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## Co-ordination in Tense Times: Issues for the G7

by Anne-Laure Delatte and Sébastien Jean

### ABSTRACT

This paper discusses what useful form international economic co-ordination might take, notwithstanding the tense climate witnessed in recent months. On international trade, we argue that aiming at wide-ranging negotiations or more-of-the-same trade liberalizations would be pointless under present circumstances. Priority should instead be given to preventing the doom loop of protectionism and retaliation, and to addressing the political concerns about globalization. On fiscal competition, we point to the risk of a potential race to the bottom despite the progress achieved thanks to the OECD BEPS initiative. We finally emphasize the need for coordinated policies on the demand side.

G7 | *Economy* | *Finance* | *Foreign trade* | *Economic governance*

keywords

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by Anne-Laure Delatte and Sébastien Jean\*

### Introduction

International economic relationships have been marked by increasing tensions in recent months. A political backlash against globalization has materialized in a several industrialized countries, potentially paving the way for more divisive policies in the near future. At the same time, signs are multiplying that international economic patterns are changing quickly, with institutions frequently lagging behind. In such tense times, co-ordination is more useful than ever, even though it is more difficult to reach. This paper lays out a few simple thoughts about possible avenues for such co-operation, spanning across various policy areas. While not the only *fil conducteur*, tax policy appears to be an area of special interest in this respect, as we outline in several places.

### 1. International trade

Until recently, international trade used to rhyme with turbo-charged growth and (challenging) discussions of liberalization agendas. It is no longer the case. On any account, the prospects for international trade cooperation and development are bleak, to say the least. Fully acknowledging this background is a prerequisite if useful discussions are to be held.

#### *1.1 Slow, unpopular and contentious: the bleak prospects of international trade*

The background on international trade issues can be characterized by five defining features.

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1) *The slowdown and its protectionist bias.* The slowdown in international trade has been widely commented upon.<sup>1</sup> It is best characterized with respect to the income elasticity of trade, calculated as the ratio between the growth rates of world trade and world income, both expressed in real terms. While an elasticity beyond two seemed to be the rule in the fifteen-year period preceding the 2008-2009 crisis, it has seldom exceeded one in recent years, and trade seems to be decelerating further in the last two years, halting altogether according to some data sources.<sup>2</sup> This slowdown is now widely recognized as being structural, and its main explanations are known. They relate to sluggish income and investment growth, to China's structural rebalancing, to the lesser dynamism of global value chains and possibly to protectionist measures. However, the magnitude of their respective roles remains hotly debated. The IMF conclusion that weak demand and investment is the main explanation suggests that the structural break is external to the trade realm.<sup>3</sup> However, this conclusion is difficult to square with the fact that the decline is apparent not only in growth rate but also in terms of elasticity, and that investment is weak but now growing on a stable path.<sup>4</sup> Many other analyses, in addition to the central importance of China's rebalancing, point to the change witnessed in the dynamics of the development of global value chains (GVCs). The spread of protectionist measures is also mentioned, but to date no valid empirical proof has been provided showing that it played a significant role in causing the slowdown. This doubt notwithstanding, there are suggestions that protectionist measures have been accumulating recently. Whatever role protectionism played in explaining the slowdown, it seems increasingly likely that slower trade is spurring protectionist decisions. In contrast to the early 2000s, when access to emerging markets was a *sine qua non* condition for growth, increasing international protectionism appears to be a zero-sum game, in which governments frequently seem to consider protecting their producers against foreign competition as the easiest way to protect their country's interests.

2) *The political backlash against globalization.* Politically, it is evident how contentious trade has become. The American presidential campaign is perhaps the most spectacular illustration of the backlash against globalization, with the two main candidates harshly criticizing international trade and its consequences.

<sup>1</sup> See, for example, International Monetary Fund (IMF), "Global Trade: What's Behind the Slowdown?", in *Subdued Demand: Symptoms and Remedies. World Economic Outlook, October 2016*, p. 63-119, <http://www.imf.org/external/pubs/ft/weo/2016/02>; David Haugh et al., "Cardiac Arrest or Dizzy Spell: Why is World Trade So Weak and What can Policy Do About It?", in *OECD Economic Policy Papers*, No. 18 (September 2016), <http://dx.doi.org/10.1787/5jlr2h45q532-en>; and ECB Task Force on Global Trade, "Understanding the Weakness in Global Trade. What Is the New Normal?", in *ECB Occasional Paper Series*, No. 178 (September 2016), <https://www.ecb.europa.eu/pub/pdf/scpops/ecbop178.en.pdf>.

<sup>2</sup> Jos Ebregt, *The CPB World Trade Monitor: Technical Description*, The Hague, CPB Netherlands Bureau for Economic Policy Analysis, September 2016, <https://www.cpb.nl/en/node/158802>.

<sup>3</sup> IMF, "Global Trade: What's Behind the Slowdown?", cit.

<sup>4</sup> Sébastien Jean, "Comments on IMF's 'Global Trade: What's behind the Slowdown?' – Or Why There Is More to Trade Slowdown Than Weak Demand", in *Le Blog du CEPII*, 18 October 2016, <http://www.cepii.fr/Blog/bi/post.asp?IDcommuniqu=483>.

