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Introduction

This book is about how business profit is, could, and should be taxed, particularly when the activities of the business transcend national boundaries. This may seem a dry, technical topic. For many years it was. However, it has become the subject of heated debate within, and amongst, many countries.

The framework of the existing system for taxing business profit in an international setting dates back to the 1920s. A multinational business earns global profit as a single economic unit operating in many countries. However, for tax purposes, the existing system allocates its profit across countries by treating it as a set of independent separate entities. The taxable profit of each entity within the multinational is calculated on a stand-alone basis through a complex system of rules derived from domestic laws and international treaties. A key preoccupation of this system is to share taxing rights between countries so that the same profit is not subject to tax in more than one country—that is, to avoid so-called 'double taxation'.

But there is a widespread perception that the system is no longer acceptable. A key complaint voiced by governments, international organizations, and tax campaigners in recent years is that the system has instead permitted businesses to escape tax altogether—or at least to have low overall tax liabilities. The Organisation for Economic Co-operation and Development (OECD) 'Base Erosion and Profit Shifting' (BEPS) project, which began in 2013 and proposed important reforms in 2015,[1] was largely aimed at combating tax avoidance through arrangements that served to shift profit to low tax countries.

The BEPS project did not address the more fundamental question of how taxing rights over multinational business profit should be shared amongst countries. But in the world of global politics it is competition amongst governments over these taxing rights—a contest between governments for the revenues—that is more likely than concerns over profit shifting to drive fundamental reform of the system.

Developing and emerging countries have for many years argued that the allocation of taxing rights under the existing system favours developed, industrialized countries. More recently, a number of developed countries have also voiced their dissatisfaction with the existing system, arguing that it did not allow them to collect a 'fair share' of tax on the profits earned by certain prominent highly digitalized businesses. For example, some countries have claimed that domestic 'users'

[1] OECD (2013a, 2013b, 2015a).

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of digital services contribute to the profit of the business, and so some taxing rights should be given to the country where they are located. But over time, this debate has broadened into a much wider battle for the rights to tax international business profit.

This contest for tax revenues may seem ironic, since for more than three decades there have been significant concerns about competition between national governments to attract mobile economic activity. This competition has led to a steep decline in rates of tax on corporate profit and the proliferation of other special tax schemes intended to attract multinationals' business and/or their profit. But there is a crucial difference between this competition and the contest over the allocation of taxing rights: governments have reduced tax rates in countries in which businesses undertake their functions and activities but are seeking to increase their revenue in countries where businesses' customers and users of digital services are found. This is a crucial distinction which plays a key role in our development of proposals for reform.

Beyond these problems of profit shifting and tax competition, businesses are not content either. They have become increasingly concerned over the staggering complexity of the tax system, and the uncertainty over how it is actually supposed to work in practice. This concern is shared by tax authorities, particularly those with significant capacity constraints (and other urgent tax problems to address), as they are faced with an increasingly challenging and costly system to operate. Meanwhile, economists have been concerned about tax-induced distortions to the real economic behaviour of multinational businesses—for example, in their location and investment decisions—which create real economic and social costs.

It has been understood for some time that the problems of the international system of taxing profit at a business level stem from its fundamental structure. This is in large part due to the existing system being based on the presumption that it is feasible, conceptually and practically, to identify with reasonable accuracy the profit arising in each 'separate entity' within the business. But a key problem with this concept is that a multinational business tends to make higher profit *because* it is multinational. That is, it can take advantage of its size and scope to locate its various activities—management, production, research and development, finance, marketing, and many other elements of the business—in the locations that best support those aspects of the business. The synergies between the different units mean that the whole can be greater than the sum of its individual parts; and so the total profit of the business can be higher than the sum of deemed profits earned by the entities within the business.

A second key feature of the existing system also contributes to its problems but is less prominent in policy debates. The existing system taxes business profit in the location of the various activities listed above. But most of these activities are relatively mobile; businesses can and do move them in order to reduce their overall tax liabilities. This causes a vast array of problems for the system. Ultimately, no

amount of tinkering with the system can resolve these fundamental issues; there is a need for major structural reform.

This book sets out to explain the problems underlying the existing system and to consider options for fundamental reform which would be stable in the face of competition for both tax revenue and economic activity. In this Introduction, we begin by exploring how the issues of profit shifting pushed the taxation of business up the international political agenda, and how the political debate was transformed into a contest over the allocation of taxing rights. We explore the different forms of competition between governments and also briefly set out other problems of the existing system. We then describe the approach taken in this book. We step back from the current political debate and start from first principles by asking basic questions, including why business profit is taxed at all. A set of criteria is then developed which can be used to evaluate the existing system and any potential reforms in a comparable, consistent, and comprehensive way. In our analysis we primarily take a global perspective, asking what tax system would be most beneficial for the world as a whole. But there is no world benevolent dictator, nor do governments cooperate—in tax design, or in sharing tax revenues—to the extent that might be mutually beneficial. We therefore have to keep in the forefront of our minds that national governments are likely to act, above all, in the interests of their own country. A central question in considering any reform must therefore be the incentives of national governments to enact it.

