Introduction to the Special Issue

Trade, investment and taxation: policy linkages

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International trade, investment and tax policies are inextricably linked. Tax is a key investment determinant influencing the attractiveness of a location or an economy for international investors, particularly those heavily engaged in international trade. Taxation, tax relief and other fiscal incentives are key policy tools to increase exports and attract investors. Investors, once established, add to economic activity and the tax base of host economies, and make direct and indirect fiscal contributions. And international investors and MNEs, by the nature of their international operations and intra-firm trade, have opportunities for tax arbitrage between jurisdictions and for tax avoidance.

This last point in particular has been the focus of public debate over the last decade. Recognizing the significance of tax avoidance through trade and investment by MNEs, the international community – policymakers, international organizations, NGOs and businesses themselves – has been heavily engaged in initiatives to counter the phenomenon. The focus of attention has largely been on tax policy, accounting rules and company law, and on initiatives to improve information exchange and to increase pressure on tax havens. However, given the fundamental role of investment in building the corporate structures that enable tax avoidance, and of trade in providing the transactions and arbitrage opportunities underpinning tax avoidance, trade and investment policy are integral parts of these efforts.

In fact, while the impetus for tax reforms has to a large extent come from intense public pressures caused by growing inequalities in the distribution of income and wealth, the shape and direction of reforms have been driven by the need to adapt international tax systems to the rapidly changing global trade and investment landscape:

- A shift away from trade in goods to trade in services. Today over 70 per cent of trade among developed countries is in the services sector. This change has been accompanied by an increase in the importance of intangible assets in the wealth of large corporations.

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- Trade patterns are also changing significantly. In 2000, 50 per cent of world merchandise trade was between developed countries and almost 90 per cent of world trade involved a developed-country partner. By 2016, trade among developed countries had dropped to 37 per cent, and South-South trade had grown to 25 per cent of the global total.
- The same applies to global investment patterns. In 2000, developed countries owned almost 90 per cent of global FDI stock. Today, their share has dropped to 75 per cent, and developing and transition economies have become important investors, accounting for almost one third of global outflows.
- The spread of global value chains (GVCs) has been one of the key developments in trade and investment over the last two decades, with MNEs operating complex GVCs across countries. Over two-thirds of global trade has been intra- and inter-firm trade by MNEs through their integrated international production networks, i.e. GVCs. These GVCs have increased the interdependency between countries: on average, about 30 per cent of countries' exports are now composed of imported inputs or are used as inputs by others.
- The increased geographical mobility of capital and the spread of international production and trade have intensified tax competition, at a time when many governments in both developing and developed economies continue to face large budget deficits and are therefore looking for new ways to raise tax revenues.
- The inexorable march of technological advances and rapid evolution of business models across entire industries, in both the digital and the digitalized economy, are transforming international production, trade and GVCs, and they are challenging traditional norms of international taxation. Blockchain technology, fintech, cloud computing, artificial intelligence, the Internet of Things, 3D printing and Industry 4.0, among others, are disrupting modes of operation and cross-border processes, pushing the bounds of taxation. At the same time, these technologies open up new opportunities to transform the ways that tax administrations operate and interact with taxpayers.

The tax policy response of governments to these pressures has varied depending on their economic, political and social environments and on the level and structure of their tax systems.

The last point, the need to formulate an effective and coherent approach to international taxation in the digital economy, has proved to be an especially complex and divisive issue. Under the auspices of the OECD/G20 Base Erosion and Profit Shifting (BEPS) project, governments are examining the extent to which existing tax arrangements work in a digital environment. The project has outlined a number of options, but there is still no international consensus on how to move forward, with countries falling into three groups: (i) One group feels that the existing international corporate tax arrangements are still applicable, subject to minor adjustments.

(ii) A second group feels that the existing arrangements do not work in a digital environment and are calling for a fundamental review of the way that tax treaties divide the multinational tax base between source and residence countries. These countries recognize that such a fundamental review must not be limited to digital companies but must cover all economic activities, and that it will take a number of years to arrive at an international consensus. (iii) A third group feels that the way forward is to have specifically designed tax rules for “digital” companies. It will be a challenge to reconcile these conflicting views.

