A podcast about the economics of trade & policy
with Chad P. Bown

Episode 165. The global minimum tax got left behind. What's next?

Episode webpage

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Transcript

(lightly edited)

Chad Bown: On August 16th, American President Joe Biden signed into law the Inflation Reduction Act of 2022.

President Joe Biden: *I'm about to sign the Inflation Reduction Act into law, one of the most significant laws in our history. Let me say from the start: With this law, the American people won and the special interests lost.*

Chad Bown: Politically, this was a huge win for the president. Economically, this law is also massively important for US policy. The Inflation Reduction Act helps climate policy by including tax credits for clean energy. It reforms the US healthcare system, allowing the government to negotiate prices for certain prescription drugs.

For the tax code, the Act also included some new provisions for America's corporate taxes.

President Joe Biden: *We're cutting the deficit to fight inflation by having the wealthy and big corporations finally begin to pay part of their fair share. Big corporations will now pay a*

minimum 15 percent tax instead of 55 of them got away with paying zero dollars in federal income tax on $40 billion in profit.

Chad Bown: But at the same time, something was missing. For multilateral cooperation and international tax, Congress chose not to include a global minimum corporate tax.

What a global minimum corporate tax is, and why that matters, is the topic of today's show.

You are listening to an episode of *Trade Talks*, a podcast about the economics of trade and policy. I'm your host, Chad Bown, the Reginald Jones Senior Fellow at the Peterson Institute for International Economics in Washington.

To help us make sense of what the Inflation Reduction Act means for multilateral tax cooperation, we're going to speak with Kim Clausing. Kim is a professor at UCLA. Until June she was the Biden administration's Deputy Assistant Secretary for Tax Analysis in the US Treasury, and she's also now my colleague here at the Peterson Institute.

Chad Bown: Hi, Kim.

Kim Clausing: Hi, Chad. Thanks so much for having me.

THE INTERNATIONAL TAX SYSTEM'S ORIGINAL PROBLEM: DOUBLE TAXATION

Chad Bown: Unlike the world of international trade, in the world of corporate tax, there is no multilateral tax system.

Where did the existing system come from historically?

Kim Clausing: So we don't really have a body of international tax law in the sense of having an international authority that determines who gets to tax what income.

What we do have are national laws and subnational laws and treaties between countries. And those treaties were often focused mostly on the problems of double taxation and making sure that when companies invested in one country, they weren't taxed both by that country and by somewhere else on the same exact income.

Chad Bown: That international tax system – that was originally worried about double taxation or taxing the same company twice and discouraging its investment – well, that began after the first world war, when global economic activity was much more fixed.

Over the 20th century, things became a lot more mobile.

First, you had containerization in, in better shipping. And then lower trade policy barriers, like import tariffs. This, combined with information technology, gave rise to multinational companies who were able to move their production around the world to benefit from comparative advantage. These companies could make stuff in one place where it was relatively low cost, and then rely on international trade to get it to their customers.

Chad Bown: When was it historically that we first started to see some tax jurisdictions just offering extremely low rates with the intention of either attracting economic activity or maybe for something else?

Kim Clausing: I wouldn't say that it's a brand new thing, that there were very low tax rate countries. Even if you go back 50 years, you can find jurisdictions that offer very favorable tax treatment.

It's certainly the case that if you go back three or four decades, the typical corporate tax rate was quite a bit higher than it is now. It's just the sort of proliferation of jurisdictions that are trying that strategy and the response of the higher tax countries, which has been to systematically lower their tax rates in order to try to make their locations competitive with these lighter tax jurisdictions, that problem has really been several decades in the making and somewhat gradual, I would say.

Chad Bown: By the end of the 20th century, some feared that governments were using lower taxes to try to attract foreign direct investment. The ability of these multinational companies to break up their production process – to make some parts in one country, other parts in a foreign country and assemble them in a third country – well, that sparked concerns over offshoring.