In this Introduction we also very briefly set out the directions in which that approach leads us and outline the structure and main themes of the book. The culmination of the analysis we present comes in two proposals for reform that we develop in detail in Chapters 6 and 7. It may seem implausible that there are any solutions that could address the combination of such problems as profit shifting, competition, complexity, uncertainty, and economic inefficiency. The central argument of the book, however, is that such solutions do exist. Fairness is an important issue, but it is also in many ways a much more difficult issue, since—as we discuss at length in Chapter 2—there is no clear basis for how the rights to tax the profit of a multinational business ought to be distributed amongst countries.

The key to the solutions that we consider is that the rights to taxing profit should be allocated to countries on the basis of factors that are relatively immobile, and which are therefore less likely to move in response to the tax. There are a number of possible candidates for these relatively immobile factors which we discuss, including the residence of the owners of the business and the country of location-specific profit. On the grounds that the customers of a business are relatively immobile, we end up by setting out in some detail two proposals for reform based on allocating the rights to tax business profit to the country in which businesses sell their goods and services.

This book is concerned with how to tax profit earned by a business, especially a multinational business that has activities in more than one country. In developing

proposals for reform, an important issue is the scope of any alternative tax regime. In principle, to avoid distortions based on legal form, a tax on profit should apply to all businesses, whatever their legal form—for example, whether it is a company with limited liability, a partnership, or a sole trader. However, by far the most important existing form of taxation of profit—especially in an international setting—is the taxation of the profits of companies, and particularly multinational companies. It is the taxation of multinational companies that has dominated the tax policy debate. In general, then, our discussion of the principles of taxing profit refers to a business, a multinational business, or simply a multinational. However, in describing the existing system, in reporting evidence, or in setting out many examples, we therefore frequently refer to companies, and corporation tax or corporate income tax.

1. Tax avoidance

In recent years the issue of the taxation of multinational business has risen high up the political agenda in many countries, based on the growing belief that multinationals are able to exploit the existing system to reduce their overall tax liabilities. Particularly in the wake of the financial crisis of 2007–08, and the need for fiscal consolidation and the heightened sense of injustice that followed, the idea that large and profitable businesses have not been paying their 'fair share' of taxation touched a chord with politicians and the general public. The idea of 'unfair competition' between large tax-efficient multinationals and small local businesses subjected to the full level of domestic taxation also came to the fore. Businesses deemed not to be paying enough in tax have had their tax affairs splashed over the front pages of newspapers and have been the subject of parliamentary and senate enquiries.

There are many examples. In one, from 2014, a United States Senate enquiry announced that Caterpillar had 'deferred or avoided paying US taxes totalling about $2.4 billion'.[2] The Committee's report begins by declaring that it 'has examined how US multinational corporations have exploited and, at times, abused or violated US tax statutes, regulations, and accounting rules to shift profits and valuable assets offshore to avoid US taxes'. The narrative that large business has been acting immorally in using all and any techniques to avoid taxation was also enthusiastically taken up elsewhere.[3] For example, the UK Public Accounts Committee—ostensibly concerned with overseeing the expenditure of UK government

[2] United States Senate Permanent Committee on Homeland Security and Government Affairs (2014).

[3] A growing academic literature investigates the development of these issues into important political topics. See, for example, Forstater and Christensen (2017).

departments—grilled executives from several businesses deemed to be aggressively avoiding tax. In one case in 2013, the chair, Dame Margaret Hodge, told Matt Brittin, then Google's Vice-President for Sales and Operations, Northern and Central Europe, that his company's behaviour on tax was 'rather devious—if I may say so, calculated—and, in my view, [constitutes] unethical behaviour in deliberately manipulating the reality of your business to avoid paying your fair share of tax'.[4] Professional advisory firms have been regarded in a similar way. Also in 2013, the finance ministers of France, Germany, and the UK issued a joint statement urging a fight against aggressive tax planning by multinational businesses.[5]

Businesses responded in different ways, but certainly became more aware of the reputational consequences of being deemed to be aggressively avoiding tax. Famously, in 2012, Starbucks volunteered to pay additional tax of £20 million in the UK. Kris Engskov, then Managing Director of Starbucks UK, said 'I am announcing changes which will result in Starbucks paying higher corporation tax in the UK—above what is currently required by law … These decisions are the right thing for us to do. We've heard that loud and clear from our customers.'[6]

His statement neatly encapsulates an important issue. If it is true that Starbucks, and other businesses, were already complying fully with tax law in the UK and elsewhere, then it is not clear that the blame for low tax collection from such multinationals should be laid at their door. Tax is not supposed to be voluntary. Persuading Starbucks or other companies like it to make a voluntary tax payment, as if a charitable gift, cannot be a sensible way of implementing taxes. It is up to governments to decide the basis of taxation. They set taxes through legislative bodies, they collect the tax which they enshrine in legislation, and they are often aware of how businesses will respond. It may be true that the lengths to which some businesses have gone to arrange their affairs in such a way as to reduce their tax liability is distasteful; however the solution is not to demonize business, but to design and implement taxes that are less prone to such manipulation. This book attempts to design and evaluate some possible solutions.

