


A proposal for unitary taxes on the profits of transnational corporations

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Foreign direct investment (FDI) in developing countries has been increasing at an unprecedented rate, and the profitability of the operations of the investing firms in poor regions like Sub-Saharan Africa is extraordinarily high. Yet at the same time there is growing evidence that transnational corporations (TNCs) are paying less and less in terms of tax. The developing countries in particular have suffered from this—it has been estimated that developing country governments lose at least US\$35 billion a year of revenue through tax avoidance practices. This paper presents empirical evidence and a proposal for applying a unitary tax system on the profits of TNCs. Such a system would eliminate one of the most powerful mechanisms at the disposal of TNCs for illegally avoiding tax payments—transfer pricing. The paper concludes by arguing that a proposal for a unitary tax system on a worldwide basis may be sufficient to unblock the negotiations on a multilateral investment code.

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I

Introduction

After a lost decade of structural adjustment and reductions in government expenditure, there is a growing acknowledgement that developing countries should be searching for new sources of revenue. It has recently been estimated, for example, that there is a shortfall of up to US\$80 billion per year in developing countries between what is spent and what should be spent to ensure universal access to basic health and education (Mehrotra, Vandemoortele and Delamonica, 2000). Yet as a result of continuous pressure from the international financial institutions to reduce expenditure, the capacity of the State to provide such services has been seriously weakened in many regions.

Indeed, in some countries revenues are so low that the State is in danger of disintegrating. In Guatemala, for instance, State expenditure currently barely reaches 10% of GDP, and the government has apparently given up any pretence of meeting its obligations with regard to the provision of basic social services, shifting its responsibilities onto the NGO sector: a role which NGOs are obviously ill-equipped to fulfill. In a similar vein, commenting on the case of Mexico, the ex-President of Uruguay Julio María Sanguinetti recently asked “how is it possible to carry out social programmes in Chiapas when the fiscal pressure of the Mexican State is equivalent to only 10% of GDP?”¹ The irony is that these trends have coincided with a growing consensus on the need to build up State and institutional capacity if any progress is to be made in the eradication of poverty. Increasingly, the international financial institutions and many donor governments are putting emphasis on “getting the institutions right” and attaching “governance-related conditionalities”, but there seems to be little predisposition towards finding new ways to provide the necessary finance to support these changes.

In such a context, it seems only logical to place more emphasis on revenue-creating strategies. Ambitious proposals for taxes to help finance development such as the Tobin Tax have apparently fallen by the wayside, in part because of doubts about their effectiveness, and in part simply because of a lack of

political will to push the proposals through.² Little attention, on the other hand, has been paid to the possibility of increasing tax revenue through more efficient taxation of the operations of transnational corporations (TNCs). Foreign direct investment (FDI) towards developing countries has increased more than fourfold since the early 1990s (from an average of US\$ 47 billion between 1988-1993 to US\$ 238 billion in 2000 (UNCTAD, 2002, Annex, Table B.1.). The growing globalization of international production confers enormous benefits on TNCs. Facilitated by liberalization and structural adjustment programmes, they have been able to enter new markets in developing countries, and have participated in privatization programmes, buying public assets often at highly favourable prices. Reflecting the opportunities available, and contrary to popular opinion, in developing regions profitability can be extraordinarily high. For example, data for United States companies reveal an average profit rate for operations in Sub-Saharan Africa in excess of 25% over the last five years (Mold, 2001). In other words, companies recover their initial investment in just four years. Clearly, globalization has been good for the largest TNCs.

Yet there are signs that the boom in FDI has been accompanied by a growing ability of TNCs to avoid tax payments in the jurisdictions where they have operations. Some of the evidence is anecdotal. For instance, a few years ago it was revealed that Newscorp Investments, a holding company with 101 subsidiaries owned by the Australian media tycoon Rupert Murdoch, had made £1.4 billion in profits since June 1987, but had paid no net British corporation tax at all (The Economist, 1999). The situation clearly has to be explained in terms of the company's extensive use of tax loopholes to shelter profits in tax havens.

Newscorp Investments is far from an isolated example. A systematic study in the United States (McIntyre and Nguyen, 2000) found that household names such as Goodyear, Texaco, Colgate-Palmolive, MCI WorldCom and eight other large corporations

¹ See *El país* 2001 p. 7.

² For a discussion of the practicalities involved see Haq Kaul and Grunberg (1996).

earned more than US\$12.2 billion in profits in the period from 1996-98, but none of them ended up paying corporate income taxes in the United States over the same period. Of the 250 large publicly traded companies analyzed in the study, a total of 24 owed no tax or received credits against past or future tax obligations in 1998, and 71 paid taxes at less than half the official 35% corporate rate during the three-year period. Similarly, a study by Altshuler, Grubert and Newlon (1998) on the effective tax rates paid abroad by large United States manufacturing affiliates revealed that average rates had fallen by more than 15 percentage points between 1984 and 1992.

Developing countries are particularly vulnerable to this type of tax avoidance strategies. Although the level of fiscal pressure is generally lower than in industrialized countries, they have far less institutional capacity to control tax evasion. Typically, they lack sufficient information from the parent company to be able to challenge transfer pricing and other forms of tax avoidance. Much of their FDI is located in sectors like the oil industry, electronics and forestry products, where the potential for tax avoidance is high. Because a considerable share of total developing country trade is under the control of TNCs, such countries are typically more vulnerable to tax avoidance practices through the over- or under- invoicing of imports and exports.