For politicians in a country like the United States, another government using low taxes as a way to attract foreign direct investment was just code for stealing jobs.

Chad Bown: How big a problem did *that* ultimately end up being – i.e., the physical movement of productive activity to be able to take advantage of low tax jurisdictions?

Kim Clausing: I think policy makers have often been focused on economic variables, such as jobs and investment, because those are the kinds of activities that they really care about having at home and they don't want to lose jobs and they don't want to lose factories to other countries.

When you look at the data, there is some evidence that jobs and investment are sensitive to tax rate differences across countries, but there is much more overwhelming and consistent evidence that paper profits are where profits are reported for tax purposes are very sensitive to tax differences across countries.

What we tended to see in this space was not so much that a company would take a factory and put it on a zero tax rate island, but that the company would have the factory wherever it made most sense to have the factory, and then try to get the profits associated with that production to the zero tax rate location.

THE CHANGING PROBLEM FOR INTERNATIONAL TAXATION

Chad Bown: The fear that lower tax jurisdictions were successfully luring away factories or jobs – this never got big enough, on its own, for policy makers to do much about it. But there was this increasing concern about paper profits or companies recording profits in one place for tax purposes, even though those profits were being earned somewhere else.

As time went by, the international tax problem was changing. It went from the old worry that the same corporate income was being taxed twice, to a new worry that some corporate profits just weren't being taxed at all.

I asked Kim about other changes happening by the late 1990s to make this paper profits problem worse.

Kim Clausing: One of the big changes was changes in the regulatory environment of the United States. We had a regulation referred to as "check the box" that made it easier for companies to create income that would go entirely untaxed. They could create entities that were disregarded for tax purposes.

There were also changes in the way companies did their business. The tax division of major multinational companies became viewed more and more as a profit center. They would devote more and more of their own human capital resources and attention to this goal of really

maximizing after-tax profits, and the techniques for doing that – for making sure that the income would be lightly taxed, regardless of where it was earned – those techniques were honed and shared across the corporate community through innovation, in part in how to best move profits.

Chad Bown: In addition to those regulatory and accounting changes, another really big difference was the changing nature of what made companies economically valuable.

Something called intangible capital.

Kim Clausing: If we look over the past few decades, we've seen a rise in the importance of intangible capital relative to tangible capital. A lot of companies are creating value, not so much through the brute force combination of plants and equipment and labor, but also through their ideas and through algorithms and patents and copyrights. That extra intangible value generates a lot of profit in the modern economy, but it also generates a lot of ambiguity about where the actual profit is located.

We know where a factory is and we know where people are, but we don't always know with any precision exactly where the value comes from an idea. And because of that ambiguity, well-trained accountants and lawyers can make sure that the profit associated with those intangible assets is earned in a tax advantageous way.

Chad Bown: This ambiguity means governments and tax authorities can't really see where the value of an idea is located geographically within a company.

I asked Kim how a smart, multinational company might arrange its intangible assets across its affiliates around the world to minimize the total amount of tax that it would have to pay.

Kim Clausing: As an example, you might want your patent holder to be located in a jurisdiction that has a rock bottom tax rate. And so then when the profits associated with that patent are earned, they are paid in the form of payments and royalties to that light tax subsidiary. And that way you can arrange to make sure that globally, when you look at the entire operation of the multinational company, you're getting the tax burden as light as possible.

Some of them have these very alluring names like the "Double Irish Dutch Sandwich." And it refers to things like a chain of ownership where a company will own a company which owns a company, and it's arranged in a manner effectively such that you can actually make some of the income disappear entirely from the perspective of taxing jurisdictions.

But the basic root of all of these strategies is the same, regardless of their label – which is to get the profits reported in the lightly taxed jurisdictions.

Chad Bown: When companies want to report the bulk of their global profits in the lightly taxed jurisdictions, it's not only intangible assets that matter.