Donald Trump's protectionist agenda seems to have played a significant role in the decisive victories he won in Rust Belt states. Similarly, opposition to globalization has been shown to have played a key role in explaining the leave vote in the Brexit referendum, even though this was not the question asked.<sup>5</sup> In a different way, the psychodrama surrounding the official signature of CETA, the agreement between the EU and Canada, also revealed the depth of tensions on trade issues. Through these examples, it becomes clear that globalization is increasingly divisive in Western societies, with some opinions and constituencies feeling left aside, or at least feeling that the gains from globalization are not well shared, and are not worth its costs. Resounding demands for protection are expressed, which are a priority for many constituencies.

3) *The WTO seems unable to deliver updated rules.* As regards multilateral negotiations, the WTO has hosted long overdue multilateral agreements in both of its latest ministerial conferences. While these agreements are in themselves valuable achievements, though, they fall short of meeting the ambitions set when the Doha Round was launched, back in 2001. As a matter of fact, they also fall short of addressing the need to update the rules governing international trade, more than 20 years after the Marrakech Agreement was signed. Since the failure to reach an agreement in 2008, it has become clear that the main trading powers cannot agree on a substantial, wide-ranging agreement in the multilateral trade arena. Put differently, the WTO no longer seems to be a forum where the rules of the game can be significantly renegotiated.

4) *Unclear whether an update can be expected from regional trade agreements either.* This reality explains to a large extent why regional agreements have flourished. For a long time, they were mainly used to organize trade relations between neighbouring countries, and their development with more distant partners remained limited, with the exception of a few countries like Chile, Mexico or Singapore, engaging in a strategy of additive regionalism. After 2008, and particularly from 2012 onwards, it has seemed that mega-regional deals could play a central role in setting new rules to govern international trade. With recent political developments, this prospect is vanishing. Not only does it seem that the incoming US administration is unlikely to proceed with ongoing projects, the recent CETA and TTIP controversies in the EU suggest that it will be difficult for the block to secure important regional trade deals in the near future –even though cannot be ruled out that the negotiation with Japan may be brought to a successful end. In sum, regional agreements may also no longer be an option for meaningfully updating international trade rules.

<sup>5</sup> Italo Colantone and Piero Stanig, "Global Competition and Brexit", in *BAFFI CAREFIN Centre Research Papers*, No. 2016-44 (November 2016), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2870313](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2870313); Diane Coyle, "Brexit and Globalization", in *VoxEU.org*, 5 August 2016, <http://voxeu.org/node/61004>.

5) *National policies, trade defence and China's new status.* Against this background of paralyzed international negotiations, national policies may well remain the only game in town. As a matter of fact, accounts of trade-restrictive national policies suggest that they are spreading,<sup>6</sup> even though the actual importance and restrictiveness of measures is difficult to assess and to compare with one another. Among the increasingly debated measures are trade defence instruments. Such instruments are legal under WTO agreements, but their use is codified through specific agreements, in particular those related to antidumping and to subsidies and countervailing measures.

This issue has become topical with the expiry of the 15-year transition period following China's accession to the WTO, during which the accession protocol allowed specific practices through which using a surrogate country method to instruct antidumping investigations against Chinese producers could be done without justification. China's request for consultations on 12 December 2016 is a first step towards a judicial settlement of the dispute surrounding the expiry of Article 15 (a) (ii) of its accession protocol to the WTO. That this dispute is to be settled based on existing rules and institutions might be interpreted as a signal that the system is able to cope suitably with this question. Such interpretation may well prove optimistic, though, for at least two reasons. The first one is that the stakes of these disputes are considerable, potentially far exceeding what the WTO's DSS has dealt with so far. Antidumping has so far been the most influential trade defence instrument, and China already been the leading world exporter for a few years. As a result, the stakes associated with changing the way of dealing with antidumping investigations against Chinese exporters are potentially very high.<sup>7</sup> In this context, it is questionable whether all parties will accept ensuing rulings. Recent examples have also shown how disputes can entail WTO-illegal retaliations, even though they are not explicitly presented as such. The second reason is that more than antidumping is actually at stake. While Article 15 (a) (ii) of China's accession protocol specifically deals with antidumping, the question raised by the expiry of this transition period is whether China has indeed transitioned to a position where it can be considered as playing by the rules defined by WTO agreements. The international trading system includes a special and differentiated treatment for developing countries, and it can accommodate waivers and exceptions for relatively small players and for countries in transition. China raises a different problem, though, because it combines a position as a trade superpower with high level of State intervention in trade.

<sup>6</sup> WTO, *Report on G-20 Trade Measures (mid-October 2015 to mid-May 2016)*, 21 June 2016, [https://www.wto.org/english/news\\_e/news16\\_e/trdev\\_21jun16\\_e.htm](https://www.wto.org/english/news_e/news16_e/trdev_21jun16_e.htm). See also Global Trade Alert reports, <http://www.globaltradealert.org/analysis>.

<sup>7</sup> Cecilia Bellora and Sébastien Jean, "Granting Market Economy Status to China in the EU: An Economic Impact Assessment", in *CEPII Policy Briefs*, No. 11 (September 2016), <http://www.cepii.fr/CEPII/en/publications/pb/abstract.asp?NoDoc=9421>; Chad P. Bown, "Should the United States Recognize China as a Market Economy?", in *CEPII Policy Briefs*, No. 16-24 (December 2016), <https://piie.com/node/12318>.