Moreover, in many developing countries a combination of low corporate taxes and the extensive use of tax breaks and tax holidays to attract foreign investment has meant that TNCs have reduced their tax liabilities dramatically. One of the most extreme cases is that of the 15 export processing zones/free trade zones set up in Honduras, where foreign firms have been granted permanent exemption from all taxes. But tax holidays of between 10-20 years are nowadays fairly commonplace in developing countries.³ Sri Lanka, for example, has 6 export processing zones (EPZs) which enjoy 10 to 20 year holidays for new large export projects or selected industries. These initiatives continue, in spite of an emerging consensus that, from a developmental perspective, these kinds of measures are ineffective or even counterproductive in the long run.⁴ These trends should force policy makers to consider

alternative methods of raising revenue. The existing system is clearly failing in terms of equity. This is true both from the point of view of what we could call internal and international equity- internal equity in the sense that within individual countries wage earners are increasingly having to finance through taxes the bulk of government expenditure, whereas internationally mobile capital is benefiting from a reduction in effective tax rates, and international equity in so far as there is evidence that tax income from TNC operations has been falling more rapidly in developing countries than in the industrialized countries. Indeed, the only “winners” in all this are the TNCs themselves and the tax havens with the lowest effective tax rates. Thus, whereas stocks of FDI for the world as a whole increased approximately ten-fold over the period from 1980 to 2000, the Cayman Islands experienced a more than 100-fold increase, to US\$24.9 billion. With a population of only 36,000, this represents a massive US\$700,000 of foreign investment per inhabitant. Similarly, Bermuda’s investment stock rose US\$10 billion in just one year, from 2000 to 2001, and now stands at a total of more than US\$66 billion. To put these figures in perspective, this is higher than the US\$50 billion investment stock for the whole of Japan and, for a population of just 64,000, represents more than US\$1 million per inhabitant (UNCTAD, 2002, Table B.3).

Beyond straightforward fraud, one of the principal ways in which TNCs manage to shift income towards low tax jurisdictions, and thereby reduce effective tax rates, is through transfer pricing. Transfer pricing involves manipulating the prices of intra-firm transfers of goods and services so as to lower tax liabilities in countries with high marginal tax rates, and increase profits in countries where the tax liability is correspondingly low. Over 80% of TNCs in one study admitted to facing a transfer pricing inquiry from local or foreign tax authorities at some point.⁵ Although it is illegal in principle, in reality transfer pricing is very hard for tax authorities to control. For many intra-firm transfers, it is very difficult for local authorities to establish a “correct” arms-length price. For instance, some types of components or intermediate products may be readily available on the open market, and thus it is relatively easy to compare the price paid by a subsidiary with the open market price. But other products may be specific to a particular company, and thus

³ A list of selected export processing zones in developing countries elaborated by UNCTAD (1999 Annex table A.IX.3) reveals a total of 16 EPZs with across-the-board tax exemptions. A further 15 EPZs enjoy a 10 to 20 year tax holiday.

⁴ See for instance the article by IMF economists Zee Stotsky and Ley (2002).

⁵ Lorraine Eden (1998) *Taxing Multinationals* University of Toronto Press p.635 cited by Giddens (2000:102).

impossible to value in terms of a “market price”. This leaves tax authorities with a dilemma. How should they estimate the “correct” price of a product traded between affiliates? These difficulties are compounded when one considers that TNCs share all kinds of managerial and innovative resources (e.g. patents). The intangible nature of these goods and services means that in practice it is impossible to assign costs accurately between affiliates. It is not surprising, then, that TNCs have considerable leeway to adjust intra-firm prices so as to reduce tax liabilities to a minimum. Notwithstanding all these difficulties, tax authorities cling to the principle that for tax purposes each affiliate of a TNC should be considered as an independent unit.

Of course, in reality it has always been a fiction to consider the subsidiaries of TNCs as free-standing entities. As Vernon (1998, p.40) has commented, “in the real world, the profit allocated to each country by a multinational enterprise commonly is an artefact whose size is determined largely by precedent and by the debating skill of lawyers and accountants.” In an increasingly globalized world, however, where subsidiaries become deeply enmeshed in the international network of the firm, this fiction is rapidly becoming unsustainable. As we shall go on to show, it is also a very costly fiction for the host countries.

This brief paper offers a proposal for a different system of taxing TNC profits: unitary taxes. Briefly, unitary tax systems involve using some notional allocation of global profits instead of the declared profits by individual subsidiaries. This makes sense because the objective of the TNC is to maximize group profits; company administrators are generally indifferent to where those profits show up within the multinational network. Under a unitary tax system, the amount of profit taxes to be paid in each country would be assigned according to some criterion such as the share of each subsidiary in global sales, employment or assets.⁶

⁶ There is a risk in including labour in formula apportionment. The imposition of a unitary tax system does not prevent different countries from imposing different corporate tax rates. Thus in countries with high relative corporate tax rates formula apportionment based on employment may provide a perverse incentive for TNCs to substitute capital for labour exaggerating a bias which already exists within the TNC because of its relatively cheap access to capital. Evidence on this point from the U.S. experience can be found in Goolsbee and Maydew (1998). Given the priority attached to employment creation in both developing and industrialized countries it may be better to base unitary taxes on an alternative indicator or a combination of different variables (see section IV).

Clearly, this kind of system would not avoid all forms of tax avoidance. Action would still need to be taken to counter the multitude of other (illegal) methods of tax evasion. Fraudulent accounting practices, like those evident in the WorldCom and Enron scandals in the United States, would still be a problem.⁷ But a unitary system would significantly reduce the capacity of TNCs to shift profits from one location to another at will. The system would have the advantage of greater transparency, and would help to increase the overall tax take, freeing up resources which could be used to help achieve developmental objectives such as the universal provision of basic health and education. Although they may be reluctant to admit it, such a system might even result in long-run benefits for the TNCs themselves, reducing the need for them to devote valuable managerial time and resources to finding ways of minimizing their tax bills, and instead allowing them to pay more attention to building up the competitive strengths of their companies.

⁷ Ironically of course both the Enron and WorldCom cases meant higher tax payments because they involved the artificial inflation of real profits - the losers in this case were principally the shareholders of the companies in question. For a prescient critical analysis of Enron's operations just before the scandal broke see Bayliss and Hall (2001).

II

Evidence of tax avoidance by TNCs

Studies on the determinants of foreign direct investment both in developing and industrialized countries reveal that TNCs generally value highly locations with good infrastructure, a well-educated workforce, high-quality social services, etc.⁸ These are all public goods which are best provided by governments. Yet, at the same time, TNCs appear to be increasingly reticent to pay their contribution towards financing these public goods. In the United States, for example, corporate income taxes as a percentage of gross earnings fell from over 40% at the beginning of the 1960s to an average of only 21.5% between 1990-1996 (Poterba, 1999, table 3).⁹ As a share of United States federal tax revenue, corporate income taxes provided 32% of total revenue in 1952, but by 1999 the figure was only 10% (Weisbrot, Naiman and Kim, 2000, p.15). For the Organization for Economic Cooperation and Development (OECD) as a whole, corporate taxes now account for only 8% of fiscal revenue, equivalent to just 3% of GDP (FitzGerald, 2001, p.7).