Kim Clausing: It can be also about things like where is your debt. You might want the debt payments, which are deductible, to be in high tax countries, whereas the income receipts to be in low tax countries.

It's about how you price things like your service exports within the firm or your even your intermediate inputs.

All of these decisions, whether it's goods or services or rental rates or finance – all of these can be tax influenced. It's just with intangible capital it's particularly ambiguous where it should be. And that creates opportunities for tax minimization.

Chad Bown: For what sorts of industries has this phenomenon been most important? Obviously the ones that make the headlines are the big internet companies and industries. But it's not limited to those I would think, right?

Kim Clausing: There are certainly plenty of manufacturing companies that are involved in this tax minimization objective. Pharmaceutical companies have been big players in this space, and even household consumer goods can play these games as well. (Companies that might sell coffee or hamburgers can arrange to make sure that the trademark profits associated with some of these activities are earned in a tax advantaged way.)

This isn't a game that's limited to just one sector. It's a game that really can be played throughout the economy. But we do see tech and pharma having a larger role relative to the size of their sector and in this problem than we see natural resource industries, for instance.

Chad Bown: How about the countries? If you were to come up with your list of these low tax jurisdictions, who would be on the list, and what would the criteria be that you would have to determine whether a country makes the list?

Kim Clausing: Different authors in this space use different criteria. The one that I like to use is very basic. It's just where are the jurisdictions that have the lowest tax rates. When we look at how much tax is a US multinational company affiliate paying in this country, or this jurisdiction, relative to how much (income) they're reporting there.

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We see some jurisdictions that are persistently really important in this space, in the sense of having very low tax rates and very high profits. The really big ones are Ireland, Switzerland, the Netherlands, Bermuda, Cayman Islands, Luxembourg, and sometimes Singapore. If we take that set of players, they're accounting for an awful lot of US multinational profit but not actually commensurate amounts of activity.

One of the key facts in this space is if you look at the activities of US multinational companies, the typical employee abroad is generating tens of thousands of dollars of profit. (The worldwide average is in the neighborhood of $40,000.) But if you look in these really lightly-taxed jurisdictions, you often can see profits for employees that are ten or even a hundred or a thousand times that worldwide average.

That's telling you that a suspiciously large amount of profit is being generated by each worker in a place like the Isle of Man, relative to what you see in countries like Italy or Germany.

RECOGNIZING THE POLICY PROBLEM

Chad Bown: Let's turn the clock ahead to the 2010s. Governments find themselves in this weird equilibrium. Some multinational companies are making loads of paper profits, but no one is really taxing them. Data from the very light tax jurisdictions show that the affiliates of these US multinationals are reporting millions or even tens of millions of dollars of profits per employee.

This ability to move so much paper profit offshore – to very lightly tax jurisdictions – means many companies are paying single digit tax rates on their global profits.

In terms of policy, there is finally recognition that this is a problem globally. In 2013, the OECD had kicked off a process to try and tackle it. But the OECD process is slow, the topic is super complicated, years pass, and not much happens.

And then, in 2017, we get the arrival of President Donald Trump.

The US Congress passes something called the Tax Cuts and Jobs Act. While that 2017 legislation was mainly about cutting taxes, it did introduce a sort of US minimum tax for corporations.

Chad Bown: Tell us about the Tax Cuts and Jobs Act. Maybe let's start by what it did to address some of this problem.

Kim Clausing: There's two minimum taxes, actually not one but two, in that legislation. There's something called the GILTI, which is an acronym that stands for global intangible low tax income. And that applies to make sure that on average, your tax rate on your foreign income is at least ten and a half percent, sometimes a little bit higher.

Then there's also one called the BEAT for base erosion anti-abuse tax. That's meant to be directed more at foreign headquartered multinationals.

Chad Bown: The Tax Cuts and Jobs Act has some good and some bad.

Kim Clausing: You're making it better with one hand and making it worse with another. There's still a big incentive to shift income offshore, and there's still a big incentive abroad to have a zero tax rate because when this GILTI tax is applied, it's applied on average.