Governments also responded collectively. The political pressure resulted in a flurry of changes to the taxation of international business taxation, at both national and international levels. A focal point for such reform was the OECD BEPS project, driven by the G20. This took place between 2013 and 2015[7] and resulted in a series of 'minimum standards' and aspirational recommendations. The OECD is a key organization in developing the structure of international taxation, not least because it is the home of the OECD model tax treaty, which underlies the vast majority of the more than 3,000 bilateral double tax treaties that have been concluded

[4] Public Accounts Committee (2013).
[5] 'We are determined that multinationals will not avoid tax', Osborne et al (2013).
[6] Cited in *The Guardian*, 6 December 2012.
[7] Some aspects of the BEPS project, notably in relation to digitalization, continue.

between pairs of countries, and of transfer pricing guidelines that play a central role in implementing the current system.[8]

We report evidence on the scale of the avoidance of taxes on business profit in Chapter 3. Estimating this is challenging, not least because it is difficult even to define avoidance. Unlike 'evasion', 'avoidance' refers to actions taken to reduce tax liabilities that are consistent with the tax system as laid down in law. But such actions can be many and varied; and most people would not classify them all as avoidance. Indeed some may not classify any as avoidance, considering that the notion itself seems to imply some standard that is not set out in law. It is even more difficult to identify the revenue that would have been raised in the absence of avoidance. As we describe in Chapter 3, there is a wide range of estimates, though certainly at the higher levels these estimates indicate a significant degree of avoidance.

In a sense though, even if the empirical evidence of the scale of avoidance is not strong, perceived avoidance is certainly a very salient issue which has repercussions for people's satisfaction with the existing tax system. The commonly held view that large multinational businesses are able to exploit loopholes in the tax system feeds the broader view that the system is rigged in favour of the rich, which in turn undermines trust in the wider tax system and fuels populism on the left and the right.

2. Competition for economic activity and tax revenue

Very broadly, the OECD/G20 BEPS project sought to stem the flow of taxable profits from countries where real activities took place to low tax countries in which they did not. The former group of countries could largely agree on these measures and the latter countries found it hard to resist politically. But the project explicitly did not address the much more difficult and fundamental question of how to allocate taxing rights among countries where real activities do take place.

2.1 Contest over the allocation of taxing rights

The existing allocation of taxing rights has for many years been criticized as unfair by developing countries which often felt unable to tax to their satisfaction the profits earned by foreign businesses operating within their borders. This is perhaps not surprising given that the foundations of the existing system were put in place at a time when many developing countries were still colonies and had little, if any, voice on the matter. The UN, and others, have attempted to change this allocation

[8] The United Nations (UN) also has a model treaty, most recently revised in 2017, that is intended for adoption between developed and developing countries.

but with limited success. Whilst the OECD/G20 BEPS project was under way, a substantial number of emerging and developing countries urged the OECD to address this issue, but again with no success: the BEPS project was 'not directly aimed at changing the existing international standards on the allocation of taxing rights on cross-border income'.[9]

In the context of the BEPS project, the more fundamental issue of allocating taxing rights instead arose in the context of taxing profit made by certain 'highly digitalized business'. Such profit is widely understood to be even more mobile across countries than that of other businesses. It can be earned with little, if any, physical presence in a country—a key factor in the existing system. Some developed countries felt they were receiving less than their 'fair share' of tax from the activities of certain highly profitable and highly digitalized businesses (including those offering social media, marketplace, search engine, and similar services). They claimed that they should have the right to tax these businesses on the grounds that the businesses benefited from the contribution of users of their services found within their borders, even if the profit-generating transactions may have taken place in other countries.[10]

India presented itself as a 'first mover' when it introduced an 'equalization tax' on inbound digital services. The UK also argued that the existing system's failure to recognize the contribution made by users of digital services posed a 'fundamental challenge to the fairness, sustainability and public acceptability of the corporate tax system'.[11] Together with other countries like France and Italy, the UK favoured altering the current allocation of taxing rights—but only to the limited extent necessary to satisfy their particular concerns with highly digitalized businesses. In 2018, the European Commission also made proposals to tax revenue from digital presence—a 'short term solution' in the form of a special tax on the turnover of certain highly digitalized businesses and a 'long term solution' extending taxing rights under corporation tax on the basis of 'significant digital presence'.[12]

Not surprisingly, others objected—notably the US, given that the main effect would be to increase the rights of the countries proposing the change to tax the profits of US multinationals. But there are other good reasons to object to special treatment for businesses with particular characteristics, even from a global perspective. Conceptually, it is hard to justify this special treatment. Practically, such an approach would require complex—and regularly updated—rules for determining which businesses would be singled out for this special treatment. Such rules would also distort choices by businesses, and competition between them.[13]

[9] OECD (2013b), page 11.

[10] The use of highly mobile intangible assets is also extremely important in the context of these businesses; as a result, businesses have been able to substantially shift profit to low tax countries by transferring intangibles.

[11] HM Treasury and HM Revenue and Customs (2018), page 3.

[12] European Commission (2018c).

[13] For discussion, see Devereux and Vella (2018a) and Schön (2018).

