WILL THE GAINS OF TAX REFORM OUTWEIGH THE PLAN'S ADMINISTRATIVE COMPLEXITY?

EXPERT VIEW

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The uncertainty from mutating coronavirus has not spared national public finances. Since 2020, countries across the world have confronted higher fiscal deficits and rising costs of borrowing. The International Monetary Fund predicts that this trend will not be reversed anytime soon. The period has also been marked by increasing salience of inequalities. For one, the stock markets have soared despite the impact on growth. All these factors have encouraged governments to consider reforming the archaic tax system laden with incentives and prone to avoidance. For example, the US is seeking to undo rate cuts by the Tax Cuts and Job Act in 2017, while considering a mark-to-market tax on financial instruments, whereas the UK explored, though unsuccessfully, the revision of capital gains tax.

Tax increases are an unpopular reform, and are acceptable in precarious times such as war where government assumes unparalleled significance in daily life. But with sporadic lockdowns, the situation is not comparable to war. Conscious of such a reality, India has adopted a more pragmatic approach by resisting the temptation to raise taxes. In its place, the government has reached out to and made peace with large and small taxpayers, be it through dispute settlement under Vivad se Vishwas, introduction of faceless assessments, taxpayers' charter, or the surprise reversal of the retrospective tax on offshore indirect transfers, signalling confidence in the tax system.

The OECD took charge of the global tax negotiations. AFP

While domestic tax reforms are still in the offing, efforts to reach a global agreement on taxing cross-border incomes of MNEs have somewhat reached fruition. The pandemic was among the precipitating factors. For nearly three years, countries were in a logjam over who receives the right to tax supernormal profits of large tech giants and on what basis. Then with the pandemic and its impact on profitability of large MNEs, many market countries such as India, UK, Spain and Italy unilaterally implemented a digital services tax. The US did not take well to this development, especially since many of the technology giants are US-headquartered. To bring order to chaos, the Organisation for Economic Co-operation and Development (OECD) took charge and sped ahead with its proposal. It was amply clear that the US' acceptance of the proposal was a clincher for reaching an agreement and so the proposal was recalibrated many times.

The US' domestic spending plan was predicated on increased revenue. This could not be realized if other countries continued to offer incentives and exemptions to shifty capital. Therefore, the US joined the talks actively in July, with the suggestion that instead of tech giants, the world's top 100 companies must pay higher taxes. The suggestion carried into the final design of the OECD tax deal. In October, 136 countries agreed to share a fourth of profits in excess of 10% of companies with global revenue in excess of $20 billion, with market jurisdictions including India. It was also agreed that companies with €750 million or more in annual revenue would pay a minimum of 15% tax in each jurisdiction, failing which the tax differential would be collected by the country of the company's ultimate parent entity. With the broad contours of the plan finalized, countries await the details of the plan to reform a century-old tax system.

It is interesting that even as countries have stalled on changes to domestic law, a paradigm shift is underway for international tax. In part, this has been possible since the change will impact select companies and does not overhaul the national corporate tax systems. If implemented, the deal will only fragment tax systems where the old regime applies to smaller firms whereas the global deal covers large corporations. As a result, countries have come to expect that more revenue will accrue without the need to change their tax systems. Yet, they must question if the gains outweigh the administrative complexity of the plan.

As the world prepares to usher in the new year, the fiscal legacy of the pandemic will not be erased easily. To remedy the gap, which is expected to widen with the low carbon transition already underway, tax rates and base are expected to increase gradually, although the pace and nature of the increase will need to be calibrated as per domestic economic objectives such as higher domestic investment.

As the world prepares to usher in 2022, the fiscal legacy of covid will not be erased easily

While there is enthusiasm for multilateral agreements, economic vision must not be clouded by diplomatic victories. India has long articulated its case for tax sovereignty that includes its right to tax as well as the right to incentivize activities that are important for its development. Therefore, even though countries have agreed to tax large MNEs better, countries such as India must evaluate their own gains from applying the deal instead of the equalization levy as well as the tax space it will lose from applying a minimum tax.

The path to a sustainable recovery is paved with challenges of finance; it is expected in the years to come that tax policy will remain a strategic ally of this transition.

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