With regard to increased tax competition, governments are adopting ever more sophisticated approaches, operating within the constraints imposed by OECD/G20 BEPS Action 5, by the EU Code of Conduct and State Aid Rules, and by World Trade Organization (WTO) subsidy rules. Corporate tax rates continue to fall – a trend that is likely to accelerate as countries respond to the tax reforms in the United States. Tax incentives are increasingly focusing on intangible assets, as can be seen by the spread of patent boxes. More and more countries now have low tax regimes targeted at high earners and high-net-worth individuals. State and local governments are increasingly providing special tax exemptions in their taxation of land and buildings. The use of special economic zones is spreading. And governments now recognize that providing a business-friendly tax administration is a very effective way of attracting economic activity: one that provides certainty, consistency and predictability, and effective ways to minimize and resolve cross-border tax disputes. The expectation is that tax competition will continue to thrive.

Although the focus in international taxation is on corporate income tax, other taxes with indirect consequences for countries’ trade and investment climates are also being reviewed. For example, consumption tax systems are evolving, with countries replacing traditional sales taxes with VAT/GST, the latest examples being China, the Gulf States and India. Today over 160 countries operate these taxes, and in many they are now the major single source of tax revenue. Yet, despite the spread of these taxes there are no internationally agreed rules on how they should apply. Unlike direct taxes, for which there are the OECD/UN Model Conventions, no such instrument exists for VAT/GST, and there are no internationally agreed mechanisms for resolving cross-border VAT/GST tax disputes.

Taxes on capital, wealth and immoveable property are also being reviewed, partly reflecting pressures on government to use these taxes to reduce growing inequalities in the distribution of income and wealth, partly because the increase in tax transparency has made it more difficult to hide assets offshore and partly because new technologies such as blockchain open up new ways of tracking the ownership of assets.

More generally, the international tax community is examining how to reduce tax uncertainty. Such uncertainty risks becoming especially harmful in an environment for global investment that has already lost much growth momentum over the last

decade, with knock-on effects for trade and GVCs. Global FDI flows were down again in 2017 and are still well below the 2007 peak. Greenfield investment in manufacturing – the type of investment most needed to boost the prospects of developing countries – has been structurally lower in the last five years. Foreign value added in trade, a key measure of the health of GVCs, has stalled and shifted into reverse after having grown continuously since 1990. And key indicators of international production – sales, assets and employment in foreign affiliates – are all growing at much slower rates than before.

Tax uncertainty compounds the already high levels of uncertainty in the global trade and investment environment, hampered by the rise of trade and investment tensions among major trading partners, and by the policy implications from changes to some major trade relationships, such as the United Kingdom's impending exit from the European Union and the renegotiation of the North American Free Trade Agreement. For emerging and developing economies, a protracted period of developed-country investor uncertainty could hamper the recovery of investment flows.

Countries are considering numerous measures to reduce tax uncertainty, including greater taxpayer and stakeholder engagement and consultation in policymaking and implementation, mechanisms to ensure clearer and less ambiguous formulations in tax legislation, greater use of clarifications and public rulings, guidance to regional tax offices on the application of legislation and tax treaties, co-operative compliance programs and the elimination of discretionary tax incentives.

A key concern adding to tax uncertainty is the increased risk of cross-border disputes in a post-BEPS environment, which could lead to unresolved double taxation. This was why BEPS Action 14 set out measures to improve the existing Mutual Agreement Process, which is the main mechanism for resolving cross-border disputes. A number of countries have been pushing for the introduction of mandatory tax arbitration provisions in tax treaties. Many less developed countries and some developed countries oppose such an approach, but if a new institutional framework could be established – one that addresses their concerns and over which they have ownership – mandatory tax arbitration could become a viable option. This is an area where the international tax community can draw both positive and negative lessons from reform efforts and developments in international investment agreements, the WTO dispute mechanism and mechanisms proposed in the trans-Atlantic and trans-Pacific partnership agreement.

There is significant scope for cross-learning and synergies between the networks of bilateral investment, trade and tax agreements. There is a need for broad-based efforts to harmonize or reform the functioning of these networks of treaties, through common reform processes, such as the ones proposed by UNCTAD for investment treaties, and through multilateral instruments, as proposed by the OECD for the implementation of BEPS. A key goal is to provide greater certainty for cross-border activities and more effective mechanisms to minimize and resolve disputes.