## 1.2 Priorities for a co-ordination agenda

In sum, international trade relationships are undeniably facing a tense situation, from both an economic and political point of view. Against this background, aiming at wide-ranging negotiations or more-of-the-same trade liberalizations would be pointless. Priority should instead be given to preventing the doom loop of protectionism and retaliation, and to addressing the political concerns about globalization.

### 1.2.1 Preventing the raise of protectionism and trade conflicts: so far, so good, but it may not last

Even though protectionist measures have been spreading recently by some measures, the modern international trading system can be credited with a rather good track record on preventing the rise of protectionism. Fears that the 2008-2009 economic and financial crisis would spur protectionist reactions did not materialize, at least not in a disruptive way. It is difficult to establish any causality in this respect, and the realization that protectionism can be very costly in the GVC era probably played a significant role in explaining this relative moderation. Still, it is fair to credit the WTO with a good track record in preventing trade conflicts and the rise of protectionism. However, acknowledging this positive role does not mean that enhanced efforts are not needed in this area, for several reasons. Firstly, the WTO's Dispute Settlement System (DSS) is overloaded. There is a growing disproportion between the expectations placed by Member States as to its capacity to settle high-stakes, complex disputes on the one hand, and its light endowment in staff and budget on the other hand. The Appellate Body is probably the case in which this disproportion is most egregious. Accordingly, as its chairman recently declared, "almost certainly there will be delays and queues".<sup>8</sup> Beyond this understatement, it should be clear that we are already in a situation where the WTO's DSS cannot play its role in a satisfactory manner, while it is facing the prospect of a "tsunami" of new cases, as Chairman Graham noted. Another possible threat to dispute settlement in the WTO is the creation of other bodies under different institutional frameworks, as has been considered in the context of negotiations or projects concerning the TPP or the Trade and Services Agreement (TiSA) negotiation. None of them is likely to be operational and effective at a large scale in the near future, but the sheer existence of these projects shows that the *de facto* monopoly enjoyed by the WTO in rule-based settling of international trade disputes cannot be taken for granted.

<sup>8</sup> Thomas R. Graham, *Speaking Up: The State of the Appellate Body*, Special lecture hosted by the World Trade Institute of the University of Bern, the University of Geneva Law School and the Graduate Institute of International and Development Studies, Geneva, 22 November 2016, [https://www.wto.org/english/news\\_e/news16\\_e/ab\\_22nov16\\_e.pdf](https://www.wto.org/english/news_e/news16_e/ab_22nov16_e.pdf).

Another dimension of the WTO's contribution to preventing trade conflicts is its monitoring efforts. The value of this work should not be understated. Trade policy reviews and notifications have greatly increased the level of information available about partners' practices. Here again, though, several concerns remain. A recurrent one is that notification obligations are often late or imperfect.<sup>9</sup> Strengthening discipline and enforcement in that respect is required if the WTO is to play its role. Another concern is the increasing complexity of trade-distortive measures. Tariffs are increasingly constrained by WTO disciplines, they appear as an unnecessary cost to importers (including those belonging to an international value chain), and their overt protectionist character risks inducing tensions or retaliation. For that reason, a variety of other measures are increasingly used, which are far less easily measured and compared. This "murky protectionism",<sup>10</sup> including bias norms and standards, local content requirements, licensing, subsidies, and buy local provisions, makes it all the more challenging to produce wide-ranging, consistent and comparable data and analyses, as mentioned above. Renewed efforts are required to monitor effectively new developments.

Beyond modalities, the deeper threat to the WTO effectiveness in preventing trade conflicts probably relates to its legitimacy. Like any organization gathering sovereign states, the WTO has no authority, the materiality of its influence critically hinges upon its principles, rules and institutions being considered as legitimate. Any member considering it more profitable to get rid of the system, or even simply of its commitments under the system, is free to do so. As emphasized above, however, Member States clearly seem unwilling or unable to agree upon a substantial update of the multilateral agreements the organization relies upon. Put differently, the WTO is condemned to work based on rules that were defined in a period where internet and mobile phones were barely known, and where the term "emerging countries" was mainly used to refer to Taiwan, Singapore and the like. Should the inability to update them endure, their legitimacy will inevitably erode.

The bottom line is that the capacity of the multilateral trading system to prevent large-scale trade conflicts or a protection upsurge may not last for long if left as is. Reform is thus indispensable. Having emphasized that multilateral and even regional agreements are not a realistic prospect to do so, it means that only political initiatives by the main actors and negotiations among them are likely to deliver. The most pressing issues have also been mentioned: addressing the questions raised by China's new status, and by the political backlash against globalization.

<sup>9</sup> For instance, the latest notification on domestic support in the agricultural sector refers to 2001 for Turkey, 2008 for Thailand, 2010 for China and 2010-2011 for India (source: WTO Agriculture Information Management System, accessed on 23 December 2016)

<sup>10</sup> Richard Baldwin and Simon Evenett (eds.), *The Collapse of Global Trade, Murky Protectionism, and the Crisis: Recommendations for the G20*, London, Centre for Economic Policy Research (CEPR), March 2009, <http://voxeu.org/node/3199>. See e.g., David H. Autor, David Dorn and Gordon H. Hanson, "The China Syndrome: Local Labor Market Effects of Import Competition in the United States", in *American Economic Review*, Vol. 103, No. 6 (October 2013), p. 2121-2168.

