

Basic Choices in Considering Reform

The previous chapters of this book set out principles for the taxation of profit and described and evaluated the existing regime and options for structural reform. We now turn to considering more specific options. We develop two of these, which we label the ‘Residual Profit Allocation by Income’ (RPAI) and the ‘Destination-Based Cash Flow Tax’ (DBCFT). These have some common features, but also differ from each other in a number of ways.

Before setting them out in detail, in this chapter we explain both the broad approach that we have taken and why we have settled on the key features of these two options. We first discuss the extent to which international coordination would be required, or desired; this depends in part on the nature of the reform, and whether a reformed regime can be designed that eliminates, or significantly reduces, the incentive for countries to compete with each other. We then consider the issue of transition to a new system. In broad terms, we can compare incremental reforms which are based on the existing structure, with more fundamental reforms that more radically change that fundamental structure. Here there is a trade-off: more radical reforms could be designed that have more desirable long-run properties, but it is likely that there would be significantly greater costs of moving towards such longer term solutions. We also discuss what should be required in terms of revenue requirements, and as part of this discussion consider the likely redistribution of revenues among countries.

We then discuss two issues which are common to the two options. First, we discuss the scope of the tax—which businesses should be liable to the tax. This question includes both the type of legal form of business, and whether small businesses would be exempt from the tax—and if so, how they would be identified. Second, since both proposals include at least an element of taxation in the ‘destination’ country, we discuss the concept and definition of destination. In this case, we draw heavily on existing experiences with Value Added Taxes (VATs). More detailed analysis for each of the two options is given in the next two chapters.

In evaluating the two options, we use again our five criteria; economic efficiency, fairness, robustness to avoidance, ease of administration, and incentive compatibility. We have set these out at length in Chapter 2, and used them in Chapters 3 and 4. In any reform, we would aim for a significant improvement on the existing tax system in at least some of these five dimensions, whilst not significantly worsening the performance in other dimensions. That may lead to some trade-offs depending on what are perceived to be the most serious problems of the existing system.

One factor is noteworthy for not being included in our list of criteria for evaluating reform: the political acceptability of any reform. We do acknowledge the importance of political acceptability—any successful reform must appeal to politicians, policy makers, and the general public. Public debate about tax reform is often shut down by the claim that one group or another would not accept the reform. But second-guessing the reaction of any group to a particular reform is hazardous. Public opinion about taxes on profit may be driven by many factors, not all of which are consistent with a balanced and evidence-based analysis of the pros and cons of any option. We therefore see our task as being to set out as clearly as possible a rigorous analysis of the properties of alternative reform proposals—whether those properties may be deemed to support the proposal or not. We hope that such a clear analysis will generate greater understanding of the issues, and that such greater understanding can ultimately sway public opinion.

1. What degree of coordination is required?

A starting point for considering tax reform is how far reform needs to be undertaken in a coordinated way by a group of countries, as opposed to being undertaken by a single country. There are two aspects of this question. First, what are the legal constraints to unilateral action? Second, would it be in the interests of a single country, or group of countries, to act unilaterally?

Reform will require changes to laws but it is clear that some laws are easier to change than others (and that the capacity to change laws relating to the taxation of profit may be greater in some countries than in others). At one level there is purely domestic law, typically set by a national legislative body (or possibly a regional or state level legislative body). Where no other country is involved or has a say in that law, then it can be relatively straightforward to change according to the decision of the national government, although this varies from country to country.

But even a single country acting unilaterally must consider law that requires agreement among two or more governments, which is necessarily more difficult to reform. There are many examples of such law. Double tax treaties between two countries are one example. These can be undone or reformed by agreement. Or in some countries, such as the US, they can be overturned unilaterally by the national government. Underlying most individual treaties is the OECD Model Treaty (OECD Model) and its commentaries. This is a ‘soft law’ instrument. In some countries changes to it are automatically incorporated into domestic law and administrative practices.¹ While countries could change this automatic incorporation, it

¹ For a detailed account of the OECD Model as an instrument of soft law see, for example, Grinberg (2016).

would be much more difficult for them to engineer a change in the OECD Model or the commentaries. Clearly such a change would require significant international agreement. Of our two proposals, the RPAI would be likely to require some alteration to existing treaties and the OECD Model; whether the DBCFT is consistent with existing treaties and the OECD Model depends on whether or not it is treated as a tax on income. We return to these issues briefly in Chapters 6 and 7.