These efforts are all the more important at a time when the world is experiencing a potentially toxic mixture of political and economic uncertainty, rising trade and investment protectionism, scepticism among some political segments of the benefits of a multilateral rules-based system and a popular backlash against globalization and MNEs.

This is why a better understanding is now needed of how international trade, investment and tax policies and instruments interact. The different policy areas are generally in the hands of different government departments; for example, the three treaty networks have often been negotiated by different ministries (trade, foreign affairs, finance), as well as tax administrations and investment promotion departments, with little coordination of how tax issues should be treated in non-tax treaties, or how dispute mechanisms in these agreements interact. Yet all of these agreements have a common overriding objective: to foster sustainable development by providing an enabling environment for FDI and cross-border trade. To achieve this, these agreements seek to establish principles setting out the respective responsibilities of governments and business (although much debate concerns the balance between the two) and putting in place effective mechanisms to both minimize and resolve cross-border disputes, while respecting national sovereignty and the constitutional constraints faced by governments.

Achieving the right equilibrium between the interests of government, business and citizens is not easy, especially at a time when many are questioning the benefits of globalization.

This is the context in which governments are reviewing the structures of their tax, trade and investment agreements. The G20/OECD-led tax agenda is revolutionizing tax arrangements. Tax transparency, in the form of effective exchange of information between tax administrations, country-by-country reporting by MNEs to tax administrations, mandatory disclosure of advance pricing agreements and tax rulings, and aggressive tax schemes – all require that corporations learn to operate in an environment where their tax arrangements are subject to unprecedented scrutiny and where cooperation between tax administrations has intensified.

The BEPS project is updating the international tax arrangements set out by the OECD and the UN Tax Treaty Models and Transfer Pricing Guidelines. Already many of the 15 BEPS actions have been finalized, and over 80 countries have now signed the Multilateral Investment Instrument as a way of achieving a rapid implementation of these changes. There remain, however, outstanding issues, especially in the areas of transfer pricing and how to deal with the digital economy.

Investment agreements are also subject to an intense review process, with some countries questioning whether these agreements are too favourable towards the private sector and many asking for more transparent and balanced mechanisms to resolve disputes. Also, just as in the tax arena, there are cautious moves towards

a more multilateral approach – for example, through the Mauritius Convention on Transparency, the subject of one of the contributions to this Special Issue.

In the area of trade, the slow process in taking forward the multilateral trade agenda under the WTO has led to a spread of regional and bilateral agreements. There has also been a push to improve the transparency of trade dispute resolution mechanisms. More generally a number of countries have questioned whether the outcomes of these trade agreements are balanced.

This Special Issue seeks to provide new insights into the interactions and linkages between international trade, investment, and tax policies and instruments, by bringing together authors from the tax, trade and investment communities. It is divided into two parts, covering two regular issues of the Journal (volume 25, issues 2 and 3). The first part, this issue, touches on some of the technical aspects of the major themes in the international debate.

The first contribution is precisely on the overlap and interconnection between the different policy arenas comprised by international commercial relations, including trade, investment and tax, but also competition policies. Lorraine Eden and William Byrnes discuss the unintended consequences of advance pricing agreements (APAs) and their spillover effects into adjacent policy realms. They show that, in the context of European Union state aid cases, APAs can be misused by lower-tier governments to attract FDI through preferential tax deals with individual MNEs, and they recommend policy changes to reduce such negative spillovers.

In the second paper, Kimberly Clausing studies the importance of tax as a determinant of investment, and the issue of tax competition among countries for the attraction of high-value FDI, in particular headquarter functions. The author provides an analysis of the extent to which tax steers the headquarter locations of the 2000 largest global firms, and discusses the trade-off faced by policymakers between competitiveness and job creation on the one hand, and protection of the tax base on the other. She touches on a number of reform options that are being debated in the international community to make this trade-off less vexing.

One such reform option, and one on which opinions are most divided, is formulary apportionment – dividing the MNE tax base among jurisdictions on the basis of some agreed share of sales, employment and assets in order to reduce profit-shifting opportunities. In the third contribution to this issue, Tommaso Faccio and Valpy Fitzgerald discuss the possible consequences of such a fundamental reform of the international tax system, based on a case study using publicly available country-by-country reporting data for a large MNE. They show the hypothetical impact of a move to formulary apportionment on a global basis and under the European Union's Common Consolidated Corporate Tax Base proposal, and they propose options for apportionment factors.