In any case, the debate on the allocation of taxing rights over profits in the digitalized economy expanded to one on the allocation of taxing rights for all international business profit. At the time of writing, this debate is far from resolved.[14] Often, the debate has been less than illuminating, and subject to much obfuscation. Ostensibly, it was guided by the principle that profit should be taxed where value is created. But this principle cannot guide reform as it is not clear where value is created.[15] There is even disagreement on the meaning of the principle among its proponents. It is hard to resist the conclusion that debate on value creation is a respectable façade for inter-governmental haggling over tax revenue. In fact recent materials produced by the OECD's Inclusive Framework in this context have already largely abandoned the concept of 'value creation' as the major benchmark for the international allocation of taxing rights.[16]

2.2 Revenues at stake

This contest between governments might lead an observer to suppose that substantial revenues from taxing business profit are at stake. In fact, the contribution in many countries is fairly small, certainly relative to other taxes such as personal income tax and value added tax. A closer look at the data reveals significant variation in the reliance different governments place on taxes on business profit.

Figure 1.1a examines the extent to which governments rely on taxes on corporate profit—the largest source of tax revenue from business profit in most countries. It shows the median share of total tax revenue accounted for by taxes on corporate profit separately for high, middle, and low income countries, from 1990 to 2017. It excludes countries with significant natural resources, which may make greater use of taxes on corporate profit.

There is a clear pattern to the figure. In the last decade, low income countries have relied more heavily on corporation tax revenues, with around 15% of revenues generated from this source by 2017. That proportion has been climbing steadily since the turn of the century. Middle income countries rely less heavily

[14] In its interim report on taxing digital business in 2018, the OECD stated that: 'These challenges go beyond BEPS and chiefly relate to the question of how taxing rights on income generated from cross-border activities in the digital age should be allocated among countries', OECD (2018c), page 18.

[15] See, for example, Devereux and Vella (2018b) and Hey (2018). Going further back, in 1923, a report to the League of Nations Financial Committee noted the following: 'By production of wealth we mean all the stages which are involved up to the point [of] wealth coming to fruition ... The oranges upon the trees in California are not acquired wealth until they are picked, and not even at that stage until they are packed, and not even at that stage until they are transported to the place where demand exists and until they are put where the consumer can use them.' League of Nations Financial Committee (1923).

[16] OECD (2019a, 2019b). On this development see Schön (2019).

Figure 1.1a Corporation tax revenues as percentage of total tax revenues: median of non resource-rich countries, 1990–2017
Source: IMF WoRLD Database

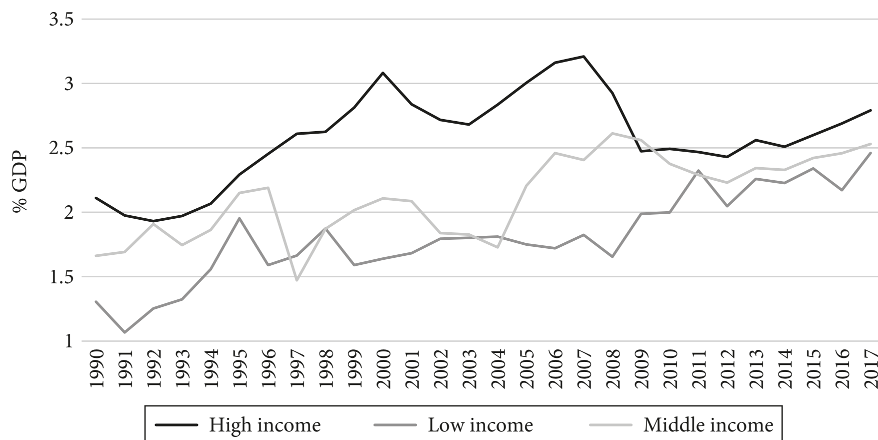

Figure 1.1b Corporation tax revenues as percentage of GDP: median of non resource-rich countries, 1990–2017
Source: IMF WoRLD Database

on corporation tax, and high income countries still less. For high tax countries the median percentage has fallen from around 13% just before the financial crisis to around 10%.

Figure 1.1b shows the same revenues from taxes on corporate profit expressed as a proportion of the country's GDP; again the median for each group of countries

is shown, excluding countries with significant natural resources. On this measure, there is much greater consistency in this measure between high, middle, and low income countries in more recent years—although low income countries in particular have strongly increased their revenues as a proportion of GDP over the period (from 1% to 2.5%). Even so, this suggests that the main reason why low income countries rely more on corporation taxes is not that they are better at taxing profit than richer countries, but because they are less able to use other taxes, especially personal income taxes. Overall, their use of taxes on corporate profit is similar to high income countries; but this is more important for low income countries since they have less opportunity to use other taxes.

This reflects wider difficulties for low income countries in raising revenue more generally. For them—with VATs that are in many cases already under pressure, weak personal income taxation, a need to reduce reliance on customs revenue, and with considerable revenue needs if they are to have any chance of meeting the Sustainable Development goals—reforming business-level taxes could be particularly useful.

2.3 Competition over taxes

National governments have been competing with each other for decades to attract real economic activity which would boost their economies. In the context of the existing system, they have done so by reducing their tax rates, and offering other inducements, to undercut other countries. This may also attract mobile profit with little if any accompanying real activity, through various forms of profit shifting; if this effect is large enough, then in itself it may lead to that country's tax revenue being higher with a lower tax rate. Yet undercutting one's neighbour's tax rate is unlikely to lead to a stable outcome; the neighbour is likely to respond, resulting in a downward spiral.