Another example is the law of the European Union which typically overrides the national law of the EU Member States. There have been many examples of national tax laws being effectively set aside by the Court of Justice of the European Union (CJEU). Any reform—or aspects of reforms—that is found by the CJEU to conflict with the EU's fundamental freedoms cannot be kept in place by Member States. Changing EU law on taxation requires the unanimous agreement of the Member States. A similar situation applies to other countries that are also members of regional blocs.²

A third example are agreements made at the World Trade Organisation (WTO). These constrain treatment of both imports from other countries and exports to other countries, for example in the form of subsidies. Although they concern trade rather than taxation, they are relevant for the design of taxes where those taxes may discriminate against foreign goods or services or where they act as a restraint on imports or a subsidy to exports.

In considering reform options we do not rule out any on the grounds that a change in the law may be difficult to achieve. However, we do acknowledge that, for example, there is a particular problem with reform proposals that may be deemed to be contrary to EU or WTO law, which are multilateral agreements and thus particularly hard to change.

What then of the incentives for individual countries to undertake unilateral reform? Under the existing system, there is an uneasy compromise between coordination and competition. In many ways, countries coordinate with each other through the international aspects of law just described, for example through the many detailed provisions in the OECD Model and the commentaries, and through mechanisms for resolving disputes including between tax authorities. Yet it is generally agreed that countries are also engaged in competition with each other—for real economic activity and also for tax revenue. This process of tax competition seriously undermines the international tax system, with ever lower rates of tax levied on business profit.³ Those countries that would wish to tax profit at a high rate may

² For example, the members of the West African Economic and Monetary Union (WAEMU) and the Central African Economic and Monetary Community (CEMAC).

³ Some have argued that competition to keep down rates of tax on business profit is beneficial. That could be true if one is not persuaded by the arguments in favour of such a tax set out in Chapter 2. But the case made more frequently is one based on competition constraining the size of government. In high income countries that is generally not the case; governments in those countries have other means by which to raise tax revenue. So a constraint on taxing business profit would typically

face significant disadvantages if they try to do so; in effect low taxes elsewhere act as constraint on the rates that any government can in practice charge. Businesses would be likely to respond by trying to shift profit out of such higher rate countries to others offering lower tax rates. Where they were not able to do so, they would face an incentive to move their real economic activity. In this way, countries with lower tax rates impose costs on countries that would otherwise choose to have higher tax rates. Such competition can take many forms—a reduction in the statutory tax rate, but also more generous provisions, for example, for interest deductibility or preferential regimes for particular activities.⁴

But competition is not a necessary feature of international tax. Competitive pressures to reduce tax rates are much more powerful for origin-based taxes, as discussed in Chapter 4. For example, there is very little pressure for a country to reduce VAT rates to match lower rates in other countries, since VAT is generally levied on a destination basis. These differences reflect the location and the mobility of the base of these taxes and suggest that tax competition may not be an inevitable feature of taxes on profit.

One key aim of any reform option should be to reduce or eliminate this incentive for countries to compete with each other and hence undermine the international tax system. As we have set out in Chapter 2, one of our criteria for evaluating taxes on profit is ‘incentive compatibility’. That is, in this context, if one or more countries operated a particular tax system, then other countries would have an incentive to join that tax system, rather than stay apart from it. For a country operating the system, there should be little or no incentive to undermine it by setting lower rates than other countries that operate the same system. The same should apply to the first mover—in principle, an incentive compatible tax system would be one worth undertaking even unilaterally.

This would have profound implications for the need for coordination in implementing a tax system. Coordination is problematic for a variety of reasons. To be most effective, coordination would require a high number of countries to participate, but, of course, reaching agreement among countries with different needs and preferences is challenging. It is likely to involve compromises that lead to sub-optimal outcomes. From a political perspective, there is also concern that weaker countries are pushed into agreeing to systems without proper consideration, or which are not clearly in their interests. Furthermore, even if countries agree to coordinate, there remains the hanging threat of defection.

mean higher taxes on other income or spending. It may be more true in low and middle income countries. But a general consensus is that such countries collect too little in tax revenue, rather than too much.