The analysis of the effects of BEPS on countries' tax revenues that underpins the reform efforts under way in the international community, led by the OECD, has been extremely complex, mostly due to data availability problems. In the fourth contribution to this issue, David Bradbury, Tibor Hanappi and Anne Moore of the OECD provide insights into the herculean data collection and analytical efforts behind the estimates of the fiscal effects of BEPS. They explain how the Action 11 report, which considered the impacts of BEPS, arrived at its estimate of global corporate income tax (CIT) losses of between 4 and 10 per cent of global CIT revenues.

In the final paper in this issue, UNCTAD staff members explain the analytical approach behind their estimates of BEPS in the *World Investment Report 2015*. This approach, based on a global bilateral FDI stock matrix and the use of indirect FDI through conduit jurisdictions, was cited in the Action 11 report as one of the possible revenue loss assessment methods. A key merit of the *WIR* approach is that it clearly shows the direct link between investment flows and tax planning, confirming the need for a coherent approach between tax and investment policies.

The second part of the Special Issue (volume 25, number 3) looks at a number of historical and political aspects of the debate, and at some of the ways forward.

In an introductory paper, Sol Picciotto traces the history of international corporate taxation and its effect on the development of transnational corporations (TNCs). He looks at how TNCs have helped shape the system and argues for policy reforms to reduce opportunities for regulatory arbitrage, which has contributed to the growth of mega-TNCs and in some cases led to oligopolistic dominance. In so doing, he further expands on the interconnections between investment, tax, trade and competition policies.

A further historical and politically engaged perspective is provided by Alex Cobham, Petr Janský and Markus Meinzer, who study the evolution of the debate on country-by-country reporting as a mechanism for improving corporate accountability and reducing profit-shifting. They argue that the level of accountability required from MNEs has diverged ever more from that required of domestic firms, and they discuss the merits of, and possible future avenues for achieving, improved global country-by-country reporting standards.

The third contribution, by Michael Lennard, takes a closer look at the reforms currently under way, and examines them from a development perspective. It focuses in particular on the concept of value creation, which takes a central role in both the OECD/G20 BEPS process and the European Union's initiatives, as a way of determining the taxation rights of countries. It is especially relevant in relation to the digital economy. The author looks ahead at possible directions in the consensus-building process, and argues that developing-country policymakers

need to be aware that their policy space in corporate taxation based on place of consumption should not be unduly limited.

The fourth contribution adds the legal perspective, a critical dimension in this debate. Nathalie Bravo looks at the future evolution of international investment and tax treaties. The author compares the Mauritius Convention on Transparency, which aims to modify investment treaties, and the BEPS Multilateral Instrument, which modifies tax treaties, and identifies common characteristics and differences. She draws lessons for future reform efforts from her analysis of the two multilateral conventions.

The concluding paper in this double Special Issue is another contribution by UNCTAD staff, which again focuses on the investment–tax policy nexus. It aims to place the debate on aggressive tax planning by MNEs, at the centre of much of the Special Issue, in the context of the continued need for countries – and especially developing countries – to attract FDI in order to generate economic growth, productive capacity, employment and competitiveness. It shows how MNEs, despite their tax avoidance practices, are still substantial contributors to government revenues in developing countries. The paper details the technical approach followed in *WIR2015* for the calculation of the fiscal contribution of MNE foreign affiliates in developing countries and presents the main results, which set a baseline for the tax avoidance debate. The authors also indicate possible avenues for further research in this area.

Taken together, it is hoped that these two issues will contribute to a better dialogue between the tax, trade and investment communities at the levels of government, business and academia.

Looking ahead, a key emerging issue that merits major efforts for research and policy analysis is the ever-growing interaction between industrial policy and trade, investment and tax policy regimes. The recent worldwide proliferation of industrial policy has intensified such interactions. According to the *World Investment Report 2018*, over 100 countries have put in place some sort of industrial policy package, 80 per cent of which were formulated over the past five years alone. This has triggered extensive realignments between trade, investment and tax policies, as well as with the newly established industrial policies and strategies. Although industrial policy may contribute to the sustainable development and inclusive growth of individual countries, it may also pose challenges and opportunities for the effort towards a coherent international approach to trade, investment and tax policies. This will undoubtedly exert significant and far-reaching impacts on tax regimes and tax reforms in the years to come.