In these two paragraphs, Multinational enterprises that utilise low tax and no tax regimes as well as the governments and residents of such countries are referred to as " free riders ". This choice of terminology here is inappropriate, particularly since the underlying allegation is unfounded. In effect, the term "free rider " is being applied to most of the multinational enterprises in the world, enterprises who contribute very substantially to their domicile countries as well as to the many foreign countries in which they operate, in terms of the job opportunities they offer and the various taxes they incur in these economies. Additionally, the residents of the low tax and no tax countries usually incur other types of imposts, e.g., customs duties, which can be substantially higher than the norm, in order to finance the operations of their government, or they do without some government services. In other words, there is "no free lunch" for either the multinationals involved or the countries involved and their residents.

**Paragraphs 26-27**

These paragraphs, in attempting to establish a country's free choice on matters of tax policy, serves to confuse the reader with very wishy-washy language. For example, we refer to the sentence in paragraph 26 reading "(C)ountries should remain free to design their own tax systems as long as they abide by internationally accepted standards…." The question of what these standards are in this context is left in the air. In paragraph 27, as a further example, it is stated that a tax incentive "may be justifiable from the point of view of the country" offering such incentive, which still leaves in the air how such incentive is to be judged.

**Paragraphs 29-31**

The discussion in these paragraphs, which generally describes the purported harmful effects of the use by enterprises of the low tax and no tax regimes, is so much hyperbole. The situation that exists today, described by the Report as "poaching" on the tax base that "rightly" belongs to other countries, is not novel, but has been extant for many years. The larger industrialised countries have accommodated to this situation in various ways, and for them now to attempt to alter it by, in effect, "reclaiming the lost tax base" could have deleterious effects on the economies of the countries under challenge.

We believe that the verbiage in these paragraphs is overblown, thus seeming to signal the existence of an emergency where no such emergency in fact exists. In paragraph 30, for instance, the claim is made that a Pandora's box of evils ( a list of six such evils ) has been unleashed by reason of the fact that the effective rates of income tax on the income from financially mobile activities located in one of the targeted countries is significantly below the prevailing rates in other countries. We would submit that, *inter alia,* the use of the lower tax regimes for these activities in no way discourages taxpayer compliance, does not contribute in any way to undermining the integrity and fairness of tax structures, and does not increase the administrative cost to taxpayers. These claims seem to be artificial rationalisations created to justify a set of recommendations intended to protect and, where possible, enhance the revenue base of the industrialised countries.

**Paragraph 37**

The language in this paragraph, namely, "……governments must take measures, including intensifying their international co-operation, to protect their tax bases and to avoid the world wide reduction in welfare caused by tax-induced distortions in capital and financial flows." This language suggests, in no uncertain terms, the formation of a cartel to undertake implementation of the Report's recommendations. There is even a sinister tone that we think is unusual in an official publication of the OECD.

**Paragraph 95**

The second sentence in this paragraph takes issue with those among the preferential regimes which are "intended and operated to facilitate the evasion of tax properly owing to other countries, which (are) non-transparent and with respect to which the ( countries ) providing the regime(s) ( do ) not exchange information……." BIAC agrees that regimes meeting these three conditions are not to be supported, particularly where tax evasion is involved; however, in our view, that is not what is at issue here. It is the countries offering preferential tax treatment to certain financial activities that do so in a proper legal framework ( no "evasion " involved ), that have proper information procedures through tax conventions or exchange of information agreements, etc., that deserve the support of the OECD and its member states rather than the choking effect of these recommendations.

**Recommendations II. 1. And ll. 2., Paragraphs 97-103**

BIAC takes issue with the prospect of ever more countries adopting Controlled Foreign Corporation and Foreign Investment Fund legislation. Such legislation, which has already been adopted in several industrialised countries, tends to be extremely complex. When one considers the compliance requirements to a multinational enterprise operating a global business in which many of the affiliates own shares in other foreign affiliates, the enormous complexity of trying to apply tiers of CFC or FIF provisions should be noted . The multinational business community needs a reduction in compliance complexities not a further compounding thereof. BIAC therefore believes that CFC legislation should be discouraged rather than promoted.

**Recommendation ll.3. , Paragraphs 104-105**

This recommendation is aimed at those countries that use the exemption system, rather than the foreign tax credit system, to eliminate international double taxation. The thrust of the suggestion is that the exemption on foreign business income be made expressly inapplicable on income from foreign affiliates subjected to foreign income tax under a low tax or no tax regime. This recommendation raises the fundamental issue of which country has the primary right to tax cross border income. Under the rationale of the exemption countries, the source country has such primary right to tax the income generated within its borders, and, provided that the source country is not a no tax country, such income is considered to be "subject to tax" in that country. In order to avoid double taxation, the income is eligible for exemption. These are rules of long standing duration and have achieved international acceptance. This recommendation would alter these

longstanding rules and, for the exemption countries, present a far-reaching new concept. In fact, it would tilt the scales to favour the credit system over the exemption in the area of double tax relief, which may be unacceptable to exemption system countries. Moreover, there is no clear superiority of the credit method over the exemption method, and the choice should be left to each country in the exercise of its sovereignty.

**Recommendation lll. 12., Paragraphs 129-132**

There exist very few tax treaties entered into by the industrialised nations with countries constituting true tax havens (no tax countries ), for obvious reasons. We would strongly suggest that this recommendation be withdrawn. For one thing, the suggestion has a ring of arrogance to it which is quite unbecoming an organisation of the stature of the OECD. Secondly, since tax conventions normally include an exchange of information article, we would think that to be in a position to conclude a tax treaty with a pure tax haven would be a plus rather a minus and, therefore, should be encouraged. In this connection, we assume that this recommendation is not aimed at countries that offer a preferential tax regime with respect to some types of activities, but otherwise have an income tax statute that meets international norms.

**Recommendation lV.15., Paragraphs 140-148**

Regarding the suggestion to create a Forum on Harmful Tax Practices, BIAC believes that its formation was premature. Without addressing ourselves to the question of whether or not there is a need for such a standing body within OECD, we believe that its creation should have awaited at the very least a reaction from, *inter alia,* the business community and a representative number of non-member states. Moreover, if the notion of such a forum is to succeed, representatives from business and non-member countries must be invited to participate in its work.

**Recommendation lV. 18., Paragraphs 154-155.**

In both the language of the recommendation itself and the language of paragraph 154, mention is made of the subject of “ enforcement “ of the recommendations. We believe that the talk of enforcement this time, even the use of the word itself, is ill advised. These recommendations are just that—recommendations. They do not constitute enforceable law or regulations. Enforcement is an improper term to use in this context.

## ANNEX II: OECD Trend Statistics

### Total tax revenue as percentage of GDP (Gross Domestic Product at market prices)

| | OECD total | OECD America | OECD Pacific | OECD Europe | EU15 |
|---|---|---|---|---|---|
| **1965** | 26 | 25,1 | 22,1 | 26,7 | 28 |
| **1970** | 29,1 | 29,3 | 23,8 | 29,9 | 31,4 |
| **1975** | 31,3 | 29,9 | 23,7 | 33,1 | 34,3 |
| **1980** | 33,0 | 25,0 | 26,1 | 35,7 | 37,2 |
| **1985** | 34,8 | 25,4 | 27,0 | 37,9 | 40,2 |
| **1990** | 36,1 | 26,7 | 29,7 | 38,9 | 41,0 |
| **1995** | 37,3 | 26,8 | 29,8 | 40,2 | 41,8 |
| **1996** | 37,7 | 27,2 | 29,6 | 40,6 | 42,4 |