Corporate taxes must evolve with global trade

Last week saw more skirmishes in the battle between European Union (EU) authorities and US tech giants. Margrethe Vestager, the European commissioner for competition, hit Amazon with a bill for €250 million in back taxes. She also referred Ireland to the European Court of Justice for failing to recover €13 billion in corporate taxes from Apple as it had been ordered to do last year. The battle is not about “political crap”, as Apple chief executive officer Tim Cook had groused last year—or, at least, not only that. It is about the changing nature of international trade and business and a regulatory paradigm that has not yet evolved to catch up.

To whom should multinational enterprises pay corporate taxes, and how much? Companies like Amazon, Apple and Google are slippery customers. This is the nature of the beast: Maximizing profit is a commercial enterprise’s raison d’être. And tax avoidance, while it might exist in an ethical grey zone, is legal, unlike tax evasion. It is helped along by countries like Ireland offering low corporate tax rates and regulations that make tax avoidance easier. Thus, Apple and a number of other tech multinationals have funnelled revenue through subsidiaries registered in Ireland.

They have been able to do so effectively because they traffic in ideas and services as much, or more so, than in goods. Take transfer pricing, their main tool for shifting revenue to various subsidiaries. Regulations employing the arm’s length principle exist to prevent the exploitation of transfer pricing. But when companies are trading in intangibles like intellectual property, it becomes difficult to collar inter-subsidiary trade for faulty pricing.

Tech giants might be the face of the problem but they are far from the entirety of it. Since the 1990s, trade in services has grown faster as a component of international trade than any other sector, with an average annual growth rate of close to 10%. Contrary to popular perception, this isn’t largely the preserve of advanced economies. As World Bank economist Ejaz Ghani has recently pointed out in this newspaper, technological changes are increasingly enabling services to be growth drivers for emerging economies as well by reducing transaction costs and information asymmetry. India is a prime example of an emerging services-led economy.

Little wonder global trade in services has shot up after the global financial crisis, unlike trade in goods. It isn’t just about enterprises that deal primarily in services either. Cross-border data flows, intellectual property and services are all increasingly part of the global value chains (GVCs) of more traditional multinationals. Think car companies that collect on-board data from increasingly networked units all over the world; this has significant monetary value. While global merchandise trade climbed from around $3 trillion in 1980 to $15 trillion in 2016, cross-border data flows—which grew sevenfold between 2008 and 2013—are projected to be worth about $20 trillion by 2025, according to the World Trade Organization (WTO), McKinsey Global Institute and TeleGeography.

The relative newness of this paradigm shift means that there is a lack of regulatory clarity about how to allocate that value. The WTO General Agreement on Trade and Services and most bilateral agreements treat services as final activities that are exported—a far cry from the reality of their ubiquity in GVCs. Political optics further complicate the issue; Cook was right in that much. Border tariffs and non-tariff barriers can regulate trade in goods, but trade in services depends more on broad domestic regulations. That puts governments in a bind in the current climate of economic nationalism across the US and EU: Do nothing and face public anger for letting corporations function as tax mercenaries, attempt to coordinate on domestic regulation and face public anger for eroding economic sovereignty.

That is why French President Emmanuel Macron’s recent proposal to tax digital companies on their revenue rather than profits is unlikely to work. For one, it ignores the role of services and data in goods GVCs. Secondly, countries like Ireland, Luxembourg and the Netherlands are unlikely to sign on to such a disruptive shift that compromises their economic models. The second reason is also liable to hold true for the European Commission's attempt to create an EU-wide corporate tax base.

Allowing the current state of affairs will result in economic inefficiency where larger companies—with more resources and scope to engineer tax avoidance—will be able to undercut meritorious challengers. Too heavy a regulatory burden, on the other hand, will be bad for business and thus economies, with a potentially disproportionate effect on emerging economies that are hoping to use services as a primary growth driver. Tax regulations are not exactly the stuff of headlines—but the nature and shape of global trade in the future will depend significantly on the ability of the WTO and regional economic bodies and agreements to craft regulatory frameworks that recognize the emerging reality.

How can corporate taxes for multinationals be made more effective? Tell us at views@livemint.com

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