Group of 20 (G20)

I. The Development Agenda

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Backdrop of Global Crisis

- The global financial crisis of 2008–09 led to a collapse of confidence, comprised deep breaches in economic fundamentals including excessive bank credit, build-up of private consumption based on uncollateralized loans, and an inexorable rise in public debt.
- Remittances slowed down, export demand weakened, export credit dried up and capital flows dwindled.

Emergence and Role of G20

- The G20 provided the critical mass needed for building global consensus for mobilizing resources to fend off the impending economic crisis.
- The G20 embarked on re-regulating the financial sector, correcting macroeconomic and development imbalances, and providing for global public goods.
- The G20 initiated a series of reforms in the financial sector. Stimulus packages were formulated in the form of unprecedented bail-outs as well as the recapitalization of banks and financial institutions to loosen a severe liquidity crunch.

Role of G20 contd.

- The G20 also initiated a series of measures to identify and check global macroeconomic imbalances, introduced measures to check friction in global monetary arrangements, enhanced financial safety nets, and supported the use of capital controls under certain extenuating circumstances.
- Perhaps most importantly, the G20 ensured that members opted for national policies that were not detrimental to the recovery of others, and agreed to avoid premature withdrawal of stimuli and exit from the programmes in a coordinated way.
- The G20 is broadly perceived to have delivered on the immediate goal of preventing the crisis from deteriorating into a full-blown depression and the global economy was perceived to recovered well in 2010.

Development Agenda

- In 2010, the time appeared to be ripe for reorienting and expanding the G20 agenda to include developmental issues.
- The G20 had to tread carefully as several matters were being dealt with elsewhere in multilateral organizations.
- Some commentators argued that, rather than embarking on its own delivery framework, the G20 should restrict itself to encouraging cooperation among international organizations, coordinating domestic policies of member countries and extending knowledge to non-members.
- Nevertheless, the G20 included a development agenda - achieving global food security, controlling commodity price volatility, recycling global savings to boost infrastructure investment, and enhancing energy and environmental sustainability.

Role of Developing and Emerging Economies

- Brazil, Russia, India, China and South Africa (BRICS) were well placed to influence, support and even lead agenda on specific issues and contribute to global economic discussion and policy settings, while **reaching out to fellow emerging and developing economies**, having a high stake in and possessing decisive power towards global recovery in the short run and global governance in the longer run.
- The current volume discusses the role of developing economies, with special reference to India, in the success of the G20 process with a focus on its development agenda. It delineates the possible barriers to their enhanced involvement in the G20 and in global governance in general.
- This volume is organized in correspondence to the major development themes especially global public goods such as recycling global savings for development, and financing investment in global food and energy security, green growth and environmental sustainability.

Recycling Global Savings

- Recycling global savings to finance infrastructure investment in developing countries:
  - Co-existence of a persistent gap in infrastructure investment while excessive savings persist elsewhere, represents a serious drawback in converting savings into investment at the global level.
  - Underlying this is the need to rebalance the current accounts of surplus countries vis-à-vis deficit countries for **international burden sharing is crucial**.
  - It would certainly provide an opportunity for removing structural impediments to growth in developing countries where the demand for investment lies.
  - However, recycling of global savings is inhibited by maturity mismatch risks.

Energy Security

- Issue of energy security addresses the costs and benefits of energy subsidies as their intent and impact vary substantially across the G20.
- OECD countries provide subsidies to ensure regional employment and energy supply security, while developing economies aim at managing prices of basic goods and services in which energy is a key input reaching out to vulnerable end-users.
- This section weighs the cost of membership at the International Energy Agency (IEA) and the loss of policy autonomy, against the fact that the non-members, including India, would enjoy the positive externalities of global oil stabilization measures taken by IEA.

Environmental Sustainability

- The issue of environmental sustainability discusses global initiatives on climate change and adaptation financing in the context of global equity and economic efficiency.
- The G20 brought issues such as fossil fuel subsidy reform, climate change finance and energy efficiency into the mainstream debate that were earlier dealt with by specialized multilateral arrangements usually lacking adequate support.
- The G20 has been able to fill the space and provide much needed political backing.

