ALLOCATING RIGHTS BETWEEN NATIONS:
LEGITIMACY AND JUSTICE IN INTERNATIONAL TAX POLICY

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ABSTRACT

Although extreme poverty has decreased in the last decades, we are a long way from eradicating global poverty. Similarly, the world has seen a considerable decrease in global inequality due to recent developments in emerging economies, but overall inequality between nations has risen in the last decades. International tax law may have a relevant role in improving or worsening global inequality. Extensive research has shown that the present international tax system was designed in a way that tends to benefit high-income economies. However, there has been no significant discussion about whether and how international tax law rules should be changed to address global inequality. The main goal of this thesis is to analyze the existing legitimacy and distributive justice issues that limit the ability of lower-income countries to raise tax revenues and consider what can be done to make the current international tax regime more aligned with global justice principles.

The thesis builds on the contemporary literature in international political economy and global distributive justice and puts forth a normative framework for allocating the international tax base among states. First, it analyzes some of the legitimacy deficits of the present international tax system. In contrast to prevailing views about improving legitimacy, it demonstrates the shortcomings of focusing solely on making international tax policymaking processes more inclusive and argues for a greater focus on global distributive justice. It then analyzes the main tax theories that have defined international tax relations to date and demonstrates some of their limitations. The final part of the thesis puts forth normative principles that integrate distributive justice and considers the practical implications of the proposed normative framework for some of the most recent issues discussed in international tax policy.

RÉSUMÉ

Bien que l'extrême pauvreté ait diminué au cours des dernières décennies, nous sommes loin d'éliminer la pauvreté dans le monde. De même, le monde a connu une diminution considérable des inégalités mondiales en raison de l'évolution récente des économies émergentes, mais les inégalités globales entre les nations ont augmenté au cours des dernières décennies. Le droit fiscal international peut jouer un rôle important dans l'amélioration ou l'aggravation des inégalités mondiales. Des recherches approfondies ont montré que le système fiscal international actuel a été conçu d'une manière qui tend à profiter aux économies à revenu élevé. Cependant, il n'y a pas eu de discussion significative sur la question de savoir si et comment les règles du droit fiscal international devraient être modifiées pour lutter contre les inégalités internationales. L'objectif principal de cette thèse est d'analyser les problèmes de légitimité et de justice distributive existants qui limitent la capacité des pays à faible revenu à augmenter leurs recettes fiscales et d'examiner ce qui peut être fait pour rendre le régime fiscal international actuel plus aligné sur les principes de justice mondiale.

La thèse s'appuie sur la littérature contemporaine sur l'économie politique internationale et la justice distributive mondiale et propose un cadre normatif pour l'allocation de l'assiette fiscale internationale entre les États. Premièrement, nous analysons certains des déficits de légitimité du système fiscal international actuel. Contrairement aux opinions dominantes sur l'amélioration de la légitimité, nous démontrons les lacunes de se concentrer uniquement sur la création de processus d'élaboration de la politique fiscale internationale plus inclusifs et plaidons pour une plus grande concentration sur la justice distributive mondiale. Ensuite, nous analysons les principales théories fiscales qui ont défini les relations fiscales internationales à ce jour et démontrons certaines de leurs limites. La dernière partie de la thèse présente des principes normatifs qui intègrent la justice distributive et examine les implications pratiques du cadre normatif proposé pour certaines des questions les plus récentes abordées dans la politique fiscale internationale.

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PREFACE

This thesis adopts a manuscript-based style. It comprises four articles, all written solely by the author of this thesis, published or accepted for publication in leading academic law journals, namely the *Canadian Journal of Law and Jurisprudence*, the *Dalhousie Law Journal*, the *Fordham International Law Journal*, and the *World Tax Journal*. The articles were organized and reformatted according to the requirements in McGill's Guidelines for the Preparation of a Doctoral Thesis in the Faculty of Law. The thesis includes other components generally required for a doctoral thesis, such as a preface, an introduction and a conclusion, and contains additional text to connect the manuscripts in a logical progression from one chapter to the next, so as to produce a cohesive text and document a single program of research, as required in McGill's Guidelines.

The thesis is divided into two parts. Part I (*Legitimacy and Justice in International Tax Policy*) comprises Chapters 1 to 4, which introduce and analyze some of the problems with the present international tax regime that give rise to a significantly inequitable allocation of taxing rights to less affluent jurisdictions. The overall argument of Part I is that contemporary rhetoric around justice in the international tax community demonstrates an outsize focus on political legitimacy to the exclusion of a concern for distributive justice, to the ultimate detriment of the pursuit of international tax justice. Part II (*Advancing International Tax Justice*) puts forth a research agenda focused on global distributive justice by considering the moral requirements for an equitable international tax system. Building on the normative framework laid out in Part I, Part

II comprises Chapters 5 and 6, which analyze two of the leading causes of the distributive justice deficits in the international tax system, namely tax competition and the rules for allocating taxing rights, and propose alternative normative principles to address these two policy areas. A more detailed outline follows.