⁴ Keen and Konrad (2013) provide a comprehensive review of the theory of tax competition. Devereux and Loretz (2013) survey the evidence and Devereux and Vella (2014) discuss different forms of competition.

A tax system that was incentive compatible would reduce or eliminate competition and would make coordination both easier and less necessary. Incentive compatibility is important for creating stability, and hence reducing uncertainty. In turn, this supports investment and economic activity.⁵ A system that significantly reduced, or eliminated, competition among countries should also be more stable. Under the existing system, most countries continuously reform their laws, to maintain or improve a competitive position relative to other countries. A system that did not provide an incentive to compete would remove this incentive for reform, and hence be more stable over time.

Of course, fundamental reform can worsen the problem of uncertainty in the short term, especially if there is doubt over the extent to which a single country has a legal commitment to international agreements. That is an example of a problem of transition, to which we now turn.

2. Transition

Any tax reform involves costs. There is the direct cost to countries of designing the new system, drawing up legislation and guidance, implementing new procedures, and training officials. There may be a need to collaborate with other countries in confirming that the reform is compatible with double tax treaties or if necessary seeking to amend them. The same applies to other international laws agreed with other countries. There are also direct costs to the taxpayer to learn and understand a new system and for businesses to implement their own procedures with appropriate training for their staff.

In principle these are one-off costs of setting up a new system. However, reform is rarely so clean-cut; it is likely that adjustments would be made to any new system to cope with unforeseen circumstances. On the other hand, the same could be said of the existing system which is constantly being adjusted to combat perceived avoidance opportunities.

There are also indirect costs. A reformed tax system may create significantly different incentives for business, which may lead to business needing to change its activities—for example, the extent and location of investment and employment, and its financial policy. It is possible that even discussion of reform could be costly if it creates greater uncertainty which can harm business investment.

⁵ There is evidence from macro data that countries with greater uncertainty experience lower growth rates; see, for example, Ramey and Ramey (1995) and Engel and Rangel (2008). At the micro level, Leahy and Whited (1996) and Bloom et al (2007), for example, find a negative relationship between uncertainty and investment. There is less evidence that uncertainty specifically about taxation affects investment; however, in a survey of large businesses, Devereux (2016) found that respondents considered uncertainty about taxation to have a significant impact on investment.

Most of these costs tend to be greater the more fundamental is the reform. At one extreme, simply changing the rate of tax is relatively straightforward. At the other, perhaps, changing the tax base and the location of tax is likely to prove more costly in transition.

These transition costs need to be taken into account to set against any perceived benefits of a reform proposal. Of course, if transition costs are greater than the potential gains, then the reform should not go ahead. But three points should be noted. First, as already mentioned, transition costs are generally one-off, whereas the potential gains from reform should arise in every subsequent year, at least as long as the new system survives. Second, it is likely to be harder to estimate the benefits of any reform than to identify its transition costs. This is partly because those benefits may be rather intangible. For example, a reform may give rise to an improvement in economic efficiency through better allocation of resources among activities or among countries. These may be real and sizeable benefits, but they are not as easily measured or understood as immediate transition costs. Related to this, the size of any benefits is likely to be uncertain. By contrast, transition costs must be paid up front, and are likely to be much more salient to the policy makers and tax administrators who would have to undertake the reform. Third, the distribution of benefits among individuals and even among countries is even harder to assess. We return to the problems generated by changing the distribution of costs and benefits below.

The reform options in the next two chapters take different approaches to the scale of change. The first, an RPAI, is intended to remain as close as possible to the existing system whilst addressing the most significant problems. The idea here is that significant gains could be made by identifying and changing some elements of the tax system; but that by not deviating too far from the existing system, transition costs would be kept to a minimum. The second proposal, for a DBCFT, is more far reaching, and would require much more substantial reform; in this case the potential benefits are in theory likely to be greater, but transition costs are also likely to be more substantial.