II. G20: The Global Taxation Agenda

Base Erosion and Profit Shifting (BEPS)

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Emergence of BEPS

- In the wake of the 2008 global financial turned economic crisis, the G20 took up a global macroeconomic agenda followed by a development agenda, the subject matter of two edited volumes (Shome, 2014, 2015a) preceding the proposed one.
- Subsequent to **Global Finance** and **Development**, the G20 directed its focus on the mobilisation of resources by governments as global resources mobilised through **International Taxation** dwindled with the onset of the 2008 global financial crisis that soon converted to a global economic crisis (Shome, 2011, 2012, 2013).
- The low tax revenue offered by multinational enterprises (MNEs) on a global basis, attracted attention of several advanced and emerging economy governments suffering lack of financial resources with its accompanying adverse socio-economic effects .

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- The G20 assigned the OECD to the task of initiating analysis and suggesting appropriate measures to stem the MNEs' global tax **base erosion** through **profit shifting (BEPS)** among parents, branches and subsidiaries.
- Accordingly, the OECD issued fifteen Action Points on 5th October, 2015 with commensurate analysis and recommendations to contain BEPS and its ramifications worldwide (OECD 2013a, 2013b, 2014, 2015).
- Selected advanced economies are already introducing income tax rules to reflect the BEPS Action Points:
  - ➢ There is also a fear that the pendulum may swing too far by requiring MNEs to meet BEPS obligations that may turn out to be difficult at best and impossible at worst, stunting, in the process, global economic activity and growth.

Firm Behaviour: Econometric Approaches

- There are few studies that have examined differences in the behaviour of non-domestic as opposed to domestic firms in terms of different types of remittances they make abroad such as interest payments or royalties at a given level of domestic parameters such as borrowing or sales or firm revenue or income.
- Or, to ask if, at the same level of firm revenue or income, non-domestic firms pay higher or lower corporate tax than domestic firms.
- Several such questions should be posed and answered to get an inkling of how MNEs tend to react to taxation and tax differentials across the globe. Currently I am attempting to test these hypotheses with an econometric approach using panel data containing time series and cross section data of resident and non-resident firms operating in India.

Discussion of Selected BEPS Action Points

- The BEPS Action - comprises 15 Actions Points.
- Action 1 addresses the emerging taxation challenges from international business carried out through the digital economy.
- Action Points 4, 7, 8, 9 and 10 are aimed at protecting the tax base associated with value creation and thereby preventing base erosion.
- Others address ever newer challenges.
- Some of them are selectively considered below.

Action 8:Aligning Transfer Pricing Outcomes with Value Creation

- One orientation in the BEPS Action Plan is to evolve a scheme of taxation based on ‘value creation’.
- The focus is on cross-border transactions involving capital – both financial and ‘intangibles’ such as goodwill or reputation.
- The idea is to ensure that a legal owner of intangibles will become less relevant while activities performed within the intangibles cycle of development, enhancement, maintenance, protection and exploitation will become more relevant.

Action 7:Preventing the Artificial Avoidance of Permanent Establishment Status

- This Action is aimed at amending the definition of permanent establishment (PE).
- The current definition of PE, through exclusion, allows an entity resident in one state to carry on substantial economic activity in another state without being legally required to pay any tax in the latter state.
- The amended definition would align the taxation to value creation to economic activities being carried on in the other state to capture a wider tax base internationally.

Action 4:Limiting Base Erosion Involving Interest Deductions and Other Financial Payments

- Intra-group financial payments are often used to reduce the tax burden by MNEs. Entities in low tax jurisdictions are over-capitalized while thin capitalization is employed in entities in high tax jurisdictions.
- Intra-group financial payments such as interest expenses, financial and performance guarantees, derivatives, and captive insurance arrangements have lowered the tax base in countries where economic activities are actually carried out.
- To counter it, the tax base on account of value created through economic activity carried in a state would be protected against base erosion through Action 4. It would limit the deductibility of interest expense and other financial payments.