The last three decades have seen competition over tax rates on corporate profit of this kind. Figure 1.2 demonstrates a common feature for all three groups of countries identified above: the average statutory tax rate has been continuously falling since 1990 (and actually even before then). On average, statutory rates have fallen by around 15 percentage points over this period. This is true of all three groups of countries, although high income countries have maintained tax rates that on average have continuously been around 5 percentage points higher than middle and low income countries. This reduction has apparently not been much slowed by the OECD/G20 BEPS process: indeed closing off avoidance opportunities by which governments have been able to attract inward profit shifting may make tax competition through headline tax rates more intense.

A significant concern is that this competition shows little sign of slowing. Indeed, from 2018, the US cut its corporation tax rate from 35% to 21%, moving it

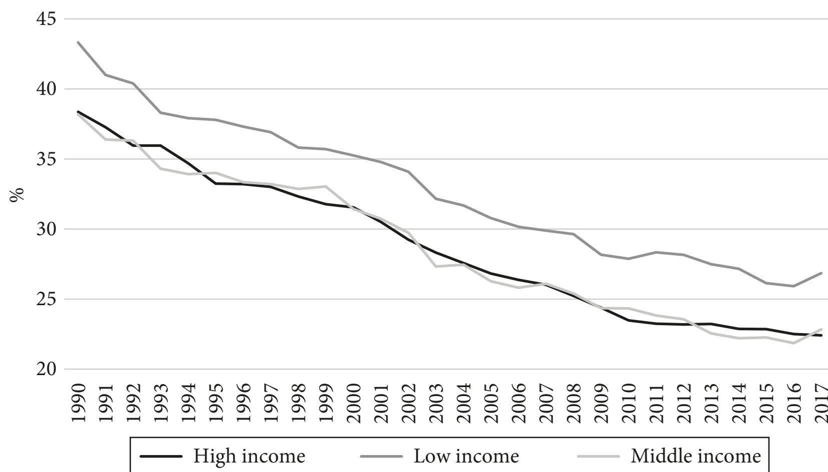

Figure 1.2 Average statutory corporation tax rates: all countries, 1990–2017
Source: IMF FAD Rates Database

at a stroke from one of the highest rates to one of the lowest. It seems likely that this will induce further cuts in other countries. There is therefore a real question as to how effective tax rates under the existing system will develop in the absence of significant reform. At some point the high costs of collecting such taxes may begin to outweigh the benefits in terms of tax revenue.

2.4 Reconciling the two forms of competition

At first sight, these two elements of competition amongst national governments may seem incompatible. At least some governments would like to claim a greater share of taxing rights over multinational business profit. But they are simultaneously inclined to reduce their tax rates to attract business. How can these approaches be reconciled?

The answer is that these contests are based on different locations of taxation. Recent proposals to change taxing rights have been based on taxing the profit of multinational business in the market country in which the business makes a sale to a third party, or alternatively where it has a user. Current tax treaties constrain the right to tax simply because a sale takes place in a country, or because a user is there. They instead allocate taxing rights primarily to countries where the business has its economic activities and a physical presence; imposing a high tax rate on this basis would drive at least some of that economic activity elsewhere.

From a national perspective, governments could take—and indeed some have taken—unilateral action to make a claim to tax business profit on the grounds that

a business has made sales in its country or that it has users there. If, over time, this approach replaced their taxation of profit based on where economic functions and activities are located, this could also be seen as an extreme form of the tax rate competition illustrated in Figure 1.2. Unilaterally giving up rights under the existing system would in effect be like setting the tax rate under existing rules to zero: the ultimate move in the ongoing tax competition game. This would be consistent with the aim of attracting inward investment from other countries. But on its own it would reduce revenue from taxes on business profit under the existing system to zero.

On the other hand, shifting the basis of taxation to the location of sales or users would have major advantages. If taxing rights depended only on the location of sales—or some other relatively immobile factor, such as the residence of owners of the business, or possibly location-specific profit, such as the location of natural resources—and not on the location of the different entities within the multinational business, then the tax would not affect business location decisions. Further, a customer, or a user, is unlikely to emigrate in response to a tax levied on the profit of a business selling to her or providing a digital service to her. So the location of sales would also be unlikely to be affected. Allocating taxing rights solely on this basis would therefore not have any repercussions on the location of economic activity. This would be advantageous both from the perspective of a country making a unilateral reform, and from the perspective of an agreed position amongst all countries. This is a central theme of this book.

Of course, such a major shift would raise issues of both implementation and revenue. Issues of implementation depend on the precise structure of any tax that is levied, and we contrast two alternative approaches in some detail. The attitude of national governments may also depend on the likely consequences for their tax base, which – at least in the short and medium run - may be lower for export-oriented countries.

3. Other problems

The OECD/G20 BEPS project focused on tax avoidance and made proposals that were intended to limit the opportunities for businesses to shift profit to low tax countries. While these proposals may have tightened the system, profit shifting opportunities remain. Furthermore, these proposals may well have worsened other major problems of the existing system.

First are the twin issues of complexity and uncertainty. These result in high compliance costs for business and high administrative costs for governments, but also in real economic costs as business decisions may be affected by uncertainty.[17]

[17] Some empirical evidence on the costs of collecting tax on profit is provided in Chapter 3.

