G20 INSIGHTS

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Trade implications of tax expenditures

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International trade and taxation are inextricably linked and have been high-priority issues within the Group of Twenty (G20) agenda. However, the interconnections between international trade and tax expenditures—that is, benefits granted through preferential tax treatment—have been overlooked. This brief calls for a better design of tax expenditures, particularly those that have implications for international trade such as a) tax incentives for investment, b) tax incentives implemented within the digital economy, c) tax benefits for energy-intensive and trade-exposed sectors, and d) export-related tax incentives, which are among the main determinants of trade misinvoicing and illicit financial flows.

Challenge

International trade and taxation are inextricably linked. Taxes, for instance, are a key determinant of investment decisions, since they affect the attractiveness of a jurisdiction to investors, particularly those heavily exposed to international trade.

Corporate income tax (CIT) competition has led to a race to the bottom that has triggered a significant reduction of statutory tax rates (i.e., the tax rate imposed by the tax law) worldwide. Even more striking has been the implementation of costly, but often ineffective, tax incentives aimed at eroding other countries' tax bases (Kronfol and Steenbergen 2020). From a trade perspective, several of these tax incentives are used as policy tools seeking to increase exports and attract investors; although, they are often considered trade barriers (e.g., the World Trade Organization [WTO] rules and the European Commission's framework for state aid).

The links between international trade and tax expenditures—that is, benefits granted through preferential tax treatment such as exemptions, deductions, credits, deferrals, and other measures—are not limited to CIT. Some countries are considering tax holidays to enhance digital trade. This is further illustrated by myriads of reduced rates and exemptions benefiting energy-intensive and trade-exposed sectors to mitigate the so-called competitiveness and leakage effects in the context of CO_2 taxation. Moreover, the abuse of export-related tax incentives (i.e., the over-reporting of exports) is one of the main determinants of trade misinvoicing, which, in turn, is the largest component of illicit financial flows (IFFs).

Whereas international trade and taxation have always been among the core topics of the G20 agenda (e.g., the G20 has played a prominent role in the Trade Facilitation Agreement, adopted by the WTO, and the G20/OECD Base Erosion and Profit Shifting initiative), the significant interconnections between tax expenditures and international trade have been somehow neglected[1].

Unlike more formal and long-standing institutional settings such as the United Nations (UN) or the WTO, the G20 has a smaller, but geographically diverse, membership that represents 85% of the global gross domestic product or two-thirds of the global population. Thus, G20 decision-making has significant legitimacy. At the same time, the G20's relatively flexible decision-making process could be an asset in times where international organizations are struggling to achieve concrete outcomes that could translate into better public policies.

Against this background, we urge G20 leaders to actively work toward a better design of tax expenditures, particularly those that have significant implications for international trade, such as: a) tax incentives for investment, b) tax incentives implemented within the digital economy, c) reduced rates or exemptions for energyintensive and trade-exposed sectors granted in the context of CO_2 taxes, and d) exportrelated tax incentives, which are at the heart of trade misinvoicing, and, hence IFFs.

Proposal

1. G20 member countries should improve the design of tax expenditures and avoid their use as tax competition instruments to erode other countries' tax bases.

Rationale:

- Taxation is an influential determinant of global trade flows.
- G20 governments should avoid the use of tax expenditure provisions, such as tax incentives for investment as tax competition tools seeking to erode other economies' tax bases.
- This would reduce harmful tax competition and, thus, contribute to the "no protectionism" pledge made by the G20 in November 2008.

Discussion

Global trade flows are influenced by many factors, including government policies that affect domestic productivity and scale economies vis à vis foreign competitors, or policies that influence firms' investment decisions—taxation is a case in point.

The WTO has perhaps the oldest and most applicable set of trade rules that cover tax issues, specifically because tax policy—far beyond traditional border taxes such as tariffs—can have a substantial effect on trade. The WTO has a set of core principles that, when considered from a tax perspective, aim to ensure that domestic tax policies do not unfairly tilt the playing field against foreign commercial interests by, for example, providing a framework to prevent various domestic tax policies such as tax incentives from bestowing advantages on domestic producers.