If you imagine a US multinational that earns some income in a higher tax country, like Japan or France, but it's also earning income in (tax) havens, it can blend those two streams of income and basically get to a rate that's half the rate that they would have to pay if they earn the income in the United States in Ohio or Pennsylvania.

I refer to it sometimes as an "America Last Tax Policy," because your first choice would be to have it in a low tax jurisdiction abroad, but even a high tax jurisdiction abroad is better than the United States because you can use those tax credits from the high tax jurisdiction to offset the GILTI tax that would be due on the (tax) haven income, whereas the income that you're earning in Ohio doesn't have that advantage.

It has some perverse incentives in this minimum tax regime as well.

Chad Bown: One way to get around this averaging problem, found in America's GILTI minimum tax, is if it were agreed that every country would have a minimum tax.

Kim Clausing: A country-by-country minimum tax is much more effective at ending this race to the bottom in corporate taxes, because if you're a zero tax country under a country-by-country minimum tax, the minimum tax will apply to every dollar that's earned in that jurisdiction. There's no ability to offset that minimum tax with tax credits earned in a higher tax jurisdiction.

That means there's no reason for Bermuda, as an example, to have a zero tax rate anymore. They might as well have a 15 percent rate because all the income that is earned in Bermuda will be taxed at that minimum level.

Chad Bown: The Tax Cuts and Jobs Act of 2017 didn't really fix the low tax jurisdiction concern, even from the US perspective. Those problematic, lightly-taxed jurisdictions, like a Bermuda (what some call tax havens), still have this incentive to keep their tax rates low, and multinationals can keep reporting profits there under this averaging system.

And abroad, nothing has changed for the other higher tax countries either. They too remained unhappy.

Kim Clausing: The typical country broad does want to collect some corporate tax, and it's seeing that their revenues are being eroded towards these light tax jurisdictions. If we look at other rich countries with these problems – e.g., Germany, Japan, France – they're all quite concerned about this.

But the IMF has pointed out that poor countries have even more at stake.

And every country is stymied by this collective action problem. They would like to collect revenue on these mobile companies, but they're being told by the companies themselves that if their tax regimes aren't sufficiently competitive that the companies will just move activities and profits offshore.

You've got this problem that each country finds it in their own interest to keep their tax rates low and competitive, but in their joint interest, they'd much rather have the ability to have a robust tax base that doesn't just fall on labor, that doesn't just fall on consumers, but also can tax multinationals.

To really get around the competitiveness worries of companies and the competitiveness worries of governments, about making sure that their locations are attractive, you really need some sort of global agreement.

ADD DIGITAL SERVICES TAXES INTO THE MIX

Chad Bown: Let's turn now to 2018 and in 2019. The world is now firmly entrenched in this international collective action problem. To economists, this is the classic prisoner's dilemma.

Countries could collectively be much better off if they would coordinate their policies and simultaneously increase their tax rates. But individually, no one country has an incentive to raise rates by itself.

The companies are telling them, “if you do so, this will make your tax jurisdiction, uncompetitive and more paper profits will just be moved offshore.”

At the global level, nothing is happening. There is no coordination of tax changes across countries to get us out of this bad equilibrium.

Then, suddenly, some countries, most notably France in 2019, start to act unilaterally against multinational companies. But they do so selectively.

Countries begin to impose new industry specific digital services taxes, or DSTs. In the United States. Policy makers were not pleased.

Chad Bown: What was wrong with the approach that say France took when it came to DSTs?

Kim Clausing: DSTs were quite frustrating on a very bipartisan basis for US members of Congress because it was felt that many of them were highly discriminatory. Some of them were designed explicitly to target particularly large companies with features that really were almost by design solely going to be big American multinational digital companies.

And administrations, both the Trump administration and the Biden administration, threatened their governments with Section 301 investigations and tariffs in response, in order to counter what they viewed as a very discriminatory tax.