Many aspects of the existing regime are highly complex, and much of this complexity arises because of the difficulties inherent in allocating separate elements of the overall profit of a multinational business to its separate entities in different ways. A succinct account of this existing system is that 'active' income is taxed in the 'source' country, while 'passive' income is taxed in the 'residence' country.[18] Even without starting to get into the definition of these four terms, it is clear that defining and understanding each is crucial in determining where specific profit is taxed.

Take a simple example for illustration. Suppose a business undertook research and development, and developed unique intellectual property (IP), in countries A and B, and used that IP to produce and sell a product in countries C and D. The entities in C and D pay royalties to the entities in A and B for the rights to use the IP. The active profit taxed in C and D would be net of the payments of these royalties, which however, constitute passive profit in A and B. The tax authorities in all four countries therefore have an interest in the size of the royalties paid. But since the IP is unique there is no comparable transaction elsewhere that would give a hint of its value, and hence of the appropriate value of the royalty payments. Transfer pricing specialists—who seek to value such payments—have struggled with this kind of situation for many years without devising simple and straightforward solutions. The business clearly has an incentive to choose royalties that would allocate more taxable profit to countries with the lower tax rates.

This example barely begins to scratch the surface of the mind-numbing complexity of the existing system. Much additional complexity arises because there is an increasing number of anti-avoidance rules built into the system to make it more difficult for businesses to shift profit to low tax countries. These include, for example, transfer pricing rules, interest limitation rules, and controlled foreign company rules.[19] The BEPS project has aggravated this problem. It set out to reduce profit shifting, but the result has been to add further complex and arbitrary rules to the system. But the BEPS project has been just part of the general increase in complexity as governments—unilaterally and collectively—have sought to limit profit shifting.

This situation also creates uncertainty, for a number of reasons. One survey found that the single most significant factor in increasing uncertainty in the taxation of business profit was complexity in the tax code.[20] But other factors are also important, including unpredictable or inconsistent treatment (and poor understanding of the tax code) by the tax authority and frequent changes in the statutory tax system. This uncertainty not only increases the costs of collection; it also

[18] See, for example, Graetz (2001).
[19] The latter are rules that aim to limit the shifting of profit to multinational subsidiaries that are located in low tax countries.
[20] Devereux (2016). See also IMF/OECD (2017).

has real economic costs. For example, the survey found that uncertainty over tax treatment was one of the most important factors in affecting business location and investment decisions.

Of course, the impact of the international tax system on business decisions is not limited to the effects of uncertainty. Any difference in effective tax rates between two locations could affect the decision of a business as to which location to choose for its activity. Suppose, for example, that costs for a business would be lower in country A, but that tax was also higher in country A. That may lead the business to instead choose country B, even though it has higher non-tax costs. Those higher costs in B would represent an economic loss to society as a whole.

The BEPS project focused on cases where profit apparently arose in countries where the business had little, or no, real economic activity, based on the presence of indicators such as capital and employees. An important direction of the project's proposals was to insist that for profit to be allocated to some jurisdiction for tax there must be some real economic activity there. A consequence, however, is that a business that wishes to locate its profit in a low tax country may consequently have to locate real activity there, even if this again involves higher non-tax costs. This translates the problem from one of profit shifting to one of a real economic inefficiency, with consequent economic costs.

There are many other examples of such costs arising due to the existing system for taxing international profit, affecting the scale of investment, whether or not to undertake research and development, the choice of how the business is financed, its legal form, and many other aspects of business behaviour. There is a literature exploring the scale of the economic cost arising from these distortions to economic activity, which we briefly summarize in Chapter 3. Again, many of the distortions arise because of the nature of the existing system.

4. A principled and comprehensive approach

International policy debates about the reform of taxing business profit tend to focus on immediate political concerns. They tend not to start from first principles, nor do they consider the range of problems of the system. This may be dictated by political exigencies, but the result is unlikely to lead to a well-functioning and stable system.

This book takes a different approach. It starts from first principles, identifying what criteria should be desired in a good international tax system. The properties of a 'good tax' have been discussed at least since Adam Smith introduced his four canons in 1776.[21] In Chapter 2 we set out and discuss five criteria which we use to

[21] Smith (1776).

evaluate how alternative forms of business level taxation of profit can raise a given amount of tax revenue. The first four are that the tax should be economically efficient, fair, robust to avoidance, and easily administered. These criteria are well known and largely accepted, although economic efficiency is often underappreciated, and fairness turns out not to offer clear prescriptions for the business level taxation of profit.

Our fifth principle is that the tax should be 'incentive compatible', which we believe is critical in an international context. In this context, a tax would be incentive compatible if an individual country would not have an incentive to undermine any international consensus, imposing costs on other countries, for example, by reducing the tax rate on profit. Imposing costs on other countries is not a necessary feature of taxes levied on international flows; for example, value added taxes typically do not do so (except to the extent that consumers that live close to borders can engage in cross-border shopping). Removing competition between countries in taxes on profit would constitute a distinct improvement over the existing system.[22]

Having identified our criteria we then address the fundamental question of whether there is a good case for a business level tax on profit at all—and if so, what it is. It is true that more or less all countries have a business level tax on profit, so returning to this question may seem unnecessary. But this is not an arid academic exercise; identifying what purpose the tax is intended to serve is a natural starting point to designing a good tax in a principled and coherent way, and understanding what properties it should have.