The WTO has also dealt with long-term tax issues largely concerning the treatment of non-domestic sales for income tax purposes as well as various tax incentives for foreign direct investment. For example, the increasingly widespread use of special economic or free trade zones (which often use tax incentives) can run counter to a country's multilateral commitments.

Thus, we pose the following questions: What are these mechanisms specifically; how much are they used; and how effective are they? The analysis of these important questions is challenging because the relevant data are difficult to find and access (Redonda and Neubig 2018). Researchers often struggle with the striking lack of transparency in the tax expenditure field. Likewise, WTO notification requirements are often either ignored or countries do not have the capacity to make such notifications, and, thus, data are either lagging or simply unavailable. There are efforts to collect data on such tax interventions, for example, by the WTO Trade Monitoring Database and the Global Trade Alert (GTA)[2]. The WTO publishes biannual trade monitoring reports; the Secretariat collects information from various sources, including member notifications and the Trade Policy Review exercises (WTO 2019b), for these reports. The GTA, which employs broader methods and categories for interventions than the WTO, collects a wide array of data on measures that could distort trade, including tax-related provisions. According to the most recent GTA report, 15 of 73 "jumbo protectionist" measures implemented between January 2017 and November 2019 were "tax-based" export incentives.

The evolution of WTO cases on taxes and subsidies points toward challenging taxrelated provisions on various grounds under WTO agreements (Daly 2016). A few wellknown cases involve disputes between the US and the EU, such as the Foreign Sales Corporations, Boeing, and Airbus cases, as well as cases involving China and "public bodies." It is likely that these challenges on the use of tax policies and other forms of government support will only increase in the near future, since many countries are considering industrial policies to support transition to "Industry 4.0" and adapting to an increasingly digital economy. The recent response packages to the COVID-19 pandemic are also likely to boost the implementation of protectionist measures (Global Trade Alert 2020).

Governments should consider the WTO's consistency in measures aimed at dealing with the pandemic. Avoiding export restrictions of medical equipment, such as face masks, medicines, and medical ingredients, is one way forward. Further measures in line with WTO agreements could include lowering tariffs on pharmaceuticals, medical devices, and other medical supplies; improving trade facilitation to reduce the cost of cross-border transport of health-related products and materials; and allowing crossborder travel of health professionals (González 2020).

Multilateral coordination on updating global tax and trade agreements to ensure coherence is vital and the G20's role in this regard is crucial. Policymakers should consider the principles underlying both global tax and trade cooperation agreements as well as how best to ensure they are effective and/or updated in rapidly changing economic geographies and technologies. As already acknowledged during the 2018 T20 process, G20 leaders must actively strengthen multilateral and cooperative approaches to taxation and protect their own tax base as well as that of developing countries (von Haldenwang et al. 2018). Particular attention must be given to the implementation of tax incentives for investment (Redonda et al. 2018).

2. G20 countries should address the digital economy in a coordinated way. Tax incentives aiming to enhance digital trade should avoid any hindrance to global trade governance.

Rationale:

- Digitalization is changing the landscape of global trade; thus, challenges in taxation of the digital economy are significant.
- Digital trade also presents new opportunities for businesses and governments across the world that are seeking to tap into these new tax bases, for example, through the implementation of ad hoc tax incentives.
- A coordinated response to the digital economy is crucial to ensure that global trade governance is not hindered.

Discussion

Digitalization significantly simplifies access to a global customer base by easing the development of business for companies (foreign and domestic) across Internet platforms. Various countries have been implementing different tax-related policies to tackle the challenges, and capture the benefits, of digital trade. There is an ongoing debate on how to tax highly digitalized businesses as well. For example, France has led the vanguard with its so-called "GAFA tax," in reference to Google, Apple, Facebook, and Amazon. Whereas, the UK, Canada, Italy, Austria, Australia, and, more recently, Spain are also proposing their own digital levies; other countries are fiercely opposed to such unilateral initiatives. In response to France's tax on US tech companies, the latter has threatened to impose 100% tariffs on $2.4 billion-worth French exports, including cheese, champagne, and luxury goods.