We believe that both reforms could meet the basic threshold of requiring the benefits to outweigh the costs. It is worth noting, though, that these two proposals move in a similar direction—towards a destination basis. The RPAI retains some origin-based taxation as well as introducing more destination-based taxation. The DBCFT moves directly to a destination base, effectively abolishing origin-based taxation, at least for the taxation of business profit.

The question remains as to whether reform should be implemented all in one go, with a ‘big bang’ approach, or whether it should be implemented gradually. This is hard to judge and would depend on the nature of the reform. But to take the example of the DBCFT, a key element of the proposal is to zero-rate exports and to tax imports (this is what changes the system to a destination basis). But, even if that were the ultimate aim, it might be possible to implement such a reform

gradually—for example, partially zero-rating exports and partially taxing imports as a start. That would clearly push any benefits associated with the full destination basis further into the future. But it may also reduce transition costs. We discuss this further in the context of the actual proposal below.

3. Revenue neutrality and distributional issues

A common approach to analysing a tax reform proposal is to consider the case in which it aims to be revenue-neutral—that is, that the new system should be expected to raise the same amount of revenue as the old system. Given an overall revenue target, combined with alternative options available for meeting this target, this is a sensible starting point. The focus of the analysis can then be on the characteristics of the proposed tax, and how well it meets the desired criteria, given a revenue target.

Without revenue neutrality, the revenue required from other elements of the tax system would have to change, or the aggregate revenue target would have to change. In either of these cases, the basis of reform would be much wider; what would be the consequences, for example, of raising the foregone revenue from some alternative tax? In principle, that would require the costs of raising such revenue in this way to be taken into account. To sidestep this issue, it is therefore natural to consider a revenue-neutral reform.

That is not to say that the size of revenue generated from any existing tax is necessarily optimal. Neither does it imply that actual reforms are not intended to increase or lower revenue. The OECD/G20 BEPS project, for example, aimed to increase the revenue from taxing the profit of multinationals. But it is worth pausing to consider what the benefits of raising more revenue in this way may be.

For example, do the benefits arise because other—less efficient—taxes can be reduced? The optimal balance between a tax on business profit and all of the other elements of typical tax systems is a complex question. It is one that we considered in Chapter 2, but it is not one that we attempt to answer. As we discussed in Chapter 3, it is certainly arguable that corporation tax as traditionally structured imposes greater costs than most other taxes and should therefore contribute a smaller proportion of total tax revenue.

Or do the benefits of raising additional revenue from taxing profit arise because some countries are unable to meet an aggregate revenue requirement, in which case almost any additional revenue is beneficial? We have argued that lower income countries especially tend to rely more heavily on taxes on business profit because of the administrative difficulties in collecting other taxes, such as personal income taxes. But this does not generally apply to higher income countries.

Or do the benefits arise because there is a sense that the system would then be fairer? That is a more difficult question, as we discussed in Chapter 2. This is

a question where other taxes are relevant; it makes sense to think about the fairness of the tax system as a whole, and not just the taxation of profit. For considerations of fairness, then, revenue raised—ultimately from individuals, and across all taxes—is relevant.

For a given distribution of pre-tax incomes, a revenue-neutral reform is almost certain to create gainers and losers—otherwise the reform would have had no effect on tax payments. Offsetting this, a successful reform may generate greater economic activity and higher pre-tax incomes. That makes it at least possible that all taxpayers might be better off. However, there is no guarantee that this would be the case, and—in the absence of side payments between gainers and losers—the gains would have to be very significant and fairly distributed for this to be even close to being true. And even if it were true, at the time of reform there would be considerable uncertainty. As a result, it is understandably extremely challenging to generate political acceptability for a revenue-neutral reform. This is why, to compensate losers, reform is often accompanied by a reduction in tax revenue (the BEPS project being an exception to this).

This problem also arises to a certain extent in an international setting where there is concern about the distribution of tax revenues amongst countries. This relates to the earlier discussion about incentive compatibility. An attempt to organize a tax reform which is coordinated across a large number of countries is likely to be difficult since at least some countries may perceive that they may be worse off under a reformed system (unless those losing out have weak political power).

But an incentive compatible system would in principle not need such large-scale international agreement; even those countries worse off under a reformed system might choose to adopt it, finding the alternative of retaining the previous system to be even worse if other countries chose to reform. That is not to say that we are unconcerned about the distribution of tax revenues among countries; this is an important issue which we address in the context of the two detailed proposals in the next two chapters.