The case for taxing business profit is not straightforward. Should business profit be taxed by a country as a proxy or backstop for the personal income tax imposed by that country—an 'ability to pay' rationale? Or should business profit be taxed by a country because the business benefits from the publicly provided resources in that country—a 'benefit' principle? It turns out that neither of these rationales fully stands up to close scrutiny—as we explain at length in Chapter 2. They are therefore only to a limited extent useful as guides for the design of a tax on business profit. Instead, we argue that a more general justification for a tax on business profit is that it meets the five criteria outlined above. Any tax that raises revenue while being efficient, fair, robust to avoidance, implementable at reasonable cost to government and companies, and incentive compatible would be a good tax, and well worth considering. These criteria therefore guide our analysis of the existing system as well as options for reform.

In Chapter 4 we set out a comprehensive spectrum of options and systematically evaluate each option against our criteria. We start with a very broad analysis of

[22] Arguments in favour of competition are typically based on the view that governments tend to overspend and should be constrained. But constraining only one form of taxation is in practice likely to put more pressure on other ways of raising revenue. Governments can still choose low tax rates if they prefer, even in the absence of competition.

where it might be possible to tax the profits of a multinational business. It is useful to divide these locations into four groups.

First, there is the place of residence of the owners of the business, who could be shareholders of a company, or partners.[23] A straightforward case for allocating taxing rights to these countries is because that is where those who receive the profit reside—personal income taxes typically aim to tax the worldwide income of residents, and so profit accruing to owners should arguably be taxed in a similar way. In principle, one way of achieving this would be to allocate profit to the owners for inclusion in their personal income tax calculation; but there could also be a tax at the business level with the taxing rights being allocated to countries where owners reside.

Second, there is the place of residence of the parent company or the headquarters of the business.

Third, there is what we call the 'origin' country.[24] This is, very broadly, where the functions and activities of the business take place, including management, production, research and development, marketing, finance, administration, and others. It could also include the location of ownership of assets by the business. These activities may take place in many countries, and a single business is likely to have many 'origin' countries. The existing system of taxing the separate entities of the business is broadly a system of taxing in these 'origin' countries.[25]

A fourth possible location for allocating taxing rights for business profit is the place where a sale is made to a third party—the 'market' or 'destination' country. This option does not currently form part of the existing system, although as noted above, proposals have been introduced to allocate some taxing rights to market countries, which may be defined broadly to include the location of non-paying users of digital services such as search engines and social media platforms. The debates over such proposals have tended to confuse origin and destination counties. If a business has activities associated with sales in a country, or owns assets associated with sales in the same country, then we would consider that to be one of possibly many origin countries. But if sales are made there, that country would also be a destination country. This is an important conceptual distinction, and the origin and destination approaches would justify very different allocations of profit to the country. Importantly, in referring to a destination country, we mean one in which sales are made, irrespective of whether the business also has activities or assets there.

[23] More generally, this could include anyone who receives a financial return from investing in the business.

[24] This is similar to the economics notion of 'source'. But as we explain in Chapter 3, 'source' has a very different legal meaning.

[25] There is a sense in which a parent company's location may also be an 'origin' country if, for example, it provides management to the business there. But we distinguish this from taxing the business solely in the location of the parent simply because it is the parent.

In Chapter 4 we examine a number of options for taxing in each of these four locations. We evaluate each of these by reference to the five criteria we set out. Overall, this approach allows for a comprehensive range of options to be evaluated in a principled, systematic, and comparable manner.

In considering possible reforms, two other important issues should also be noted. The first is that the taxation of business profits ultimately depends not only on taxes levied at business level but also on the taxation of dividends, capital gains, and other possible returns at personal level, possibly through intermediaries. In this book we focus primarily on taxes applied at the 'business level'. This is not because we think personal tax issues are unimportant. However, as we discuss at some length in Chapter 2, there are good reasons to believe that domestic personal taxes are rather less important than business level taxes for the decisions made by businesses which operate in an open economy.

The second is that the definition of the tax base at the business level—that is, what is 'taxable profit'—is important. A key distinction that is made throughout the book is between profit which represents the 'normal' return to investment, and profit which is over and above that normal return, known as economic rent. The 'normal' return can be thought of as the rate of return available on an alternative investment of comparable risk; as such it also represents what should be the 'required' return of the investor (at least in expectation when the investment is made). The effects of taxing the normal return are very different to those from taxing economic rent, and we set out the key differences in Chapter 2.

5. Proposals

The final chapters of the book put forward two proposals for reform. The different strands of thinking which led to these proposals have been introduced in this Introduction and will be expounded in much more detail in subsequent chapters. We briefly summarize the key principles by way of introducing the two proposals.

In Chapter 3 we show that the existing system performs badly under our criteria. It distorts real activity thus causing economic inefficiency, it is susceptible to avoidance, it is extremely complex and thus expensive to administer and comply with, and it is not incentive compatible. A key factor in creating each of these problems is that the existing system seeks to assess the profit earned in each separate entity of a multinational business, and tax it accordingly. This is problematic in concept and in practice since a multinational business may earn additional profit due to the synergies between its different parts. But, in addition, the factors determining profit in the location of these entities—that is in 'origin' countries—are relatively mobile. The business is taxed, for example, where its headquarters is located, where its research and development and manufacturing activity takes place, and where its IP is owned. The relative mobility of these factors is a primary reason for economic

inefficiency—businesses can shift their real activities to low tax countries—and for profit shifting—they can also shift their profit. Voluminous legislation and guidance are used to address the profit shifting opportunities, which contributes to making the system extremely complex. And because businesses have an incentive to move their real activities and profit to low tax countries, countries, in turn, have an incentive to compete through the tax system to attract these activities and profit.