Chad Bown: France did not even pretend that its DST was non-discriminatory. French politicians branded it the “GAFA Tax” for targeting Google, Apple, Facebook, and Amazon. By design, it would really only tax these American companies.

And this painted all digital services taxes in a bad light.

Kim Clausing: You could design versions of these taxes that are not discriminatory.

Countries have taxes on cigarettes and taxes on wine, and we don't think those are necessarily discriminatory if they fall on every exporter of cigarettes or wine. You might imagine that if you had a tax that was just designed to only tax grape varietals that came from a certain region of Italy, then that would start to be a discriminatory tax, because you're really just targeting one particular country with your tax.

Chad Bown: The fact that these DSTs from France and other countries were so blatantly discriminatory against US companies created a new problem internationally.

These DSTs were structured much like a discriminatory import tariff. They were a basic violation of the WTO's Most-Favorited Nation rule. So trade policy makers started to get involved.

The US Trade Representative responded with an investigation, as Kim noted, under the US Section 301 law. Both the Trump and Biden administrations have threatened retaliatory tariffs on other countries' exports if they go ahead and implement DSTs that selectively target American companies.

The old problem of multinational tax coordination has now spilled over to become a new problem for international trade.

Heading into 2020, we were on the verge of a potential mini trade war between the United States and Europe.

But in the background, there were these multilateral tax reform negotiations going on at the OECD.

Chad Bown: The OECD talks have been ongoing now for 5, 6, 7 years, and the United States has been involved.

By 2020, what was the Trump administration's position on progress at the OECD on this issue?

Kim Clausing: The Trump administration didn't have a position that was well aligned with the Europeans or others in this area. They thought that US multinationals might not be advantaged by this global agreement. They suggested that they might step aside, or implement it in an optional way, or that there might be safe harbors that would exempt US companies from the scope of this international agreement.

It was basically a death knell to the agreement to not have US companies be involved, or to be only optionally involved, because they're such a big part of the entire world community of multinational companies.

JOE BIDEN CAMPAIGNS ON TAX REFORM

Chad Bown: Let's turn now to the summer of 2020.

The OECD process on multilateral tax reform has stalled. There are threats of DSTs and US retaliatory tariffs.

But in a democracy like the United States, 2020 is also election season. President Donald Trump is campaigning against Barack Obama's former vice president, Joe Biden. Tax reform was a big part of then candidate Biden's platform.

Chad Bown: Were you, at that stage, involved in helping to draft what the potential international tax positions of a future Biden administration might look like?

Kim Clausing: Over the summer, alongside many others, I was part of informal expert committees that were giving advice to the Biden campaign and to the upcoming hopeful transition. And one of the big areas that the Biden campaign was interested in tax was this international tax realm, in part, because there's a lot of money on the table there.

If we look at how much we could raise through serious taxation of the foreign income of US multinational companies, it looked to be a lot. But there was also arguments that the tax code could do a better job in terms of efficiency here as well. A lot of the companies that we've been talking about are companies with not just the normal return to capital, but with these excess profits. And we, as economists, we think that the excess profits are relatively efficient to tax, and that this tax is mostly born by those at the top end of the income distribution.

You've got a chance to make the tax code fairer, with respect to vertical equity, such that rich people are paying more relative to poor. You've got a chance to make it more efficient, because you're falling mostly on excess profits. And you've got a chance to discourage offshoring and profit shifting, because there's this huge advantage associated with earning income offshore, relative to what you would pay if you're earning income in Ohio.

All of that made it a very attractive area for reform. The Biden campaign actually suggested a country-by-country minimum tax of 21 percent.

Chad Bown: As everyone knows, Joe Biden wins the 2020 election.

In one of the very first priorities of the new US administration is to quickly restart multilateral tax reform negotiations through the OECD process.

Chad Bown: The Biden administration takes over on January 20th, 2021. You arrive at Treasury shortly thereafter.