There are basically two channels through which globalization has facilitated such a big reduction in tax rates. Firstly, the growing importance of trade that takes place within the firm (i.e., between affiliates and the parent company) is enhancing the ability of firms with international operations to shift profits from one tax jurisdiction to another. Intra-firm trade now accounts for approximately a third of all world trade. This creates enormous problems for the national tax authorities, due to the use of “transfer prices” by TNCs and the likelihood that these enterprises manipulate these transfer prices to move profits to the jurisdictions where taxes are low. Moreover, as Tanzi (2000, p.18) observes, “under present tax arrangements this problem is likely to grow. The tax authorities of many countries are now worried about this

trend, but are often at a loss on what to do about it”.

The other means by which TNCs are managing to reduce their effective tax rates is the pressure on governments to reduce taxation on internationally mobile capital. Governments are increasingly putting policies into place to attract foreign investment. Since 1991, a further 58 nations have begun to apply investment promotion policies, making a total of 116 countries that now do so (Moran, 1998, p.37). One of the most popular measures for attracting foreign investment is the granting of tax concessions. As an International Labour Organisation (ILO) report comments, “in a world characterized by a decisive trend towards “globalization”, where liberalization of trade and capital flows has become increasingly prevalent, the temptation for nation-States to engage in “competitive de-taxation” and “competitive deregulation” is self-evident” (ILO, 1997, p.70). Indeed, there are growing fears that this process is degenerating into a damaging “race to the bottom”, whereby the tax base of States is gradually eroded and the remaining tax burden falls disproportionately on non-mobile factors (especially labour) (Kozul-Wright and Rowthorn, 1998; Radaelli, 1999).¹⁰

This trend is easily observable in statutory corporation tax rates. In the past, countries typically levied taxes on the net incomes of corporations at marginal rates ranging from 30% to 50% (Caves, 1996, p.189). Moreover, there was little difference in corporation tax rates between developing and industrialized countries. In contrast, nowadays there is evidence of a widening gap between OECD and developing country rates. Few developing countries apply corporate tax rates in excess of 20%. According to estimates by Oxfam (2000), if developing countries were applying OECD corporate tax rates their

⁸ An extensive review of econometric studies on the locational determinants of FDI is to be found in Mold (2000).

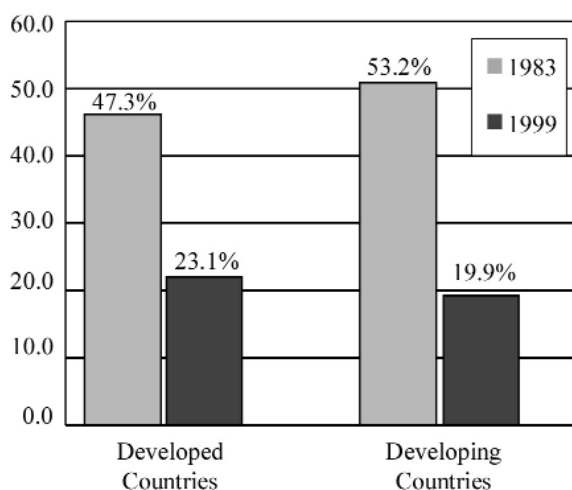
⁹ In the United States case at least it may be misleading to attribute this fall in corporative income tax rates to trends related to globalization: the main cause would seem to be the passing of the Economic Recovery Act of 1981 which resulted in a sharp decline in corporation tax rates (Poterba 1999 p.13).

¹⁰ Of course there is nothing new in these fears. In an article published back in 1974 entitled “Coming Investment Wars” Bergsten was particularly prophetic on this point: “Many investments are largely indifferent to location and hence close to zero-sum games; in such cases a decision that is one party’s gain is another party’s loss. Furthermore world welfare may actually decline as a result of some foreign investments such as those induced primarily by host-country tax preferences” (Bergsten 1974 p.145)

revenues would be at least US\$35 billion higher.¹¹ But the changes are even more notable when effective tax rates are calculated.¹² For instance, calculations carried out for this study on data for majority-owned subsidiaries of United States firms reveal that on a worldwide basis their average effective tax rates have fallen from 49.6% of pre-tax income in 1983 to a mere 23.3% in 1998 (see Annex and figure 1).

FIGURE 1

**Developed and developing countries:
Effective tax rates paid by United States
majority-owned affiliates, 1983 and 1999
(Percentage)**



Source: Prepared by the author on the basis of United States Department of Commerce data (see Annex).

¹¹ This figure was calculated using an estimated FDI inward stock for developing countries of US\$1219 billion. It was assumed that that stock gave a rate of return of 20% and the tax rate was set at a typical OECD rate of 35%. On that basis developing countries should be receiving tax revenues of around US\$85 billion a year from foreign corporations but they actually receive around US\$50 billion per year at most. As the authors of the study concede however this is likely to be an extremely conservative estimate as not only do official figures tend to understate the true value of FDI stock but also these figures fail to take account of the financial transactions of large firms.

¹² Effective tax rates are defined as the ratio of foreign income taxes to gross income (the sum of net income plus foreign income taxes). If a high nominal rate of corporation tax is accompanied by generous dispensations then a large discrepancy can appear between nominal and effective rates. From the point of view of the companies themselves what matters is obviously the effective rate.

Insofar as these figures probably substantially underestimate true pre-tax income, real effective tax rates are likely to be even lower. Moreover, whereas effective tax rates were marginally higher in developing countries than in the industrialized countries in 1983, by 1998 that relationship had been inverted, and effective rates were on average higher in developed countries (19.9% versus 23.1%).¹³ Another point which stands out from the figures calculated in the Annex is the large dispersion in effective tax rates. Thus, whereas in countries like Nigeria or Indonesia the effective tax rates in 1999 were 53.3% and 32.2% respectively, for Luxembourg, Bermuda, Panama or Switzerland the corresponding figures were only 2.5%, 2.8%, 0.5% and 5.7%. The incentive to shift pre-tax profits towards the latter tax jurisdictions is obviously very strong indeed.^{14, 15}

¹³ These findings are broadly comparable with the conclusions of a study carried out by Altshuler Grubert and Newlon (1998) on the average effective tax rates for large United States manufacturing firms. Their study was based on data from the US Treasury corporate tax files between 1980 and 1992. They found that rates fell by more than 15 percentage points between 1984 and 1992. Falls in effective taxation rates were particularly sharp in many developing countries.