Chapters 1 and 2 focus on the legitimacy deficits affecting the current decision-making processes that inform the international tax regime. Legitimacy deficit generally refers to the imbalance of power and influence between countries in the international tax policy decision-making. The international tax regime poses two types of legitimacy problems that directly affect developing countries. Chapter 1 analyzes the first type, which I call Institutional Legitimacy Deficit. It relates to how the design of international governance institutions and processes excludes the participation of many of the countries that are affected or subjected to its rules and standards. Chapter 2 introduces the other type of problem, which I call Structural Legitimacy Deficit. It involves long-standing, entrenched issues in the international tax regime that result in an unbalanced distribution of power and influence between jurisdictions. The main contribution of these two chapters to the literature is, first, to propose a classification that furthers the understanding of these legitimacy problems in international tax policy and, second, to provide a clear connection between the structural inequities affecting current international relations and the development of international tax policy. These background inequities are not limited to the area of international tax law, but they are ultimately one of the main decisive factors determining the result of international tax negotiations.

Chapter 3 focuses on the distributive justice deficits affecting the current international tax regime. It explains how the current tax competition environment affects the ability of jurisdictions to set their tax regimes optimally to promote normative goals and to raise needed tax revenues. It demonstrates that tax competition produces relatively more severe effects on the world's poorest countries and thus worsens international inequality. This chapter also discusses how taxing rights are currently allocated between jurisdictions in a way that significantly disfavours lower-income countries. The chapter concludes by arguing that these features of the present international tax system render it morally unjust. It puts forth a view of global justice that requires that international rules and global institutional arrangements do not worsen the situation of the worst-off countries. The main contribution of this chapter to the current literature is to connect two issues that are often analyzed separately, namely the inequitable allocation of tax jurisdictions between developed and developing countries, which severally affects the latter, and the problem of tax competition, which generally negatively impacts both wealthy and less affluent countries. Since any potential solution for each of these problems will substantially change the current division of taxing rights, a normative discussion of international tax justice must consider both.

Chapter 4 argues that although the literature recognizes the existence of both legitimacy deficits (discussed in Chapters 1 and 2) and distributive justice deficits (discussed in Chapter 3) in the international tax regime, proposals to address these issues mainly focus on improving legitimacy as if addressing legitimacy deficits would invariably solve distributive justice problems. The conflation of political legitimacy and distributive justice has resulted in what I call the

Legitimacy-Justice Fallacy, that is, the tendency of policy prescriptions to seek either to solve legitimacy problems by addressing distributive justice concerns or, conversely, to solve distributive justice problems by addressing legitimacy concerns. The chapter concludes by calling for a greater discussion about the moral principles that should guide tax policy decision-making so that the resulting international tax rules produce a more equitable allocation of taxing rights for less affluent jurisdictions. The main contribution of this chapter to the literature is to make a clear distinction between legitimacy and distributive justice problems. The main corollary is that these two different dimensions of international tax justice require consideration and that simply improving inclusivity for lower-income countries (to address legitimacy problems) may not reflect a meaningful change in the allocation of taxing rights (which is required to address distributive justice problems). The chapter provides four main reasons to argue that the prevailing tax theory needs to come to terms with the existing international inequalities and reflect a normative framework based on distributive justice. In the lack of normative principles built on global justice, legitimate procedures alone may not suffice to promote global distributive justice.

Chapters 5 and 6 pursue the research agenda outlined in Chapter 4. Chapter 5 proposes normative principles to address the problem of tax competition. It argues that the existing literature on international tax competition extensively points to the benefits of mitigating competition through global tax reform but generally fails to consider the negative impacts of reform on some lower-income countries. Borrowing from recent developments in the political theory of climate change, it puts forth normative principles for sharing the burdens of institutional tax reform among

the affected countries. The main contribution of this chapter is to be the first, to the author's knowledge, to provide a normative analysis of the potential consequences of tax reform aimed at curbing tax competition.

Chapter 6 proposes normative principles to attain a more equitable allocation of taxing rights. It examines the main tax theories that have defined international tax relations to date and demonstrates that they are increasingly limited in scope. Global tax policy discourse has long focused on deontological consensus but has recently moved to a consequentialist rationale. The chapter submits that this shift warrants a normative principle that integrate distributive justice considerations that the predominant normative framework fails to include. It further analyzes the practical implications of a revised normative principle for some of the most recent discussions in international tax policy. This last chapter's main contribution to the literature is to propose a normative framework that reconciles two primary normative goals of the allocation of tax jurisdictions, namely preserving states' fiscal sovereignty on the one hand and reducing global inequality on the other.