I know you're not a tax negotiator – certainly that was Secretary Yellen – but what can you tell us about how the process worked for rebooting those (OECD) talks, and then how they played out over the course of the first year of the administration?

Kim Clausing: Almost everybody, even the optimists, were surprised with how swift the progress was and how quickly this agreement came together.

There was an agreement announced at the October meetings of the G-20 that approximately 135 countries had agreed to the basic political outline of this international tax agreement, to a global minimum tax, that would tax on a country-by-country basis all multinational companies in the world. That set of countries is about 95 percent of world GDP. It's really just a huge achievement came together very quickly.

There were some bumps in the road. There's some low tax jurisdictions that were, understandably, reluctant. And there was a lot of negotiation around the rate. I think 15 percent was an achievement that – even though it was lower than the US negotiating position, we wanted 21 percent that's what we wanted to do domestically, it would be ideal if everybody did that, but you know, 15 percent is still quite a bit higher than, than observers thought we might get at the beginning of the year. To bring countries like Ireland along, Ireland really would've preferred probably 12 to 15.

Getting all of the low tax jurisdictions on board was difficult. European Union unanimity has been a constant thorn in the side of this process because to get action from Europe, it's easiest if they all agree. And so that was a very arduous process.

But it was amazing to all of us that it came together so quickly and that political agreement was so swift.

CAN THE MULTILATERAL TAX DEAL MAKE IT THROUGH US CONGRESS?

Chad Bown: In less than a year of negotiations under the new US administration, we suddenly have this amazing political agreement for multilateral tax cooperation, between more than 135 countries.

But things are not done. The next step is equally hard. The agreement needs to be implemented, domestically, by each of the countries, including the United States.

Right after this deal is agreed in October, US Treasury Secretary Janet Yellen says that, “This deal paves the way for Congress to enact these proposals, and I'm hopeful they'll do so swiftly.”

Chad Bown: It looked like the US got off to a good start. So tell us what happened in November.

Kim Clausing: So in November the House passed legislation that was fully consistent with the international agreement and also did a lot of other important tax measures. It passed in a fairly partisan manner, but it was passed.

It included a 15 percent, country-by-country, minimum tax and, in fact, a tougher base erosion anti-abuse tax that was meant to also encourage other countries to adopt.

Had the Senate followed suit, that would've been an excellent kickstart to this process. And I think it would've encouraged the Europeans and others to adopt very swiftly.

Chad Bown: Spoiler alert. The Senate would never pass the November 2021 version of that legislation.

For us policy nerds. I wanted to ask Kim how writing this sort of tax legislation works in the United States and how involved she and the Treasury team were in November 2021.

Kim Clausing: So there are two major tax writing committees in the US Congress – the House Ways and Means (Committee) and the Senate Finance Committee. And these two groups were both involved in drafting international tax legislation.

Treasury has a role in providing technical assistance on how to write these bills in ways that won't open up inadvertent loopholes and also in setting priorities. And as part of this international negotiation that Secretary Yellen was deeply engaged in, and in fact played an enormous leadership role in, one of the things that Treasury would communicate to Congress is which elements of the legislation were absolutely crucial to make this agreement happen.

Congressional tax-writing committees were in close collaboration with Treasury about making sure that international tax reform could work alongside this negotiation. It was a collaborative and I think quite successful endeavor, regardless of the fact that it didn't get across the line ultimately in the Senate.

Chad Bown: US politics in the Senate just wouldn't let it work out.

Kim Clausing: It was very exciting when the House passed the legislation, but everybody expected that the road in the Senate would be more difficult.

As you well know, the Senate is like a 50-50 balance. So that means that there is absolutely no margin for error. You have to bring all 50 of the Democratic senators along. The Republican senators showed zero interest really in anything that would raise taxes and, in particular, that

would claw back any of the Trump tax cuts from the Tax Cuts and Jobs Act. So we knew we weren't going to get help from the Republicans senators.