4. Scope of the reformed taxes

Any tax on business profits has to contend with a number of questions relating to its scope. These include specifying which legal forms of business are to be subject to the tax, whether there is to be a minimum threshold below which businesses would be exempt, and how such businesses would then be taxed. In setting the scope of either the RPAI or the DBCFT, a number of efficiency considerations arise. In principle, the tax should have a minimal impact on the choice of legal form, size of the business, or competition between different businesses. It should also in principle not affect the choice of owner-managed businesses to take remuneration in the form of labour income or profit. Of course, most existing systems

create some forms of distortion in these dimensions, which partly arises whenever there are different rates for personal and business income.⁶ It is also important to consider the administrative and compliance burden on small businesses and revenue authorities.

Under existing systems, the scope of the tax on business profits varies between countries. In most, corporation tax is applied to all incorporated businesses. But this is not universal. In the US, for example, 'S-corporations' are subject to pass-through treatment, under which profit is allocated to individual shareholders and is subject to personal income tax.⁷ By contrast, VAT is normally applied to all businesses over a certain size threshold, almost always defined in terms of turnover; the smallest businesses are not required to register for the tax because for them administrative and compliance costs would be disproportionate to the revenue at stake and potential distortions from their exemption.

Ultimately, the key choice here is that of the threshold between those businesses (whether or not they are incorporated) that would be subject to a separate tax on business profit, and those that would not be. The latter could most probably be subject to pass-through treatment. Two questions arise in choosing the threshold. First, what should the nature of the threshold be? Should it be specified in terms, for example, of having a certain number of investors, earning some level of profit or (like most VAT systems) having turnover above some level?⁸ Second, at what level should that threshold be set?

The appropriate level of threshold has been most extensively studied in relation to the VAT. This literature points to three main considerations.⁹ First, as might be expected, a lower threshold tends to raise more revenue. Second, and acting in the opposite direction, administration and compliance costs rise the more businesses lie above the threshold. A third, though somewhat less clear-cut, consideration is that the competitive distortions among different types of businesses are likely to increase with the number of businesses that do not face a separate tax on business profit.¹⁰ Businesses that are not subject to a separate tax but are subject to

⁶ Crawford and Freedman (2010) and Mirrlees et al (2011) propose to maintain the corporation tax for incorporated businesses only, but to introduce the combination of a rate of return allowance at the personal level, an allowance for corporate equity at the corporate level, and an alignment of rates to limit shifting between personal and corporate taxes.

⁷ There are restrictions on which businesses can elect for S corporation status. For example, S-corporations are allowed a maximum of 100 shareholders, who must be US citizens or residents and must have a single class of equity shares.

⁸ It is worth pointing out that one can cover most business activity, or at least the activity of large businesses that operate in a manner similar to corporations, without covering most businesses, given the size distribution of the business sector. For example, according to Auerbach (2010), in 2007 in the US, 90% of all S-corporations, accounting for 58% of all net income of S-corporations, had at most two shareholders. Only 0.2% of the sector's returns, accounting for less than 8% of the sector's income, came from S-corporations with more than twenty shareholders. So limiting the reform in the US to those S-corporations with more than a few shareholders would probably have a minor impact on the sector as a whole.

⁹ See Ebrill et al (2001); Keen and Mintz (2004); and, on empirical evidence, Liu et al (2021).

¹⁰ Further considerations arise when noncompliance is accounted for; see Kanbur and Keen (2014).

pass-through treatment may be better or worse off than businesses subject to the separate tax, depending on the relative rates of tax.

On balance, the best option may well be to follow the same approach as is standard under the VAT and apply a separate business tax to all businesses over a certain (modest) size, measured by domestic sales. Indeed, an obvious and simple approach would be to set the threshold at the same level as the VAT threshold.^{11, 12}

The question also arises as to whether businesses outside whatever scope is determined should be allowed to register for the tax voluntarily. Efficiency considerations argue that they should be; but this may need to be tempered by the costs and risk of including taxpayers who are a call upon, rather than contributors to, public funds.