¹⁴ Some developing areas in particular Africa appear to have very high effective tax rates. These figures do not necessarily reflect high overall rates however. Rather they reflect the sectoral spread of investment (principally in the oil and mining industries) where the share of gross income retained by the host government is relatively high. Thus in the case of Nigeria for instance whereas the effective rate for all industries was 32.4% according to figures provided in the aforementioned study by Altshuler Grubert and Newlon (1998) the effective tax rate for United States manufacturing firms in Nigeria was only 13%. The high apparent tax rates on the oil and mining sectors may also be the product of extensive transfer pricing activity giving a misleading impression of real effective tax rates.

¹⁵ There is an important caveat to be made here. Some important source countries of FDI provide foreign tax credits that can be offset against taxable income. For instance the US government obtains very little corporate tax revenue from the profits of US firms in high-tax countries since the taxable profits in those countries generate foreign tax credits that erase any residual US tax liability. By contrast a large fraction roughly 40% of US revenue from taxing the foreign profits of United States corporations comes from taxing their tax haven profits (Hines and Rice 1994 p.150). Thus tax credit systems can lead to the perverse result of larger tax payments in the investor's home country. Because of this phenomenon in some circles tax holidays have become known as "reverse foreign aid" (Wells and Allen 2002 p.8). It would be interesting to extend our analysis to countries which do not provide extensive tax credits like France – we could expect much higher incentives to switch profits to low tax jurisdictions in these cases.

III

The implications for developing countries

From the point of view of reducing the overall tax take, the repercussions of such “investment wars” are potentially very damaging for developing countries. Tax breaks and holidays are becoming increasingly generous. In some cases, such as Honduras, Jamaica, Namibia and Senegal, firms have been granted permanent tax exemptions. Tax holidays in export processing zones have on occasions been stretched out to as much as 20 years. Yet one of the ironies of offering increasingly generous tax breaks is that the evidence regarding the impact of tax regulations on business location decisions is ambiguous. For instance, a detailed study by Wells and Allen (2002) into the elimination of tax holidays in Indonesia found no detectable impact on the subsequent ability of the country to attract substantial flows of foreign investment. Likewise, in an econometric study of the locational decisions taken by U.S. and Japanese manufacturing firms in 74 host countries, Kumar (1999) finds scant evidence that lower tax rates or tax incentives affect the decision to produce in developing countries. Indeed, the results of some of Kumar's regressions seem to suggest that higher tax rates were positively related to higher levels of production by foreign subsidiaries.¹⁶ Although there are obviously individual cases where tax rates have affected the final decision, on the whole TNCs seem to take a long-term view of locational decisions, and are more likely to be swayed by factors such as the quality of local infrastructure, the availability of a well-educated workforce and, probably most importantly of all, a dynamic local market.

Findings such as these lead credence to the idea that governments have conceded too much to TNCs in exchange for too little - tax competition is not even a very effective way to attract long-term foreign investment. Indeed, there are other more effective ways of

attracting FDI rather than having to depend on tax breaks. It has been suggested, for example, that a better policy would be to support investment in human capital, education, or local technological capacity (MacEwan, 2001, pp.299-300). That way, if the subsidiary is eventually closed, or lost to a country with a lower tax rate, then at least the government retains the benefits of the initial investment in terms of a better educated workforce or an improved infrastructure. If the only incentive offered is a low tax rate, all is lost if the company finally decides to locate elsewhere.

In addition, despite the great enthusiasm shown by policymakers, for developing countries as a group the potential gains to be reaped by attracting FDI through tax breaks and reductions are probably limited. For instance, it has been estimated that total employment in developing country Export Processing Zones (EPZs) is no more than 4 million (Dicken, 1998, p.131).¹⁷ Jobs in EPZs typically represent no more than 5% of total employment in the manufacturing sector of developing countries: a tiny amount compared with the estimated 300 million people who work in the “informal sectors” (Madeley, 1999, p.113). When one considers that there are an estimated 1,200 million people living on less than US\$1 a day, it is clear that the potential impact of EPZs on poverty reduction is limited.¹⁸ It is also no coincidence that, with the exception of Mexico and China, the developing countries that have made best use of these practices to attract foreign investment tend to be relatively small island States such as Mauritius. In short, as models which other developing countries could follow, their relevance is limited. Reviewing the evidence, one group of IMF economists conceded that “setting-up and/or maintaining export processing zones is rarely advisable” (Zee, Stotsky and Ley, 2002, p.1507). Yet governments of developing countries have allocated substantial amounts of scare funds, and forfeited a considerable

¹⁶ For a recent review of these studies see Morriset and Pirnia (2002). It is true that some more recent studies do find a relationship between fiscal pressure and investment studies: much would seem to depend on how the tax variable is defined in the regression analysis (effective tax rates would seem to have much stronger explanatory power than nominal tax rates). Nonetheless as Hines (1996a p.8) acknowledges even in these studies the impact of tax rates on the location and volume of investment still tends to be relatively small.

¹⁷ Moreover those jobs are highly concentrated geographically. Mexico alone accounts for 600 000 jobs and China too is responsible for a large share of total employment in EPZs. The vast majority of developing countries have an insignificant share in the employment generated by such zones.

¹⁸ There are of course all kinds of potential spillover effects to be gained from the entry of foreign firms. But there is no automatic guarantee that such positive spillovers will be forthcoming.

amount of tax income, to attract companies into EPZs.

Of course, the proposal made in this paper to revive the debate on unitary taxes can do little to avoid tax competition and “investment wars”. That is a problem which clearly requires greater coordination between tax authorities. But the transfer pricing problem can indeed be tackled through unitary taxes. Developing countries are particularly susceptible to income shifting of this kind. Much of their investment stock is in primary industries. Sectors like the oil industry are renowned for their ability to move funds in and out of countries. Transfer pricing is facilitated by the large volume of cross-border transactions in the mining and oil sectors. Nor do developing country fiscal authorities have the capacity to control transfer pricing activities to the same extent as the developed countries.