THE INFLATION REDUCTION ACT OF 2022

Chad Bown: To get the legislation passed you need all 50 Democratic senators, and there are some who are not on board with everything in that House bill, including Senator Joe Manchin of West Virginia.

So that version of the legislation died in December 2021.

In the first half of 2022, senate leaders and the Biden administration tried to kickstart negotiations with Senator Manchin, time and time again. But it's just not happening.

And toward the end of July, it looks like this tax legislation is finally dead. Congress is about to head off on vacation. And in the fall, they are going to be way too busy campaigning for reelection to get it done.

But then, suddenly, on July 28th, we get a surprise.

CBS News / Bloomberg: *We begin with a big surprise in Washington on a bill that could affect Americans for generations… There is a deal that breaks the long deadlock on major parts of President Biden's economic agenda. Democratic Senator Joe Manchin of West Virginia and Senate Majority Leader Chuck Schumer have agreed on a tax, energy, and climate bill…*

Chad Bown: So when they ultimately got a deal at all in late July, how surprised were you?

Kim Clausing: I was surprised. I'm an optimist, so I had often hoped that the sheer logic of a lot of these reforms would drive people to get it done.

I think we were all very happy when they got some of it done, because there's some really important things in that Inflation Reduction Act that was ultimately passed and signed in August.

Chad Bown: And I presume, when Senators Manchin and Schumer were hashing out their deal on July 28th, that their committees were not calling Treasury to keep them abreast of all of the last minute changes?

Kim Clausing: No. That was a very well-kept secret. I wasn't there at the time, because I had left a bit earlier, but my understanding is that that was one of the better kept secrets in Washington. And that surprised a lot of people, including a lot of people in the administration.

Chad Bown: The Inflation Reduction Act of 2022 has a lot of really important stuff in there. On climate, on healthcare and on tax reform. It is pretty amazing.

But there is also a problem with it. A big chunk of the November version of the legislation, that Kim told us about, has now gone missing. There's nothing in there about multilateral tax.

In the end, the global minimum tax part had been stripped out.

Kim Clausing: I think the international tax part did face really strong headwinds. By the time mid-summer rolled around, it wasn't clear anything was going to get done, but also the probability of doing the international part seemed quite low.

The omission of the international tax reform was the biggest disappointment. Even though we celebrated the climate action, the funding of the IRS, lowering healthcare costs, and other achievements of that legislation, it, it was unfortunate that they left international tax behind.

INTERNATIONAL TAX WAS LEFT BEHIND

Chad Bown: In the Inflation Reduction Act of 2022, international tax was left behind. The United States did not go first and change its tax system to comply with the October 2021 multilateral deal. It will not have helped spur other countries to also raise their taxes.

We've not yet fixed the global collective action problem.

Chad Bown: Let's talk about what is in the Inflation Reduction Act and what's not in there. So there is something about minimum taxes of 15 percent, but it's not the global minimum tax of 15 percent that is the OECD deal.

Kim Clausing: Yes, there was a lot of confusion at the time, including people calling me up to congratulate me because they thought that somehow that international tax was part of the legislation.

The legislation did adopt a corporate alternative minimum tax. It happened to be 15 percent, so it did have a lot of commonalities on the surface with this international tax deal. But there's

some really important differences in practice that mean that the US minimum tax is not compliant with the deal and won't really solve the problems that the deal was meant to solve.

To unpack that a little, this 15 percent tax that was actually adopted is not a country-by-country minimum tax. What that means is that there's still every incentive for very low tax jurisdictions to offer 0 percent because that 0 percent tax rate can generate income that offsets tax that would be due in these other high tax country jurisdictions.

You are not going to end the race to the bottom in corporate taxation if you're not providing some sort of floor. Without the country-by-country feature, there is no floor, because there's always an incentive to undercut the floor because you can average streams of income across countries.

Chad Bown: The minimum tax in the new US legislation does not have the country-by-country feature. So it is not compliant with the multilateral deal agreed in October 2021.