### 1.2.2 China's new status calls for political negotiations

The importance of the questions raised by the 15th anniversary of China's accession to the WTO has already been discussed above. The disagreement is deep, with China considering that its partners are not abiding by their commitments regarding antidumping procedures, while its partners do not view the functioning of its economy as being consistent with WTO rules. As a matter of fact, the present situation is paradoxical: the multilateral trading system, set up to ensure fair and undistorted competition among market economies, is now dominated by a country whose economy remains largely centralized. This is not to deny the remarkable transition of the Chinese economy over the last 15 years, nor its increasing reliance on market mechanisms. But it remains undeniable that state intervention is ubiquitous in its economy, in a way that bears no comparison with other major trading countries. Antidumping procedures cannot be considered independently from this specificity, because the former has thus far been one of the important ways used to cope with the consequences of the latter.

Among the main agreements on which the WTO relies is the one regarding subsidies and countervailing measures. This agreement stipulates that "no Member should cause, through the use of any subsidy" which would be "specific to an enterprise or industry or group of enterprises or industries", "adverse effects to the interests of other Members".<sup>11</sup> As a matter of fact, it is difficult to assess practically how such commitments should apply to China, where government intervention is widespread through credit allocation, land and energy prices, state enterprises, licensing and authorizations, or VAT rebates on exports. And no doubt Chinese competition has serious consequences for its trading partners.<sup>12</sup> Given the pressing demand for protection, it is impossible for China's main trading partners to renounce the main tool they have been using so far to deal with this competition without receiving guarantees in exchange.

The present context actually makes it legitimate, and probably even necessary, to make sure that defence instruments are efficient and timely enough to grant real protection to workers and firms when they are threatened by unfair competition. As long as such reform is principled and consistent with international commitments, it should be welcome. Rather than a purely judicial dispute, which may end up jeopardizing the whole institution, China's new status requires a political negotiation between the main partners to discuss how institutions and policies might be adapted to this new context. Political discussions about how to deal with overcapacities in the steel industry are an example of such negotiations.

<sup>11</sup> WTO, *Agreement on Subsidies and Countervailing Measures*, [https://www.wto.org/english/docs\\_e/legal\\_e/24-scm\\_01\\_e.htm](https://www.wto.org/english/docs_e/legal_e/24-scm_01_e.htm).

<sup>12</sup> See e.g., David H. Autor, David Dorn and Gordon H. Hanson, "The China Syndrome: Local Labor Market Effects of Import Competition in the United States", in *American Economic Review*, Vol. 103, No. 6 (October 2013), p. 2121-2168.

### 1.2.3 Addressing concerns about globalization

More generally, addressing concerns about globalization should be a political priority. Part of the answer is necessarily national, through tax, education, infrastructure and territorial policies, for instance. In terms of international agenda, the question is how co-ordination might help in this respect. Trade is a case in point because it is an area of direct interaction between countries, where a number of binding agreements exist or are being negotiated, hence questions about the necessity to include in trade agreements commitments and disciplines regarding non-trade areas such as exchange rates, or social, environmental and fiscal rules.

The rationale to do so is twofold. Firstly, international trade can be used as a leverage to foster co-operation in other areas, because it lends itself comparatively well to valuable, verifiable and actionable commitments. As this leverage is potentially large given the intensity of international trade flows, not using it would mean missing a valuable opportunity. Secondly, there is a strong complementarity between trade policy and other areas, as lowering barriers to trade increases the leakage effects associated with other regulatory policies. Indeed, when a country engages in regulatory competition by relaxing its requirements to lower production costs, both the potential benefits and the costs involved for any partners increase as barriers to trade are lower. Put differently, less costly trade means easier regulatory arbitrage, so that liberalizing trade without taking other areas into account may create a risk of levelling down regulations, or at least exacerbating the perverse consequences of policy asymmetries.

Non-trade provisions entail risks, though. The most obvious is that overburdening trade policies may make it impossible to reach an agreement, thus paralyzing the instrument.<sup>13</sup> Non-trade issues should thus be restricted to areas where a significant result can reasonably be hoped for. An additional risk is intrusiveness and useless interference with national sovereignty. The Brexit vote has illustrated how these matters can be sensitive, and the legitimacy of trade agreements in non-trade issues only goes so far.