There are a number of other incentives which encourage TNCs to indulge in intensive transfer pricing activity in developing countries. Although in the past profit taxes have tended to be lower than in industrialized countries, the level of ad valorem tariffs on trade is still usually higher in developing countries. By under-invoicing the true cost of intra-firm imports or exports, TNCs often use transfer pricing to minimize payments of trade duties. Similarly, as a way of promoting the reinvestment of earnings in the host economy, developing country governments have traditionally imposed more restrictions on profit repatriation than developed countries. In the face of such restrictions, however, the transfer price mechanism has provided TNCs with an alternative form of shifting income out of a country (Grimwade, 2000, p.149).

To what extent is the potential for manipulation of transfer prices actually used to the detriment of developing countries? Most of the empirical studies on this subject date back to the 1970s and 1980s. But, as Elson (1995, p.305) observes, the few systematic investigations that have been carried out have all shown that transfer prices are used to the detriment of developing countries. For instance, one early study by Vaitos (1977) into the pharmaceutical industry in

Colombia revealed that reported profits accounted for only 3.4% of effective returns; royalties for 14.0%, and over-pricing for 82.6%. The additional cost of pharmaceutical imports alone for the Colombian economy was estimated at US\$20 million a year. In addition, there was a substantial loss of government tax revenue - amounting to US\$10 million a year - where transfer pricing was used to under-report profits. Investigations carried out by Lall and Streeten (1977, p.153) confirmed this pattern of systematic overpricing of imports by the pharmaceutical industry in Colombia: some individual items were found to be overpriced by up to 5,000-6,000%. Such practices were also prevalent in the rubber and electrical industries. More recent studies have tended to focus on comparisons of pre-tax profitability levels as an indirect measure of transfer pricing activity. An extensive study based on 1982 data carried out by Hines and Rice (1994) into the profitability of US affiliates in 59 host countries revealed that on average a 1% higher tax rate reduced the declared before-tax profitability by 2.3%.

It has often been argued that one way of minimizing abusive transfer pricing activity of this kind is to enforce joint ventures; local partners are hardly likely to countenance the massive shifting of income abroad. But the international liberalization of investment codes is making it increasingly difficult to impose joint ventures on TNCs. Moreover, even where local partners exist, they are often kept in the dark regarding the structure of costs. The true level of profitability is thus extremely difficult to gauge. As a former managing director of the Nigerian National Petroleum Corporation, a joint venture with Shell, commented: “proper cost monitoring of their [Shell’s] operations has eluded us and one could conclude that what actually keeps these companies in operation is not the theoretical margin but the returns which they build into their costs” (Obi and Soremekun, 1995, cited in Frynas, 1998, p.20).

IV

Unitary taxes as a way of tackling tax evasion

An alternative solution would be to impose taxes on the consolidated results of the TNCs and distribute the tax burden on the basis of some easily quantifiable variable (such as sales, or fixed capital, etc.) instead of on profits. In practice, the most common formula is to allocate a corporation's income on the basis of the country's average share in total sales, fixed capital and labour remuneration. Expressed more formally, if π is a TNC's overall profit, then the profit attributed to country j for tax purposes, π_j , is

$$\pi_j = \left(\alpha_j^p \frac{P_j}{P} + \alpha_j^l \frac{L_j}{L} + \alpha_j^s \frac{S_j}{S} \right) \pi$$

where P is total assets, L is total employment and S is total sales of the TNC, and P_j and L_j and S_j are the assets, employment and sales within the tax jurisdiction of the country in question, while α_j^f is the weight of each factor f in country j in the overall tax. In practice, the most common system of weighting used is a third for each component.

Unitary taxes of this kind would eliminate the incentive to shift profits towards low tax jurisdictions. Needless to say, a proposal of this nature would inevitably provoke an indignant reaction on the part of TNCs - past experience shows that these companies are able to lobby aggressively on any issue that could potentially affect their interests. Apart from political expediency, however, there are few reasons for keeping these issues off the agenda: revenue-creating initiatives like this are essential in order to strengthen the fiscal position of the State in developing countries, and there may also be significant payoffs for the developed countries concerned. On the basis of the financial reports of 46 U.S.-based TNCs, a recent study by Shackelford and Slemrod (1998) estimates that the application of unitary tax in the U.S. would have increased those companies' U.S. tax liabilities by 38% percent, with the percentage increase being much higher (81%) for oil and gas firms.

Moreover, although TNCs may be initially reluctant to admit it, a system of unitary taxes would even hold certain advantages for them. Transfer pricing distorts the ability of the firm to evaluate subsidiary performance - the more the company resorts to transfer

pricing, the more difficult it becomes to determine whether subsidiary profitability is due to the level of productivity, or is simply an artifice of accounting. Thus transfer pricing activity ends up distorting the incentive structure within the firm: a subsidiary told to charge a high transfer price for a good or service supplied to another subsidiary will appear to be doing better than it actually is, while the subsidiary purchasing the good or service will appear to be doing worse. Unless this built-in bias is recognized when performance is being evaluated, serious distortions in management incentive systems can occur (Hill, 2000, p.625). In this sense, TNCs themselves would gain through the greater transparency of a unitary tax system. Unitary taxes would also allow firms to concentrate on strengthening their competitive advantages, instead of wasting valuable managerial time and resources on time-consuming tax avoidance strategies. Because of the simplified nature of the system, unitary taxes also have the potential for substantially reducing accountancy costs. As Phillip Gillett, tax controller at ICI, has commented: "Commercially, transfer pricing makes no sense. It forces us to spend a lot of time doing things that are pointless from a business point of view...Businesses want to organise as if there were a single regional product market. Instead tax is determining how they organise themselves" (*The Economist*, 2000, p.14).

In addition, it is manifestly unfair that differences in company performance should hinge to such a great extent on the ability of company accountants to reduce tax payments. In the aforementioned study by McIntyre and Nguyen (2000), it was revealed that competitors in various industries faced sharply varying effective tax rates. For example, Maytag and General Electric both make kitchen appliances. But whereas Maytag paid 35% of its profits in taxes from 1996 to 1998, GE paid only 8.1%. Likewise, Abbot Laboratories and Pfizer are both in the drug business, but the former paid almost 29% of its profits in taxes from 1996 to 1998, while the latter paid only 3.1%. This amounts to competitive sleight of hand, and is unfair to shareholders. Unitary taxes would provide a more level playing field.