The starting point of our analysis is therefore to identify factors that are less mobile. Almost all activities of a business are relatively mobile. Some may be less mobile, for example the existence of natural resources, and this may provide the basis of special forms of taxation. But identifying and introducing a general tax on location-specific profit is difficult both conceptually and in practice. Individuals also tend to be less mobile: this includes the owners of the business, for example the shareholders of a multinational corporation; they are much less likely to move in order to reduce the taxation on the business profit. In addition, a key element of our proposals is to shift taxing rights for business level profit to the country of the customer—the 'market' or 'destination' country. The customer is particularly likely to be immobile when it is an individual, and where the purchase does not constitute a significant part of her expenditure. It is possible to imagine business customers that purchase from a single and unrelated supplier being willing to change their location to reduce the tax liability of their supplier (and hence the price they are charged), but this possibility seems significantly less important than the forms of mobility that exist under the current system.[26]

The value of basing taxing rights in the country where a sale is made is intuitive. If the tax charge of the business were determined solely where it makes its sales, then the location of its real functions and activities would be irrelevant. Also the opportunities for profit shifting would be greatly diminished, if not eliminated entirely.[27] In turn, this would reduce the need for complex legislation. And finally, countries would not have an incentive to reduce their tax rates as this would not attract real activities or profit, eliminating tax competition.

These arguments equally support the VAT, which is also levied where sales are made. This has emerged as one of the most widespread and stable sources of revenue for governments around the world and which faces considerably less tax rate competition than the taxation of business profit. However, as its name suggests, this is a tax on value added—which is equivalent to the combination of both profit and wages paid by a business. This book instead focuses on taxes on profit only.

We consider two possible directions of reform that build on this insight. These are introduced in Chapter 5, and set out in more detail in Chapters 6 and

[26] Of course, there are cases when other elements in the value chain are relatively immobile—natural resources being an obvious case in point.

[27] Some, but not all, forms of destination-based taxation may be susceptible to a business engineering its sales to arise in a low tax jurisdiction.

7 respectively. Both would move the system towards a destination basis for taxation. And both, we believe, have considerable merit. While they are very different from each other, they share the common feature of moving in part, or entirely, to a destination basis.

The 'Residual Profit Allocation by Income' (RPAI) proposal set out in Chapter 6 has the feature that it would use, to a considerable degree, the rules of the existing system, but would also introduce important reforms that address some of its key weaknesses. It also, as we shall see, has a family resemblance to the system of 'formulary apportionment' that has been proposed by the European Commission and has been advocated more widely by civil society and others.[28] Yet these relatively narrow changes can have a profound impact on how the system works, and how well it meets the five criteria. The RPAI scheme is based on a clear idea of what the principles of the reformed tax are—in this case, a sharing of taxing rights between the country where functions and activities takes place and the country of residence of the independent customer.

The second approach would be to design a new system from scratch. The 'Destination-Based Cash Flow Tax' (DBCFT) is an example of this approach and is set out in Chapter 7. The most obvious problem with such an approach is that there may be very substantial costs of transition moving from the existing system to such a completely new system. Governments are unlikely to be persuaded to implement such a change unless the long-term benefits would clearly outweigh any short-term costs. In following the second approach it is therefore important also to identify the costs and difficulties likely to be encountered as part of the reform. Unlike the RPAI, the DBCFT would give sole taxing rights to the country of destination; this reform would have more radical consequences for revenue in some countries.

Both of these ideas have been developed over several years by the authors, building also on the work of many others. We have presented them on many occasions and have made earlier versions of Chapters 6 and 7 publicly available. These ideas have already permeated into the political and academic debate on reform. For example, the DBCFT was widely discussed in the run-up to the US tax reform in 2017.[29] And the current proposals of the OECD draw on the RPAI.[30] We hope that by setting them out in this book in the context of a fundamental review of business level taxes on profit, their merits will become even clearer.

The analysis in this book suggests that the existing system is not viable in the long run. Waiting for the system to crumble under the weight of its increasing

[28] We discuss this proposal in detail in Chapter 4.

[29] It was also considered much earlier by the President's Advisory Panel on Federal Tax Reform in 2005, which also followed earlier work—see, for example, Bond and Devereux (2002).

[30] The proposals in OECD (2019a, 2019b, 2019c) split profit into routine and residual components and allocate part of the residual to the destination country. While there are differences in the proposed implementation, this is broadly similar to the RPAI proposal although the RPAI allocates the entire residual profit to the destination country and routine profit to the jurisdictions in which functions and activities are performed.

complexity or to wither away under the pressures of economic forces is clearly unsatisfactory. Racing to secure political compromise on a scheme that lacks the coherent rationale surely needed for it to be robust against the unknown challenges ahead is not much better. Instead, this book offers two principled, coherent, and comprehensive reform options that will remain viable and effective for years to come.