How to proceed, then? Concretely, non-trade provisions are already included in most trade agreements, especially those recently signed, and in particular in relation to social and environmental issues. In most cases, though, their effective impact has remained limited so far. In rethinking their reach and design, the discussion above suggests a few principles. The first one is to favour an approach based on minima and guarantees. This makes it possible to prevent excessive gaps in practices, without impinging upon the expression of national preferences on the areas concerned. The second one is to focus upon verifiable commitments. It

<sup>13</sup> An additional complication in the EU case is that non-trade provisions are likely to reinforce the mixed nature of agreements, as opposed to purely trade agreements, which fall under the exclusive community competence.

is noteworthy that tax policy is a very suitable area in this respect, even though tax bases are less easily codified and compared than tax rates. Where commitments cannot be verified and auctioned as needed, cooperation and information might be a more fruitful approach. The third principle is to favour automatic mechanisms. The “consistency plan” included for Vietnam’s social commitment under the late TPP is an interesting example. However, dispute settlement has proved ineffectual so far in bilateral agreements, and is at risk of saturation in the multilateral arena. The fourth principle is that it should be more easily understood and accepted that commercial benefits should be foregone when they conflict excessively with other objectives. In other terms, this means wondering whether further trade liberalization is really desirable without agreements on basic principles. After all, trade is an instrument, not a policy objective *per se*.

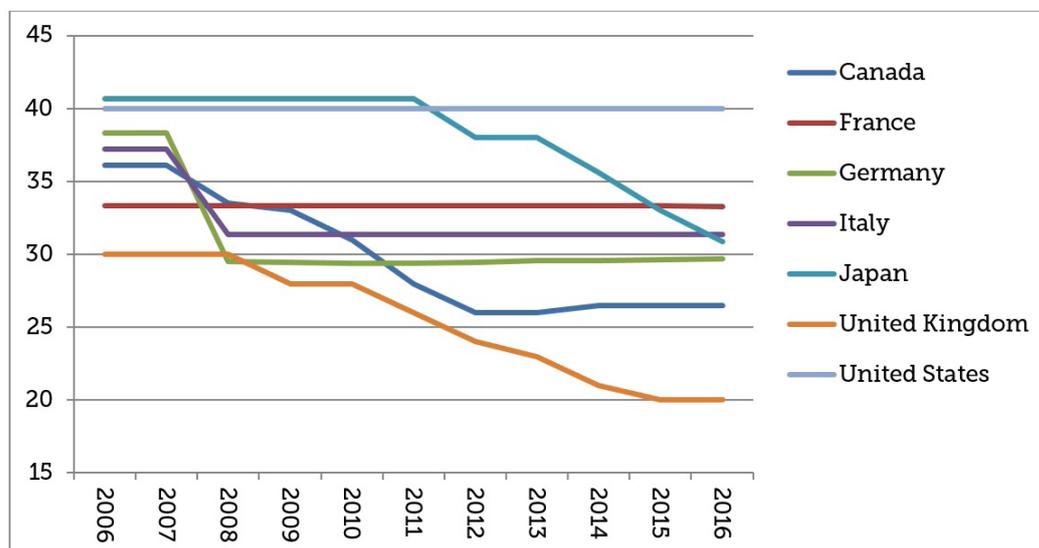
## 2. Profit shifting and tax competition

In December 2012, the G20 group of nations in Los Cabos supported the OECD “Base Erosion and Profit Shifting” initiative to address the issue of multinational profit shifting. Three years later, some progress has been made on the data sharing while important parts of the agenda still need to be implemented and enforced. In the meantime corporate tax reforms are being discussed in several G7 member countries at different stages of elaboration and the legislation process. Some proposals would have significant implications on trade and capital flows, the localization of multinational economic activity, and exchange rates. As a consequence, tax competition is still a mostly relevant international matter and multilateral coordination among G7 member countries on corporate tax is certainly required.

### *2.1 Why is the taxation of multinational corporations (MNCs) still on the international agenda?*

At the aggregate level, increasing trade liberalization has led to a generalized gradual decrease in the corporate tax rate in advanced economies justified as to avoid a loss of national competitiveness in industrial recruitment and retention. This decline could still be ongoing: in fact, while the optimal tax rate has been estimated around 30 percent<sup>14</sup> several G7 countries have a higher corporate tax. This simple observation suggests that political pressures to reduce the corporate tax will continue to be strong (Figure 1).

<sup>14</sup> Alan J. Auerbach, James R. Hines Jr. and Joel Slemrod (eds.), *Taxing Corporate Income in the 21st Century*, Cambridge and New York, Cambridge University Press, 2007.

**Figure 1** | Statutory tax rates

Source: KPMG.

In several countries, the current dismantling of multilateral trade agreements goes hand in hand with the unilateral move of cross-border corporate taxation in several countries. On the one hand, following the Brexit referendum, the United Kingdom has used the corporate tax rate as leverage in their negotiations, a fact that has stirred tensions with EU members. The UK has stated that the failure to reach an agreement with the EU on the trade dimension would entail the UK lowering its tax rates to attract investors.<sup>15</sup> On the other hand, the economic agenda of the new US administration includes corporate tax incentives to bring manufacturing activity back to the US (more on the US corporate tax reform below).<sup>16</sup>

In addition to the political pressure to reduce the statutory tax rate, the effective tax rate has actually declined because of the practice of income-shifting by MNC. The term "income-shifting" generally entails both strategic transfer pricing (i.e. charging relatively low prices for goods and services transferred from high-tax to low-tax affiliates) and the strategic use of inter-affiliate debt (i.e. financing the activities of high-tax affiliates using debt issued by low-tax affiliates). The consensus of the recent literature is that a 10 percentage point increase in the tax rate difference between an affiliate and its parent would increase the pretax income reported by the affiliate by 8 percent. For example, if the tax rate in the affiliate's country falls from 35 to 25 percent, the pretax income reported by the affiliate is

<sup>15</sup> George Parker, Jonathan Ford and Alex Barker, "Is Theresa May's Brexit Plan B an Elaborate Bluff?", in *The Financial Times*, 19 January 2017, <https://www.ft.com/content/3501446a-de36-11e6-86ac-f253db7791c6>.