Other countries have been trying to capture a larger share of digital trade, for example, through the implementation of tax incentives for e-commerce activities. Some of the tax incentives for e-commerce implemented in developing economies include a fiveyear tax holiday for companies incorporated in Mauritius before June 30, 2025 and the setting up of an e-commerce platform; a three-year (which can be extended for another two years) tax exemption from CIT for e-commerce businesses with pioneer activities, that is, activities contributing to the economic development of Nigeria; and a CIT exemption for income generated from e-commerce activities in Kazakhstan.

A few G20 countries have also recently started using similar provisions. India, for example, has introduced tax holidays for start-up companies in the e-commerce sector. In December 2019, China announced the creation of 24 pilot cross-border e-commerce zones (free trade zones), where several exemptions on value-added tax and consumption tax for retail and exported goods were introduced along with a reduction in CIT rates in some of these zones.

While these goals are worth supporting, there exists a crucial question on the effectiveness and potential negative externalities that these provisions might trigger. Although e-commerce might be a potential source of untapped tax-revenue and job creation, governments would be better advised to comprehensively evaluate the effect of these provisions in reaching these goals. This is crucial in order to assess whether and how the use of these tax incentives fits a national e-commerce strategy for ensuring the digital economy enhances inclusive and sustainable growth, particularly in developing and least developed economies.

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In a context marked by protectionism and increasing tensions among the big players in the international trade arena, efforts to guarantee global trade governance are needed. G20 countries should seek to address the digital economy in a coordinated manner. This would ensure that trade and tax-related decisions are made by involving all relevant stakeholders. The role of international institutions such as the G20, OECD, WTO, and UN is crucial to ensure that the use of these incentives is in line with international tax standards and does not hinder global trade governance.

Regarding digital trade, most G20 members signed the Osaka Declaration on Digital Economy in 2019, where the Osaka Track was launched. The Osaka Track promotes discussions on trade-related aspects of e-commerce at the WTO. This Declaration was limited to a commitment to collaborate on the Joint Statement Initiative on E-Commerce and seek a high standard agreement with maximum participation among WTO members (WTO 2019a). It explicitly avoids reference to sensitive aspects, where members may have conflicting views, such as cross-border data flows versus data localization and privacy versus security issues.

In line with the spirit of the Osaka Declaration, future decisions of the G20 should pay close attention to the ongoing conversations among WTO members outside these plurilateral negotiations in the context of the Moratorium on Customs Duties on Electronic Transmissions. While WTO members agreed on an extension of this Moratorium until the Twelfth Ministerial Conference of the WTO in Nur Sultan (MC-12) in June 2020, a non-extension at the next Ministerial Conference would certainly have a significant effect on global trade governance.

The G20 should enhance digital trade initiatives that contribute to inclusive and sustainable development. It should increase efforts to establish a global framework on taxation and digital trade by, for example, renewing its members' support to multilateral approaches such as the OECD Inclusive Framework on Base Erosion and Profit Shifting Project or the UN Tax Committee.

While the prospects of reaching a broad agreement in the tax and digitalization field seem remote in the short term, G20 countries should consider that ongoing unilateral initiatives such as the GAFA tax can have deleterious consequences for global trade governance and the already strained relations among trading partners. The "weaponization" of trade policy through punitive tariffs would only cause additional harm to international economic relations.

Thus, countries should prevent the use of wasteful tax incentives for e-commerce activities. When implemented, these tax incentives should be subject to evaluation before, during, and after their implementation. Leveraging the role of the OECD Forum on Harmful Tax Practice (FHTP) could be seen as a low-hanging fruit. Nevertheless, the G20 should finance the monitoring of tax incentives by the FHTP. This way, the Forum systematically collects information on tax incentives and conducts economic evaluations on the effect of these provisions.

The COVID-19 pandemic is likely to be a game changer in terms of the role of multilateralism regarding taxation and digitalization. In response to the current pandemic, India has recently extended the equalization levy on gross payments to non-Indian vendors beyond just digital advertising to all e-commerce operators who provide "e-commerce supply or services" to India. The role of the G20 in ensuring that multilateralism prevails as agreed upon during the finance ministers meeting in Riyadh at the end of February was acknowledged—especially now, when countries are forced to overcome the pandemic and governments are increasingly tempted to implement unilateral measures to raise revenue to service and contain the post-crisis debt burdens.