V

Unitary taxes in practice

Tax reforms are never easy: tax systems tend to evolve in a topsy-turvy fashion, and although the outcome often appears irrational and unjust to outsiders, domestic political interests are created which often stop well-intentioned reforms in their tracks. The experience of the economist Nicholas Kaldor is instructive here. Throughout the 1950s and 1960s Kaldor took part in many tax missions to developing countries. Although many of his proposals were based on sound economic principles and would have provided the basis for a more equitable tax system, few countries were willing, or able, to follow his tax prescriptions. In Ghana, for instance, Kaldor was asked by Prime Minister Nkrumah to advise on the budgetary position and tax system during the economic crisis there in 1961. Kaldor wanted to reform company taxation to prevent foreign firms escaping tax through transfer pricing, and to introduce a scheme of compulsory saving to aid the development effort. Politically, however, his proposals were untenable, and they led to political agitation and a workers' strike (Thirlwall, 2003, pp.522-524).

Cautionary tales such as this are no reason for not lobbying for change, however. Unitary taxes are not innovative - they have been tried before - and in this sense important lessons can be drawn from past experience.¹⁹ Indeed, it is one of the ironies of the process of globalization that unitary taxes were first implemented in the single most important source country of FDI in the world - the United States. In fact, no state in the U.S. attempts for tax purposes to measure the within-state profits of multistate enterprises by requiring separate accounting. Instead, all states use some variety of formula to apportion total U.S. (and, in some cases, worldwide) profits among the states (Shackelford and Slemrod, 1998, p.41). In the 1980s twelve U.S. states adopted a worldwide unitary tax.²⁰ State legislators were aware of the ease with which

TNCs could avoid state profit taxes, simply by shifting income towards states with a lower tax burden. Unitary taxes were thus championed by state comptrollers as a way of minimizing tax avoidance through transfer pricing.

The political reaction against these measures was almost immediate. The constitutionality of this method of state taxation was questioned in the courts on numerous occasions. At least twenty nations filed official protests in the United States on behalf of TNCs, complaining that the taxes subjected foreign firms to double taxation, required burdensome accounting procedures, and forced TNCs to write detailed reports on their global operations. As California is one of the favourite locations for gaining a foothold in the United States market, that state's unitary tax legislation provoked a particularly adverse response. As Vernon (1998, p.42) noted, California's initiative to abandon any pretence to value tax liabilities using arms-length prices on intra-firm transfers "horrified the international community, almost as if the misguided state authorities were breaching some infallible religious principle".²¹ Under fierce pressure from TNCs and foreign governments, every state but Alaska ended up repealing unitary tax laws.

Nonetheless, the lesson to be learned from the United States experience is not that unitary taxes are unpractical, nor politically untenable. Rather, the US case demonstrates the need to apply unitary taxes across the board. Because only a small majority of US states imposed unitary taxes, TNCs were able to play off one state against another, simply by threatening to withdraw their investments. In the end, this pressure paid dividends for the foreign TNCs. One of the first states to repent was Oregon, which rescinded its unitary tax in 1984. The incident which provoked a reconsideration of the policy was the loss of an important Japanese investment by automobile manu-

¹⁹ To our knowledge the first author to argue that countries ought to abandon the separate-accounting approach in favour of a formula apportionment approach was Musgrave (1973).

²⁰ Much of this account of the United States experience in the application of unitary taxes is drawn from Glickman and Woodward (1989 pp.210-213). See also Hines (1996b).

²¹ In the event much of the outrage was exaggerated. For instance despite Japanese TNCs' well-known antipathy towards the state's unitary tax law California managed to attract more Japanese investment than any other state. Of 295 new manufacturing plants announced by Japanese companies from the early 1970s up to 1985 109 (37%) went to the Far West with California dominating the picture (Glickman and Woodward 1989 p.210).

facturers Mitsubishi, an investment which finally went to North Carolina.²² The campaign against the unitary taxes reached a showdown in Sacramento, where lobbyists for the TNCs argued that California would lose investment dollars if the method of assessment was not repealed. By the end of 1980s, only Alaska had managed to resist the pressure to capitulate and abandon the unitary tax code.²³

Arguably, however, the scenario would have been very different if worldwide unitary taxes were imposed across the 50 US states simultaneously. The United States is such an important market for foreign companies that a massive withdrawal of foreign investments would have been inconceivable. The same is also true of the European Union (EU) - any single member State acting on its own is likely to have to confront a barrage of complaints and threats from TNCs. But concerted action simultaneously on the part of all fifteen member States would make it very difficult for TNCs to take any evasive action. For instance, the EU currently accounts for around 48% of worldwide sales and 56% of value added produced by United States affiliates abroad.²⁴ It would consti-

tute an important strategic error on the part of most TNCs to withdraw from such a market simply to avoid tax payments.

For developing countries, of course, the situation is obviously more delicate - if they try to impose new tax measures, they are far more likely to suffer the consequences of retaliation on the part of TNCs. Even here, however, experience suggests that the bark of the multinationals is often worse than their bite.²⁵ The number of cases where multinationals have actually pulled out of a country are relatively few. Even when quite draconian measures have been imposed against multinationals in developing countries, most have stayed put.²⁶ Anyhow, it is likely that the firms that might be lost as a result of the change towards a unitary tax system are precisely the firms that developing countries should not be very eager to attract anyway: highly mobile firms that do not care much about the services (education, for example) that exist in their host countries are not firms that are likely to make a big contribution to development.²⁷ In this sense, a unitary tax system could even enhance the quality of foreign investment received.

²² In fact a report prepared for the state administration on the reasons for the loss of the project to North Carolina concluded that ultimately Oregon lost the plant because market proximity was the key factor in the decision process and Mitsubishi wanted to settle close to the East Coast market. The officials also concluded that "while the unitary tax was carefully evaluated by the Japanese it does not appear to have been a critical factor in their decision to build in North Carolina rather than Salem" (cited in Glickman and Woodward 1989 p.212).

²³ California Montana and North Dakota also continue to have worldwide unitary tax systems but in these cases their use is optional for taxpayers (Hines 1996b p.1079).

²⁴ Data taken from US Department of Commerce U.S. Direct Investment Abroad Benchmark Survey 1999 [<http://www.bea.doc.gov/bea/ai/newiid.htm>].