5. Identifying destination

A central element in the implementation of the RPAI or the DBCFT would be making operational the relevant notion of ‘destination’. For the RPAI this is key to identifying where residual profit is taxed. For the DBCFT, it is key to identifying ‘exports’ to be taken out of tax and ‘imports’ to be brought in. In thinking about this, the design of either tax can usefully draw on experience under the VAT, for which notions of destination have been most fully discussed and developed.¹³

The OECD VAT/GST Guidelines define the destination principle as when ‘tax is ultimately levied only on the final consumption that occurs within the taxing jurisdiction’ (OECD, 2017b). The Guidelines recognize the difficulties in identifying where business use or final consumption actually takes place, since VAT must in principle be charged at or before the time when the supply is made available for business use or final consumption. VAT systems therefore generally use ‘proxies to determine the jurisdiction of taxation, based on features of the supply that are known or knowable at the time that the tax treatment of the supply must be determined.’¹⁴

The use of proxies is a near-universal feature of VAT systems, recommended by the OECD as an appropriate way in which to establish destination. The complexity

¹¹ See though Kanbur and Keen (2014), who show there can be disadvantages in aligning thresholds for distinct taxes (in aggravating the bunching of taxpayers just below them).

¹² In the case of the DBCFT, aligning it with VAT would bring the two routes to implementing a DBCFT (discussed in Chapter 7) closer together. As part of their credit-invoice method VATs, approximately two-thirds of OECD countries allow small businesses to elect to be exempt from VAT. Because small businesses exempt from the credit-invoice method VAT cannot claim input credits, and purchases from small businesses do not provide input credits, exempting small businesses generally does not provide a significant advantage to those businesses.

¹³ It has to be said, however, that there has been endless scope for confusion in the VAT context in both the usage of the term ‘destination’ and the notion of ‘consumption’: see Hellerstein and Keen (2010).

¹⁴ OECD (2017b).

of this approach varies. For example, the European VAT system has been particularly complex, with determination of the place of taxation of any specific transaction depending on such issues as: whether the supply involved goods or services; the identity of the acquirer, in particular whether she is a VAT registered person; the timing of the supply; the location of the supply; and the nature of the goods or services supplied.¹⁵

The general principle set out by the OECD, that the tax should be levied in the place of final consumption is not quite the same as the principle set out in this book. Our fundamental principle underlying the idea of a ‘destination’ basis is not that the tax should be levied in the place of consumption per se, but that the tax rate that is ultimately decisive should be determined by the location of a factor of relative immobility. In principle, a more immobile location than the place of consumption is likely to be the place of residence of the consumer, rather than the place of consumption.¹⁶ In principle, then, in considering cross-border shopping, for example, the RPAI and DBCFT should be applied to the residence of the consumer, rather than the place in which they made a purchase. However, in many cases, tracing the residence of individuals may not be practical, and so the place of purchase may have to serve as a proxy.¹⁷

Two distinctions are important in practice for implementing a tax on a destination basis. The first is between the taxation of goods as opposed to services. The OECD generally regards the taxation on a destination basis of cross-border sales of goods as being straightforward in theory and effective in practice, on the grounds that a physical good must cross borders, and therefore at least potentially subject to border controls. VAT on imported physical goods is generally collected at the same time as customs duties, although it may be postponed until declared on the importer’s next VAT return. But this does not apply to sales of services and intangibles. The VAT Guidelines focus on the latter. There is therefore a considerable body of experience to draw on for practical implementation of a destination basis, even for services and intangibles, summarized in the VAT Guidelines.

The second distinction is between sales to businesses (‘business to business’, or ‘B2B’, transactions) and sales to consumers (‘business to consumer’, or ‘B2C’, transactions). The VAT Guidelines make clear that B2C transactions should be taxed in the place of consumption; but this is less easily identified for B2B transactions.

¹⁵ See de la Feria (2009).

¹⁶ In the context of discussing the implementation of a DBCFT, de la Feria and Devereux (2014) analyse in some detail the use of proxies for ‘destination’ in VAT. This discussion also applies to considering the nature of destination for the RPAI. Taking into account the aim of having a relatively immobile tax base, they recommend the use of the customer location proxy, defined as ‘the location, residence, or place of business of the customer, the person to whom the seller has a contractual legal obligation to supply the goods’.

