Second-best source-based taxation of multinational firms*

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Abstract

The international standard of taxing multinational firm profits at source is increasingly challenged, and there are ongoing negotations about fundamental reform towards (more) residence-based taxation or destination-based taxation. This paper offers a model in which the current standard emerges as an optimum choice and the reforms under consideration can be evaluated. In the model, a large number of source locations compete for the firm's affiliates. The source locations levy taxes and provide public inputs that increase the firm's productivity. The firm employs mobile capital and shifts profit to tax havens. With an unconstrained set of policy instruments, the optimal tax system is source-based with positive (non-linear) marginal tax rates on profit and capital use. Public input provision is inefficiently low. Optimal tax and input choices are expressed as functions of the underlying elasticities (sufficient statistics). An optimal complement to second-best source taxes are residence taxes that partially credit foreign taxes in order to increase source countries' public input provision. The OECD's "substance approach" and the Pillar 2 minimum tax proposals turn out to be welfare-enhancing. In contrast, shifting taxing rights to the market economies (a kind of destination-based tax) does not necessarily improve efficiency, neither does the harmonization of tax rates.

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