²⁵ For instance in the March 2000 Budget the British government announced the prohibition of using mixer companies which enable British-based transnationals to lower their overall tax liabilities (Grant 2000). The British government estimated that the change would cost the transnationals some £300 million in extra tax payments. But the figure was strongly contested by business lobbies which alleged that the total cost could run into several billion pounds. Even the Financial Times however noted a "whiff of hysteria" surrounding private sector assessments of the impact of the changes. In the event the only concession that the Government offered was a nine-month delay in the implementation of the new measures. This case is especially interesting because it demonstrates the extent to which even a purportedly pro-business government like the Blair administration is capable of making big business back down if it is concerted in its action and is sure that it has got its arguments right.

²⁶ The most commonly cited examples of multinationals pulling out of a developing country are the departure of IBM Coca-Cola and Exxon from India in the 1970s. But that dispute was related to restrictions on majority ownership imposed by the Indian government and was in no way related to taxation issues.

²⁷ I am grateful to Arthur MacEwan for this point.

VI

Conclusions

This paper has argued in favour of a new unitary tax system on the profits of TNCs as a way of helping to finance development-related expenditures on social services and infrastructure. Back-of-the-envelope calculations by Oxfam UK suggest that evasion of tax by these companies is currently costing at least US\$35 billion a year in lost revenues for developing countries. Although not the only mechanism, transfer pricing is one of the principal ways through which TNCs manage to reduce their tax “exposure”. Unitary taxes would eliminate the incentive to carry out this form of pricing.

At the same time, it should be stressed that unitary taxes do not take away the ability of countries or regions to offer lower tax rates. As a part of regional policy, for instance, it might be considered perfectly acceptable to have lower corporate tax rates to avoid an excessive concentration of economic activity and to spread the benefits of economic growth toward less-developed peripheral areas. Likewise, developing countries could continue to offer lower tax rates as a way of attracting internationally mobile investment.

The advantage of the unitary tax system would be its inherent transparency - it would be far more difficult for firms to shirk their fiscal responsibilities. Hopefully, business leaders too could be made to see that a fair tax system in the long term is in their own interests. Not only would a unitary tax system simplify their accountancy practices, and allow them to concentrate valuable managerial time on strengthening their competitive advantages, but they would also benefit in numerous other ways from public expenditures on infrastructure, social programmes, etc. By improving the health and education of their employees, TNCs could also be important beneficiaries of social expenditures through higher productivity. The links are indirect, of course, and the benefits long-term ones, but the preference of direct investors for developed market economies with high levels of social protection surely suggests that responsible companies are aware of these potential benefits, and are usually prepared to make a fair contribution to funding them.

Although coordination would obviously be desirable, it is worth stressing that the imposition of a unitary tax system by any single country or group of countries does not in principle require greater coordination

between tax authorities or exhaustive international negotiations. Consolidated results are always required by company shareholders, no matter where the multinational is registered. Of course, different accounting conventions mean that reported profits will vary depending on where the company is inscribed, and for the efficient working of a unitary system, it would be convenient that all companies followed the same accounting practices. But the failure to have a completely homogeneous accounting system at the international level would not impede the application of a unitary tax by any country or set of countries which wished to apply it (though they might wish to pressure multinationals within their territory to abide by either America’s generally accepted accounting principles (GAAP) or the London-based International Accounting Standards Board (IASB)).²⁸

Fortunately, concerns over tax evasion are common to both developing and industrialized countries. The globalization of markets is giving rise to fears that traditional forms of raising revenues are increasingly threatened. An initiative to resolve these problems is thus far more likely to succeed. Concern about current trends has been expressed even within the IMF: an institution not normally associated with worries over the impact of low taxation rates. One recent paper by Fund economist Vito Tanzi (2000) warns: “while the fiscal house is still standing and looks solid, one can visualize many fiscal termites that are busily gnawing at its foundations”. The ability of TNCs to indulge in illegal transfer pricing activity is undoubtedly one of the fiscal termites to which Tanzi refers.

Of course, whatever its merits, the proposal on unitary taxes would meet with much opposition amongst business lobby groups. However, the arguments in favour of unitary taxes are sufficiently strong to prevent these political pressures from sidetracking a reform along these lines. So far, all efforts to reform tax codes have been directed towards eliminating international double taxation: measures which international

²⁸ Depending on which of these two accounting systems is used discrepancies in the reported profits can often be large. In the aftermath of the Enron and WorldCom scandals the probability of the IASB standards gaining the upper hand has been enhanced considerably. See *The Economist* (2002).

investors have obviously been very keen to support. In view of the evidence regarding the fall in effective tax rates paid by TNCs, this emphasis is manifestly unfair. Against this backdrop, the imposition of unitary taxes would provide an important impetus to reform. International legislation should provide the basis for levelling up of standards, rather than levelling down, as it has tended to do up to now. One possibility to make the proposal politically more palatable may be to lower corporate tax rates through unitary taxes. TNCs might be more prepared to countenance a unitary tax system if the base rates were lower. From the point of view of governments, too, it might be preferable to have a lower rate, but to achieve more efficient revenue collection.

The European Union is in a good position to take action on this issue. Although progress has been slow up until now, there is a growing consensus on the need to take action to prevent tax competition and tax evasion among member States (Radaelli, 1999). The imposition of a Europe-wide unitary tax system would provide a much-needed impetus to tax reform. Action by

the EU along these lines would set a good precedent which other countries could then follow. Bearing in mind the fact that approximately 85% of TNCs are incorporated in OECD countries, the OECD also represents a good forum for proposing a shift towards unitary taxes. So far, attempts to approve an international legal framework for FDI, such as the OECD's ill-fated Multinational Agreement on Investment (MAI), have only contributed to relaxing controls on foreign companies. In this context, a proposal to strengthen the ability of nation States to raise a fair share of taxes on the operations of TNCs might be sufficient to tip the balance in favour of any future agreement: support for the initiative would be broader, and developing countries would feel that they are not merely conceding ground to the TNCs, but also gaining something out of the agreement. Bold initiatives such as this are clearly required to restore greater fairness and equity to the global economic system, and should be part and parcel of any future proposals.