<sup>16</sup> Chris Giles, "Prepare for Donald Trump's Corporate Tax Revolution", in *The Financial Times*, 18 January 2017, <https://www.ft.com/content/5b1c8314-d9a2-11e6-944b-e7eb37a6aa8e>.

estimated to increase from 100,000 to 108,000 dollars.<sup>17</sup> As far as inter-affiliate debt is concerned, Mooij estimates that a reduction in the corporate tax rate from 35 to 25 percent reduces the debt-to-asset ratio by 2.8 percentage points.<sup>18</sup> In total, the OECD estimates that 240 billion dollars in global corporate income tax revenues are lost annually.<sup>19</sup>

Has income shifting grown over time? Several studies have found that tax-motivated income shifting within multinational firms has indeed increased over time: for example, Grubert showed that foreign income of more than 700 US MNCs has grown more than their foreign sales over 1996-2004.<sup>20</sup> This might result from the dematerialization of the economy due to a growing service economy which increases the capacity of multinationals to exploit tax differences. Indeed Dischinger and Riedel find that intangible asset holdings are disproportionately concentrated among affiliates in low-tax jurisdictions: a decrease in the average tax difference to other affiliates of 1 percentage point raises the subsidiary's level of intangible assets by 2.2 percent.<sup>21</sup> The impact on intangible assets is even stronger: Karkinsky and Riedel estimate that an increase in the corporate tax rate of 1 percentage point reduces the number of patent applications by 3.5 percent.<sup>22</sup>

Lastly, from a political perspective, the current global macroeconomic context of tight fiscal space amplifies the public pressure to address multinational income shifting. In fact, there is a widespread public concern that fiscal revenues are lost from profit shifting activity. Subsequently, a tighter monitoring of MNCs' income tax collection is expected to enhance equity and social justice among taxpayers.

<sup>17</sup> Dhammika Dharmapala, "What Do We Know About Base Erosion and Profit Shifting? A Review of the Empirical Literature", in *Fiscal Studies*, Vol. 35, No. 4 (December 2014), p. 421-448, <http://dx.doi.org/10.1111/j.1475-5890.2014.12037.x>.

<sup>18</sup> Ruud A. de Mooij, "Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions", in *Fiscal Studies*, Vol. 33, No. 4 (December 2012), p. 489-512.

<sup>19</sup> OECD, *Addressing the Tax Challenges of the Digital Economy, Action 1. 2015 Final Report*, Paris, OECD, 2015 (OECD/G20 Base Erosion and Profit Shifting Project), <http://dx.doi.org/10.1787/9789264241046-en>.

<sup>20</sup> Harry Grubert, "Foreign Taxes and the Growing Share of US Multinational Company Income Abroad: Profits, Not Sales, Are Being Globalized", in *National Tax Journal*, Vol. 65, No. 2 (June 2012), p. 247-282. It is worth mentioning though that some studies find that the tax-sensitivity of reported income has fallen.

<sup>21</sup> Matthias Dischinger and Nadine Riedel, "Corporate Taxes and the Location of Intangible Assets within Multinational Firms", in *Journal of Public Economics*, Vol. 95, No. 7-8 (August 2011), p. 691-707.

<sup>22</sup> Tom Karkinsky and Nadine Riedel, "Corporate Taxation and the Choice of Patent Location within Multinational Firms", in *Journal of International Economics*, Vol. 88, No. 1 (September 2012), p. 176-185.

## 2.2 Why is G7 coordination required for the taxation of multinational corporations? The BEPS three years later

A set of policies implemented to address base erosion and income shifting has started to be implemented thanks to the coordination of the OECD BEPS program, supported by the G20 group of nations in Los Cabos. This initiative consisted of fifteen specific actions intended to facilitate multilateral cooperation among governments with regard to the taxation of MNCs, with the general objective of seeking to “better align rights to tax with economic activity”.

It is important to underline that the BEPS initiative has been a major success as far as issue awareness and data sharing are concerned. Substantial progress has been made in data sharing with the MNCs’ country-by-country reporting of indicators of economic activity.<sup>23</sup> In addition, automatic exchange of information is implemented across fiscal administrations on a bilateral basis.<sup>24</sup> We observe that the bilateral feature of automatic exchange of information introduces the possibility that small countries are treated unfavourably. Therefore we recommend making the automatic exchange of information a multilateral necessity. In addition, in order to enhance the monitoring and evaluation of effectiveness and impact of BEPS by the civil society, we recommend making reporting publicly available. This is particularly relevant to promote statistical research.

Last, the BEPS initiative upgraded rules for transfer pricing to align outcomes with economic reality. In fact up to 60 percent of international exchanges are intra-group exchanges, a fact that suggests the large use of strategic pricing and inter-affiliate debt to reduce the tax burden.