Action 9

- This Action narrows down on transfer pricing of risks and capital.
- It would address how transfer pricing principles may be used to achieve the objective of preventing tax base erosion using interest deductibility.

Action 1:Addressing the Tax Challenges of the Digital Economy

- This Action deals with tax challenges of the digital economy and addresses the flip side of value creation which is value consumption.
- It would evolve a scheme of taxation based on the digital footprint in the state where the consumption of products and services occurs.
- However, the OECD’s recommendation on Action 1 has turned out to be weak, pushing the primary analysis to a future date.

Action 13: Apprehension of BEPS Overreach in Accounts and Administration

- An increasing cynicism of BEPS comprises the likely impact of the proposed new documentation requirements under BEPS on MNEs.
- It is being proposed that MNEs operating in multiple jurisdictions have to meet tax compliance requirements of each of the jurisdictions in which they operate.
- For enhancing transparency, tax administrations would require:
  - A ‘master file’ containing information relevant for all MNE group members, providing a high–level overview of their global business operations, transfer pricing policies, and global allocation of income and economic activity. The master file is to be made available to all relevant country tax administrations.

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- A ‘local file’ containing detailed information on all relevant material on intercompany transactions in each country to be provided to such country’s tax administration; and
- A country–by–country (CbC) report containing certain information relating to the global allocation of the MNE group’s income and taxes paid, together with certain indicators of the location of economic activity within the MNE group.

Challenges

- Challenges faced by MNEs in preparing stipulated TP documents appear to be many. The biggest challenge would be when companies within the group operate on a decentralized manner and/or follow different transfer pricing methodologies for similar businesses.
- The understanding is that the master file, local file and CbC report should be reviewed and updated annually.
- The question remains whether the preparation of such detailed reports would justify the cost of compliance.
- Some companies within an MNE group may operate in a particular jurisdiction and not in all the jurisdictions.
- Some countries may require the new TP reports to be prepared at a group level.
- It may be irrelevant to prepare such reports when many of the subsidiaries of the group do not even operate in those countries or the scale of operations is minimal.
- This may result in preparing and providing information to tax authorities which is of little significance.

Which Method to Adopt

- Irrespective of the transfer pricing documents prepared, the primary challenge for any MNE group and the tax authorities is in determining the most appropriate method for allocating taxable income.
- That challenge could continue under BEPS while escalating compliance costs.
- It is imperative that the BEPS exercise does not ride over the wheel of global economic activity.
- The emerging danger is that OECD’s BEPS exercise will have receding support not only from MNE’s but also from important country authorities.

Other Action Points

- Most other Action Points are geared towards what is widely termed as ‘anti-abuse’ in taxation parlance.
- This indicates an established perception that all—rather than a few in selected sectors of economic activity—MNEs have been able to legally ‘avoid’ tax globally, a presumption that could be erroneous.
- Here the term used by accountants and lawyers is ‘tax efficiency’ that is, minimizing tax payment legally, which is distinct from the use of the term by economists who use it to denote that a tax should have at best minimally distortive effects on the relative price structure among goods and services in the economy.

Conclusions

- Through the BEPS process, the tax sovereignty of a nation should not be impeded, yet, the protection of its tax base should be achieved, harmful tax practices discouraged, and the likelihood of best practices being adopted should increase.
- Countries are joining together to exchange information, share formats of Transfer Pricing documentation, co-operate in sharing experiences of harmful tax practices, and discuss ways of dispute resolution.
- BEPS should continue to provide guidance on these matters, help evolve consensus on a common approach, influence treaty negotiations, yet leave the domain of tax legislation to the sovereign.

Conclusions contd.

- Yet concerted and consistent action by countries to discourage harmful practices on a cooperative basis would be needed for success of BEPS. This is not apparent yet.
- As long as they do not yield to a common understanding and approach, gaps in the interplay of their respective domestic laws would remain. And opportunities to arbitrage on these differences would continue.
- On the other hand, it has to be safeguarded that the BEPS exercise does not result in a menu of too harsh a set of demands on MNCs with their increasing compliance costs posing binding constraints on their operations.