(Original: English)

Annex

World: Effective tax rates on United States majority owned affiliates, 1983 and 1999
(Millions of dollars and percentages)

	1983			1999			% change in effective 1983-1999 tax rate
	Foreign income taxes (1)	Net income (2)	Effective tax rate (1)/[(1)+(2)]	Foreign income taxes (1)	Net income (2)	Effective tax rate (1)/[(1)+(2)]	
<i>All countries</i>	30 122	30 600	49.6	45 791	160 490	22.2	-55.3
Canada	3 700	5 588	39.8	6 676	14 951	30.9	-22.5
<i>Europe</i>	12 075	12 503	49.1	22 464	91 467	19.7	-59.9
Austria	47	80	37.0	259	599	30.2	-18.4
Belgium	265	453	36.9	916	2 570	26.3	-28.8
Denmark	65	175	27.1	234	790	22.9	-15.6
Finland	38	54	41.3	161	282	36.3	-12.0
France	736	666	52.5	2 089	3 610	36.7	-30.2
Germany	1 316	1 766	42.7	3 513	8 375	29.6	-30.8
Greece	13	25	34.2	153	204	42.9	25.3
Ireland	31	1 090	2.8	1 141	13 147	8.0	188.8
Italy	488	744	39.6	1 869	2 235	45.5	15.0
Luxembourg	32	88	26.7	100	3 906	2.5	-90.6
Netherlands	486	494	49.6	1 825	15 669	10.4	-79.0
Norway	2 197	827	72.7	1 022	1 052	49.3	-32.2
Portugal	25	29	46.3	258	939	21.6	-53.4
Spain	137	16	89.5	899	2 439	26.9	-69.9
Sweden	132	169	43.9	424	1 617	20.8	-52.6
Switzerland	233	1 504	13.4	653	10 713	5.7	-57.2
Turkey	26	39	40.0	127	118	51.8	29.6
United Kingdom	5 800	4 197	58.0	6 266	22 602	21.7	-62.6
Others	2 842	2 805	50.3	165	460	26.4	-47.5
<i>Latin America and other western hemisphere countries</i>	2 509	5 129	32.8	4 481	26 000	14.7	-55.2
South America	1 648	1 003	62.2	1 540	3 012	33.8	-45.6
Argentina	47	392	10.7	375	350	51.7	383.1
Brazil	740	268	73.4	553	880	38.6	-47.4
Chile	59	50	54.1	172	586	22.7	-58.1
Colombia	185	125	59.7	227	475	32.3	-45.8
Ecuador	-	61	-	25	27	48.1	-
Peru	125	119	51.2	83	14	85.6	67.0
Venezuela	196	-41	126.5	39	642	5.7	-95.5
Others	-	28	-	66	37	64.1	-
Central America	422	517	44.9	2 297	6 979	24.8	-44.9
Costa Rica	-	-	-	37	40	48.1	-
Honduras	-	-	-	22	26	45.8	-
Mexico	274	-229	608.9	2 179	4 805	31.2	-94.9
Panama	85	648	11.6	10	1 939	0.5	-95.6
Others	62	98	38.8	49	170	22.4	-42.3
Other western hemisphere countries	439	3 610	10.8	644	16 009	3.9	-64.3
Barbados	7	141	4.7	158	1 337	10.6	123.4
Bermuda	36	1 664	2.1	238	8 175	2.8	33.6
Dominican Rep.	9	26	25.7	15	509	2.9	-88.9
Netherlands Ant.	221	1 283	14.7	-	-	-	-

(continuation)

	1983			1999			% change in effective 1983-1999 tax rate
	Foreign income taxes (1)	Net income (2)	Effective tax rate (1)/[(1)+(2)]	Foreign income taxes (1)	Net income (2)	Effective tax rate (1)/[(1)+(2)]	
Trinidad and Tobago	140	100	58.3	-	-	-	-
Common wealth islands of the Caribbean	1	286	0.3	85	4 817	1.7	397.7
Others	27	110	19.7	148	1 171	11.2	-43.1
<i>Africa</i>	4494	724	86.1	2 039	2 242	47.6	-44.7
Egypt	(D)	515		125	461	21.3	-
Nigeria	1 421	357	79.9	1 096	960	53.3	-33.3
South Africa	272	388	41.2	99	169	36.9	-10.4
Others	4 494	724	86.1	720	652	52.5	-39.1
<i>Middle East</i>	2 162	516	80.7	1 022	1 343	43.2	-46.5
Israel	53	90	37.1	110	342	24.3	-34.3
Saudi Arabia	461	104	81.6	29	206	12.3	-84.9
United Arab Emirates	1 618	292	84.7	133	163	44.9	-47.0
Others	29	31	48.3	751	632	54.3	12.3
<i>Asia and Pacific</i>	7 810	9 261	45.8	9 054	24 126	27.3	-40.4
Australia	989	597	62.4	1 020	3 157	24.4	-60.8
China	-	-		249	912	21.4	-
Hong Kong	73	662	9.9	450	4 111	9.9	-0.7
India	32	21	60.4	134	-27	125.2	107.4
Indonesia	2 383	1 779	57.3	1 069	2 249	32.2	-43.7
Japan	764	776	49.6	4 136	4 848	46.0	-7.2
Korea Republic of	31	88	26.1	361	787	31.4	20.7
Malaysia	213	431	33.1	228	1 601	12.5	-62.3
New Zealand	37	74	33.3	78	106	42.4	27.2
Philippines	83	59	58.5	214	724	22.8	-61.0
Singapore	109	631	14.7	524	3 905	11.8	-19.7
Taiwan	43	184	18.9	297	980	23.3	22.8
Thailand	36	40	47.4	218	647	25.2	-46.8
Others	3 017	3 919	43.5	78	127	38.0	-12.5
International	104	384	21.3	55	360	13.3	-37.8
<i>Addenda:</i>							
European Union ^a	9 232	9 698	48.8	20 106	78 984	20.3	-58.4
OPEC ^b	8 342	2 690	75.6	2 996	4 648	39.2	-48.2
Developed countries ^c	17 565	19 538	47.3	34 374	114 529	23.1	-51.2
Developing countries ^d	12 557	11 062	53.2	11 417	45 961	19.9	-62.6

Source: Prepared by the author on the basis of US Department of Commerce data [<http://www.bea.doc.gov/bea/ai/newiid.htm>].

^a Consisted of 10 countries in 1983 and 15 in 1999.

^b Organization of Petroleum Exporting Countries.

^c Developed countries include Europe Canada Australia New Zealand and Japan.

^d Developing countries include the rest of the world.

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