## 2.3 Unilateral tax reforms

In addition to the BEPS initiative, reforms are discussed at the national level to address the currently prevalent forms of income-shifting in different G7 countries. We want to warn here that some proposals may imply massive changes in the geography of international activity of multinationals and changes in relative prices. It seems key to us to identify the implications of each proposal and set up multilateral discussions.

<sup>23</sup> Action 11 requires the MNCs country-by-country reporting of their foreign activity including their turnover, number of employees, taxes, profit and losses.

<sup>24</sup> Swiss Federal Department of Finance, *Questions and Answers on the Automatic Exchange of Information*, 14 January 2015, <https://www.news.admin.ch/news/message/attachments/37903.pdf>. See also Swiss Federal Department of Finance, *Questions and Answers on the Automatic Exchange of Information*, 29 September 2015, [https://www.sif.admin.ch/dam/sif/en/dokumente/Automatischer-Informationsaustausch/AIA-QA\\_29.09.2015\\_E.pdf.download.pdf/AIA-QA\\_29.09.2015\\_E.pdf](https://www.sif.admin.ch/dam/sif/en/dokumente/Automatischer-Informationsaustausch/AIA-QA_29.09.2015_E.pdf.download.pdf/AIA-QA_29.09.2015_E.pdf).

Since June 2016, the United States House of Representatives has been examining a tax reform which would move the corporate tax from a source-based to a destination-based cross-border tax and from income to cash flow tax (companies are allowed to expense capital investments, i.e. they can write off capital investment on day one rather than gradually over a period of year. Interest payments are no longer deductible). It is named a destination-based cash-flow tax (DBCFT). An important provision largely debated in the United States is the border adjustment, i.e. the fact that the corporate tax is applied to all domestic consumption and excludes any goods or services produced in the United States, but consumed elsewhere. In order to make the corporate tax border adjustable, the revenue from sales to nonresidents are no taxable, and the cost of goods purchased from nonresidents are deductible. So if a business purchases 100 million dollars in goods from a supplier overseas, the cost of those goods are deductible against the corporate income tax. Likewise, if a business sells goods to a foreign person, the revenues attributed to that sale are added to taxable income.

An exhaustive analysis of the implications of such a reform is beyond the scope of this paper. However, we would like to point out potential issues as far as international cooperation is concerned.<sup>25</sup> The first issue that would need to be discussed is whether the US tax reform can potentially trigger a race to the bottom. Countries watching their tax bases drift to the US could be tempted and domestically pressured to adopt a similar system. The second issue is to determine whether the reform is WTO compatible. On the one hand, those in favour of this tax argue that the import tax is similar to the VAT tax already applied by a majority of countries; on the other hand, those against point out that the reform combines an import tax and an export subsidy, each of which justifies a case at the WTO. A last potential implication is the effect of the reform on factors allocation, relative prices and the exchange rate. On the one hand, US multinationals have a strong incentive to repatriate production to the US; on the other hand, the DBCFT provides a tax incentive to multinationals of any nationality to transfer headquarters to and produce in the US and export from there to the rest of the world. If these circumstances were to hold, i.e. a repatriation of production factors to the US, one could expect a significant appreciation of the US dollar.

In the meanwhile, the European Commission has developed the proposal of a Common Consolidated Corporate Tax Base (CCCTB), first proposed in March 2011.<sup>26</sup> After stalling because of diverging interest among members, the proposal

<sup>25</sup> This reform “could be the biggest shake-up of cross-border taxation since the 1920s” according to Michael Deveraux, a tax expert and director of Oxford University Center for Business Taxation. See Barney Jopson, Sam Fleming and Shawn Donnan, “Trump and the Tax Plan Threatening to Split Corporate America”, in *The Financial Times*, 13 February 2017.

<sup>26</sup> With the CCCTB, cross-border companies would comply with one, single EU system for computing their taxable income. Companies would file one tax return for all of their EU activities. Corporate tax rates in the EU would not be changed by the CCCTB, as EU countries would continue to have their own corporate tax rates. Allocated profits would be taxed according to the national tax rates. In sum, while addressing income shifting this new proposal introduces incentives to shift

was relaunched by the European Commission in 2016.<sup>27</sup>

The European Commission proposal keeps the income for the tax-base and uses an apportionment formula based on factors of production. The European Commission proposal departs from separate accountings for each affiliate. Instead of separating out the activities of different legal entities within the same economic firm, the tax reform project consists in defining a consolidated entity, calculate an aggregate income and split profit according an economic activity criterion. More precisely, the tax base is consolidated and the allocation of corporate income is apportioned according to an apportionment formula.<sup>28</sup>

In addition several designs are discussed to reduce or eliminate the tax-induced debt bias in corporate taxation.<sup>29</sup> However it is important to have in mind that the tax base is not significantly changed in these different designs, i.e. a major difference with the cash-flow tax system proposed in the United States.

In sum, the current tax reform proposals may well reduce profit shifting but entail production shifting and exports subsidies. More generally, it is key to set up a multilateral coordination among G7 member countries to assess together the implications of such proposals and consider cooperation.