¹⁷ This will be the case where the supply of services requires the physical presence of both the supplier and the customer in some way, such as restaurant services, concerts, and sports events.

As an example, consider a business that has a purchasing subsidiary that buys office furniture for its subsidiaries around the world. In principle the furniture should be sold on to each of the subsidiaries and so the ultimate place of consumption would be where the furniture was eventually used. In this case, there is no problem for VAT. However, if there were no formal transactions within the multinational group, with the furniture simply allocated to different subsidiaries, then it would appear that the destination of the entire purchase would be the location of the purchasing company. Of course, such an approach would not be consistent with the arm's length principle. The same issue arises in respect of the DBCFT, which uses the same border adjustment as VAT. However, as we explain in detail in Chapter 7, one way of dealing with B2B imports under the DBCFT is simply to ignore them. No tax would be paid on the import but equally there would be no credit against the tax eventually due on income earned. This is a considerable simplification relative to keeping track of purchases and sales through a multinational business.¹⁸ But this would not be a suitable approach for the RPAI. In the case of the RPAI, the business agreement between two businesses in a B2B transaction should enable a proxy based on the customer location to work reasonably well in most cases, although this would not avoid the incentive of the purchasing business to locate purchases in a low tax jurisdiction where services or intangibles are used by multiple related-party recipients located in multiple jurisdictions under an internal recharge arrangement. We discuss these issues in more detail in the subsequent chapters.

B2C transactions in cross-border services create difficulties for administrative obligations, especially when the selling business does not have a presence in that country by, for example, selling over the internet or through catalogues and distributing the goods through third party or related-party logistics providers. The destination principle requires the tax authority in the market country to collect tax, even if the seller does not have a physical presence there. The considerations here differ depending on the nature of the tax. The DBCFT would tax the value of the import, while the RPAI seeks only to tax the residual profit of the selling business. These raise different considerations, which are discussed in the separate chapters on the RPAI and the DBCFT. This implementation issue would also arise under the Pillar I proposal currently being discussed by the Inclusive Framework. It might be noted that countries which have recently proposed a Digital Sales Tax have not seen this as a problem. For example, the UK Treasury has stated that it has 'significant experience of collecting tax from businesses with no physical presence in the UK in areas such as VAT' and concluded that it 'does not therefore see collection as a significant issue.'¹⁹

¹⁸ For further detail on why a DBCFT cannot be gamed by placing a purchasing subsidiary in a low tax jurisdiction see Devereux and Vella (2018c).

¹⁹ HM Treasury (2018).

But in principle it would be necessary for the business to register for tax in the country into which it is exporting the good or service; this is difficult to administer for relatively small exporters, particularly when the good or service can be downloaded electronically, or where there are no customs operations at borders. The exporter must also identify the location of its customer. The tax authority must identify businesses from around the world that export to its country, and—again in the case of the DBCFT—also guard against any opportunities for fraud if final consumers pretend they are businesses. For this purpose, gathering information from intermediaries such as credit card and other payment companies is likely to be an important enforcement tool.²⁰

6. Final thoughts

In sum, international tax reform is difficult to achieve. It is likely to mean revising, or unilaterally withdrawing from, existing international agreements. There would be significant transition costs. There would very likely be taxpayers who would be worse off, certainly without taking into account any consequential improvement in economic conditions. There will certainly be a revenue shift between countries the magnitude of which—in particular in the long-term—is hard to predict. And the benefits of reform in terms of an improvement in economic efficiency are likely to appear abstract and uncertain. It is little surprise then that we have a system that in its essentials has been unchanged for a century.

But the analysis in Chapter 3 suggested that the existing system is in dire need of reform. Indeed, at the time of writing there appears to be a general consensus in favour of reform—the question is what form it should take. Our preference is for a principled, coherent, and comprehensive reform that performs well under our five criteria. The next two chapters present two reform options of this kind.

²⁰ One innovation in the EU that could be applied amongst cooperating countries in implementing a DBCFT is a 'one stop shop', as described in Chapter 7. However, this approach would not be easily applied to the RPAI, since the tax base in the market country is more complex.