3. The G20 should nudge member countries and non-G20 economies toward a global carbon tax (CO_2 tax) to tackle climate change. As a second-best alternative, the G20 should encourage the unilateral pricing of CO_2 emissions and, to avoid negative competitiveness and leakage effects, implement border carbon adjustments (CBAs), instead of reduced rates or exemptions for energy-intensive and trade-exposed sectors.

Rationale

- A global CO_2 tax is the first-best option to tackle climate change. Hence, the G20 should increase its efforts to reach a coordinated agreement going in this direction.
- As the second-best option, G20 leaders should encourage unilateral actions to price CO_2
- To mitigate potential competitiveness and leakage effects, G20 governments should introduce a WTO-compatible CBA scheme that

penalizes imports from countries without a carbon pricing system instead of implementing costly and ineffective reduced rates or exemptions for local energy-intensive and trade-exposed sectors.

Discussion

Carbon pricing is the most economically efficient policy instrument to reduce greenhouse gas (GHG) emissions and reach the target defined in the Paris Agreement (Stern and Stiglitz 2017). The number of active carbon pricing schemes has been increasing over time. Currently, around 40 countries (including a few emerging economies such as Chile and, recently, South Africa) and more than 20 cities, states, and provinces (e.g., California in the US and British Columbia, Quebec, and Ontario in Canada) have carbon pricing mechanisms in place (World Bank 2019).

Yet, the overall picture remains striking: Only about 13% of annual global GHG emissions are currently covered by carbon pricing schemes (World Bank 2019) and the first-best strategy of a global carbon pricing system is far from becoming a feasible solution, mainly because of a lack of public support and political will (Carattini et al. 2019).

Given the current unfeasibility of a global CO_2 tax, G20 leaders should lead the way toward carbon pricing and take concrete actions either unilaterally or in groups. This approach is less effective in lowering global GHG emissions because it only offers partial coverage. Moreover, diverting from a global approach opens the door to socalled competitiveness and leakage effects.

When a carbon price scheme is implemented, governments often grant costly tax expenditures (e.g., reduced rates or even exemptions) for energy-intensive and tradeexposed sectors, since the increased price on carbon would disadvantage these economies compared with countries with no pricing scheme. This, in turn, could create incentives for businesses to move (and, hence, leak emissions) to jurisdictions with lower carbon prices.

Yet, empirical evidence shows that the competitiveness effect is highly overestimated (Ellis, Nachtigall, and Venmans 2019) and tax expenditures aimed at reducing the negative effect of carbon pricing on businesses have been proven ineffective (Martin, de Preux, and Wagner 2014).

Therefore, G20 leaders should implement CBAs instead of tax expenditures. Both policy instruments could be seen as opposite sides of the same coin. Whereas their stated goal is similar (i.e., to put foreign producers in low-tax jurisdictions and local producers in high-tax jurisdictions on a level playing field), their mechanisms and net effects are likely to be significantly different. While tax expenditures lower the burden of local energy-intensive industries and reduce their incentives to increase energy-efficiency, CBAs penalize dirty foreign producers willing to export their goods into high-tax jurisdictions. Although the final effect is still uncertain, the recently announced European Green Deal is a promising step in this direction, and it should be strongly supported by G20 leaders.

However, the devil is in the details. The trade implications of CBAs can be significant; indeed, these schemes are criticized for their potential incompatibility with the WTO and their use as a form of green protectionism. Yet, under certain conditions (e.g., focusing only on preventing leakages, which is an environmental goal, and not on preserving competitiveness; allowing individual foreign producers to produce their own actual data; challenging any benchmarks imposed; and allowing exemptions to countries that have taken climate action comparable in effectiveness to domestic action), CBAs could be WTO-compatible (Cosbey et al. 2012). G20 leaders should strategize to adapt to the global multilateral rule-based system, or employ the alreadyexisting policy space granted by it, to urgently reduce GHG emissions.

4. G20 governments should phase-out tax expenditures that incentivize traderelated IFFs. They should also tackle the abuse of trade and transfer mispricing by improving statistical infrastructure.