### 3. Macro-coordination

Two features in the current macroeconomic context of the advanced economies call for coordinated policies to support and boost demand-side: (1) the persistence of a low activity growth and the inefficacy of the current policy mix to reverse the course; (2) the rising probability of a recession and the lack of room for rate-cutting if recession materializes. The current mix which mostly relies on unorthodox super accommodative monetary policy and in the Eurozone structural reforms is not sufficient. Policy measures need to be implemented to restore the demand for investment.

The main indicator suggesting a persistent deficient investment demand is the persistent decline of the real interest rates in the advanced economies. There is a common downward trend in interest rates of advanced economies since 1985. As a result the actual and potential GDP of the G7 countries have substantially declined. It is due to a combination of long term features and specific post-crisis features.

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production factors to low-tax countries.

<sup>27</sup> See the European Commission Taxation and Customs Union website: *Re-launch of the Common Consolidated Corporate Tax Base (CCCTB)*, <http://europa.eu/!bK83jP>.

<sup>28</sup> More precisely, the new tax scheme would make it possible to consolidate EU taxes and the group income would be allocated to each member state according to the proportion of production factors located in these countries.

<sup>29</sup> The design of corporate tax systems in most countries allows for the full deductibility of interest payments, while preventing it for dividend payments.

On the long term factors dimension, the rising inequality has shifted income to the wealthy households who have a lower marginal propensity to consume.<sup>30</sup> The IMF has estimated a resulting decline of global consumption by 3 percent. A demographic factor of ageing population is responsible for higher savings, lower consumption and lower demand for capital – basically, elderly buy less houses. The third factor is the *demassification* of the economy, i.e. the development of high value-added services with little traditional investment.<sup>31</sup>

On the post-crisis features dimension, an implication of this analysis is that the financial crisis cannot be held fully responsible for the current low growth environment. However the interaction of an unprecedented financial shock with these long run trends has resulted in a moving sand-like macroeconomic management situation. Advanced economies have implemented massive unorthodox monetary policies to force down the nominal interest rate. While the short term objective was to address the global systemic risk and restore the financial sector balance sheets, the resulting negative real interest rates bring macroeconomic management to a deadlock. If real interest rates are low and even negative in normal times, there is no room left through forward guidance to address adverse macroeconomic shocks.

The current state of business and the financial cycles in advanced economies suggest that the probability of a recession in the next three years is sizeable (2020). More particularly, the fact that the US economy has been growing for the last five years suggests that the odds of a recession within the next three years are going up. The fact that the current interest rates are historically low in the advanced economies and the unorthodox monetary package still highly active implies minimal room for rate-cutting as a monetary response to a recession. In sum, the economic policy mix looks ill-prepared for the next recession. The inability of monetary policy to restore a full employment saving-investment balance in the case of an adverse shock calls for complementary policy instruments.

In sum there is a significant need for fiscal stimulus to restore the demand for investment. And the current global challenges entail a logic focus on greenhouse reduction technologies.

There is an urgent need for coordinated policies that can reverse the course of long term features responsible for low growth: the objective is to increase productivity and restore the demand for investment in advanced economies.

<sup>30</sup> The real interest rates clear the market for loanable funds. Its equilibrium value is determined by the demand for funds to finance public and private investment and the supply of saving.

<sup>31</sup> AirBandB is the often-cited illustration of the low impact this surging tourism activity has had on the demand for real estate. Similarly, the average law firm uses half as much space per lawyer today because of the Internet Cloud, implying a lower demand for real estate investment.

Empirical surveys find that different category investments have different long-term payoffs with investment in research and development performing best. Global greenhouse gas emissions, a main driver of climate change, continue to rise rapidly. Since its inception, the United Nations Framework Convention on Climate Change (UNFCCC) has emphasized the key role of technology development and transfer in helping to stabilize greenhouse gas concentrations (Article 4.5 UNFCCC). For this to happen, a global adoption of climate change mitigation and adaptation technologies as well as policies that support the effective transfer of technologies are crucial. Quantitative studies show that innovation is mostly occurring in non G7 countries except for Japan. For example, while Japanese companies continue to play a prominent role in the solar PV patent landscape, where the highest rate of technology investment is, China and the Republic of Korea have contributed most in recent years. In solar PV, the top 20 technology owners are based in Asia.

In conclusion, the current low-growth context calls for coordinated demand-boost policies and the current global warming makes it a natural candidate to focus on greenhouse reduction technologies.

### Conclusion

The policy paper discusses three important areas of multilateral coordination in the context of widespread opposition to globalization forces, implying inward movements, i.e. international trade, financial stability and international coordination of macroeconomic policy.

International trade relationships are undeniably facing a tense situation and priority should be given to preventing the doom loop of protectionism and retaliation. Our main recommendation is to include commitments and discipline regarding non-trade areas such social, environmental and fiscal rules in trade agreements.

Regarding financial stability, we focus our discussion on the current tax competition across countries motivated by the need to address profit shifting of multinationals. Despite the progress accomplished by BEPS, we emphasize the risk of a race to the bottom that would be detrimental to all. We discuss the implications of the destination-based tax reform and advocate a need for multilateral cooperation on this issue.

As far as macroeconomic coordination is concerned, not only has the current policy mix been unable to reverse the trend of low activity growth but we argue that it leaves no room for addressing the future recession, the probability of which is dangerously on the rise. We advocate the need to restore the demand for investment, with a special focus on investments making globalization more sustainable.

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