This has implications for US companies in jurisdictions that are implementing the OECD agreement.

Kim Clausing: This means that, from US companies' perspective, they could end up paying both this US corporate alternative minimum tax, but not being compliant with other countries' adoption of this global minimum tax. Then they could also fall prey to these top-up taxes abroad that are meant to implement that global minimum tax.

From US companies' perspective, it's kind of weird that the United States one isn't matching all the others. It means that there's some situations where they may end up paying both of them. There's also some situations where they're still going to have opportunities to shift profits to low tax jurisdictions.

We haven't really solved that international collective action problem that we were hoping to solve. It's a step in that direction. Some people think this could be a bridge toward US compliance, but it's not compatible with the agreement.

To the extent that it's helpful I really think it's helpful at levying some tax on some of the same firms. So then it might be less traumatic that to then take the extra step toward this global minimum tax because you're closer to that outcome than you used to be. But it's rather different from the global agreement.

Chad Bown: US companies could end up getting taxed anyway. Because the US government has not hit them with the 15 percent minimum tax another country could top up their taxes to collect it for themselves. Then the really big question is, what happens next?

Chad Bown: What are the different ways that the US government could respond when it sees that happen?

Kim Clausing: One way is that US says, OK, it looks like it would make some sense to change our laws because our companies are going to be facing these tax burdens regardless. They might as well pay the US government and serve US fiscal needs rather than paying foreign government. So we should align with this agreement because that's the right step forward. It'll provide more certainty for the business community because all countries will have similar thoughts on what the corporate tax base should be and what corporate taxing rights should be.

Another possibility is that a different-minded administration is in power by the time this all arises. They start to see US companies getting hit by these taxes and they respond by lashing out and starting trade wars and breaking down collaboration in this issue instead. You could imagine that scenario as well, where the US government is like, listen, we don't want you taxing our companies. And so we're going to respond by putting on tariffs or something like that.

A third route is that the agreement just falls apart. Without US participation, other countries don't see the reason to go forward. They don't call our bluff, and we resort to this equilibrium we were in before where some countries levy DSTs and others just kind of go without.

Chad Bown: And in that third equilibrium, the entire OECD process gets abandoned. There is no international cooperation on taxing multinational companies.

Kim Clausing: I think that would be particularly unfortunate because, as you well know, there's just a host of global collective action problems that we need to solve as a community including most importantly climate change, but also including a lot of other areas like public health, responding to national security threats and the like.

I think multilateralism is a really important thing to build up rather than tear down at this moment. So I'm hopeful that this agreement will go forward, because I think there's a lot of really useful lessons in the agreement for collaboration in other areas, including the importance of the enforcement principle and including the importance of leadership.

Chad Bown: To wrap things up, I too hope this agreement goes forward and this setback is not the end of the story for multilateral tax cooperation.

Since the US has failed at going first, maybe some other country will show the courage at taking the lead on implementation. Canada or Japan or Australia – maybe the EU can overcome its internal challenges with bringing Hungary on board – and implement the reforms demanded by the multilateral deal.

Then, after the US midterm elections in November, maybe Congress comes back to the issue. It sees the silliness that other tax jurisdictions are now collecting revenue from these multinational companies that the multilateral agreement allows the US government to collect, if Congress would just implement a country-by-country minimum tax.

We'll see.

Chad Bown: Kim, thanks so much for explaining all this to us, and thanks as well for your government service.

Kim Clausing: Thank you so much. It's really always a pleasure to talk to you.

GOODBYE FOR NOW

Chad Bown: And that is all for *Trade Talks*.

A huge thanks to Kim Clausing at UCLA, former Biden administration Deputy Assistant Secretary for Tax Analysis in the US Treasury, and now also my colleague here at the Peterson Institute.

Thanks and apologies to UCLA law student Joel for my interview with Kim running long and interfering with her office hours.

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