Rationale:

- IFFs significantly erode the tax bases of poorer countries and, hence, these countries' capacity to mobilize domestic resources.
- Tax rate differentials and expenditures are a key determinant of trade-related IFFs.
- G20 governments should phase-out tax expenditures that create incentives for IFFs as well as improve statistical infrastructure to uncover trade and transfer mispricing.

Discussion

IFFs—that is, cross-border financial flows that are considered illicit in terms of their origin, cross-border transfer, and/or end use—have emerged as a key concern in the 2030 Agenda for Sustainable Development. The mispricing of trade transactions is a major channel through which IFFs are generated. This involves customs and/or tax fraud, whereby exporters and importers deliberately misreport the value, quantity, or quality of traded goods or services and, thus, erode the tax base of poorer countries. In turn, these countries' capacity to mobilize domestic resources to achieve the Sustainable Development Goals is reduced.

Commodity-dependent countries are especially affected by trade-related illicit financial outflows, since they generate a significant share of their public revenues from the production and sale of mineral and agricultural commodities. Conversely, major trading and financial hubs may (in)advertently attract illicit financial inflows that expose their financial sectors to regulatory and financial risks related to tax evasion, money laundering, and stolen assets (Middle East and North Africa Financial Action Task Force 2014; FATF 2016a, 2016b).

Recent research shows that tax incentives—in terms of corporate tax rate differentials among trading partners, and often aggravated by tax expenditures—provide incentives for trade-based IFFs (Ahene-Codjoe and Alu 2019; Nolintha and Sayavong 2020; Carbonnier and Mehrotra 2019). For trading hubs, these tax expenditures usually take the form of ad hoc tax exemptions on imports. For instance, Switzerland's valueadded tax (VAT) rules exempt gold products—including coins, bars, and especially unprocessed, semi-manufactured, and scrap gold—from taxation. Further, any alloy containing only 2% or more gold is exempt from VAT, as the full shipment qualifies as gold[3].

To attract foreign investment, resource-rich developing countries also rely on tax expenditures, for example, in the form of holidays on corporate tax and royalties, reduced import taxes for capital intensive imports, and VAT exemptions. Yet, this may result in poorly designed tax incentives that erode domestic tax bases in exchange for uncertain returns. An unstable tax and regulatory environment combined with poor data recording capacities—especially within customs—create additional incentives for trade misinvoicing, resulting in IFFs from resource-rich countries (Intergovernmental Forum on Mining, Minerals, Metals and Sustainable Development 2019).

Despite multilateral efforts to adapt financial and taxation rules to curb tax base erosion and aggressive profit shifting as well as money laundering, the proliferation of tax incentives, combined with regulatory limitations and lack of transparency, especially within the commodity sector, contributes further to the persistence of sizable IFFs.

G20 governments should phase-out tax expenditure provisions that create incentives for IFFs. Especially in advanced trading hubs, they should improve statistical infrastructure to uncover trade and transfer mispricing by, for example, improving the product classification system used by national trade and customs administrations for precious metals. Governments should also support better trade transaction valuation in order to accurately record whether physical trade occurs among related business entities. This way, abusive transfer pricing that reduces global tax liabilities of multinationals is minimized.

Finally, the leverage of new technologies has significant potential to improve international trade governance, in general, and reduce IFFs in particular. For instance, artificial intelligence and machine learning-based platforms, combined with FinTech services, are being explored not only to optimize trade shipping routes and reduce transaction and logistics costs (Lund and Bughin 2019; Fan and Chiffelle 2019), but also to detect fraud and abnormal patterns in statistics. All G20 governments should support these efforts.

Disclaimer

This policy brief was developed and written by the authors and has undergone a peer review process. The views and opinions expressed in this policy brief are those of the authors and do not necessarily reflect the official policy or position of the authors' organizations or the T20 Secretariat.

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Appendix

[1] . The report to the G20 "Options for low income countries' effective and efficient use of tax incentives for investment" is an important exception (IMF et al. 2015).

[2] . The Trade Monitoring Database and GTA are accessible at https://tmdb.wto.org/en and https://www.globaltradealert.org/, respectively.

[3] . As per Article 44, Ordinance on Value Added Tax by the Swiss Federal Council, 2009; for more details, see https://www.admin.ch/opc/en/classified-compilation/20091866/index.html.

Existing Initiatives & Analysis