Introduction

1. Background—Inequities in the International Tax Regime and Global Inequality

The tax literature has extensively shown that the current international tax regime is problematic from a normative viewpoint. The present tax policy decision-making processes and the resulting international tax rules tend to significantly benefit high-income economies. The problem includes how these political processes exclude meaningful participation of developing nations and how the current international tax rules limit the allocation of tax jurisdictions to low-income countries.

From a more procedural account, international tax policy today is primarily driven by the Organisation for Economic Co-operation and Development (OECD), and the policymaking process significantly excludes the participation of non-OECD countries. Although the OECD has sought to include non-member countries in some of the tax policy discussions,[1] the reasons seem to have less to do with increasing their actual participation in setting the rules than securing their engagement and fostering a public perception of inclusivity.[2] Additional imbalances arise from

[1] OECD, *OECD/G20 Inclusive Framework on BEPS: Progress Report July 2017-June 2018* (Paris, OECD, 2018) at 6. Along with the group of 46 countries (OECD and G20 members), 83 jurisdictions have joined the Inclusive Framework, amounting to a total of 129 participating jurisdictions. See OECD, *Members of the Inclusive Framework on BEPS*, available at www.oecd.org/ctp/beps/inclusive-framework-on-beps-composition.pdf (accessed April 5, 2019).

[2] See Michael Lennard, "Base Erosion and Profit Shifting and Developing Country Tax Administrations" (2016) 44:10 Intertax 740 at 745; Irma Johana Mosquera Valderrama, "The EU Standard of Good Governance in Tax Matters for Third (Non-EU) Countries" (2019) 47:5 Intertax 454 at 461.

path dependence constraints.[3] Even if formal equality were achieved at some point through greater participation, many rules and concepts have already been established in favour of developed countries, and some entrenched rules may be difficult to change. Throughout decades of tax policymaking, stakeholders who have become involved at an early stage tend to enjoy greater influence over international tax policy due to the lock-in effect and the costs associated with changing the existing standards and the ongoing process. This suggests the existing agenda, concepts and standards of the international tax regime not only tend to favour more powerful countries but are also less likely to change to a more balanced division with less powerful countries even if participation over tax policymaking were equalized.[4] Having entered the discussion as latecomers, developing countries also have reduced experience and resources to keep pace with developed countries.[5]

From a substantive perspective, the present allocation of taxing rights among countries significantly favours wealthier nations. The international tax regime consists of a network of

[3] Path dependence refers to the causal relevance of preceding stages in a temporal chain of events. It suggests that once institutions have started down a track, the costs of reversal become significantly high due to the entrenchments of certain institutional arrangements. See Pierson, Paul, "Increasing Returns, Path Dependence, and the Study of Politics" (2000) 94:2 Am Pol Sci Rev 251 at 252.

[4] See Tsilly Dagan, *International Tax Policy: Between Competition and Cooperation* (Cambridge: Cambridge University Press, 2018 at 173–74 ("In other words, in designing the treaty mechanism to favor countries of residence in the allocation of tax revenues, the network initiators were able to extract monopolistic rents at the expense of late-coming developing (host) countries."). See also Lall Ranjit, "Timing as a Source of Regulatory Influence: A Technical Elite Network Analysis of Global Finance" (2015) 9 Reg & Gov 125 (pointing out the importance of first-mover position in setting the agenda in global rulemaking, especially in influencing distributional outcomes by ensuring that proposals made by first movers are increasingly difficult to change at later stages of rulemaking).

[5] Irene JJ Burgers & Irma J Mosquera Valderrama, "Corporate Taxation and BEPS: A Fair Slice for Developing Countries?" (2017) 1 Erasmus L Rev 29 at 38.

bilateral tax treaties—most to some extent based on the OECD Model Tax Convention—that determine how taxing rights are divided between home (residence) and host (source) country in cross-border transactions. Tax treaties effectively reallocate taxing rights from source (developing) to residence (developed) countries, since in the absence of such treaties, source countries would first enjoy taxing rights over income, leaving the residence country to double tax or provide relief for the source country tax.[6] The OECD tax treaty model came to dominate the international tax arena, and the costs of not being part of the network gradually increased for late-coming developing countries. The result is that the tax treaty regime has allowed developed countries to benefit from a model so widespread that it is unlikely to change.[7] More fundamentally, the tax treaty network provides the legal infrastructure for the principles and concepts that shape the international tax regime today, so that the overall structure of international tax law is based on standards, principles, and methods that lead to an inequitable distribution of taxing rights between developing and developed countries.

Despite these problems, which lead to an unbalanced division of tax jurisdictions between developed and developing countries, there seems to be increasing global awareness and concern about global poverty and inequality. One prominent example is the United Nations' Sustainable Development Goals (SDGs), which acknowledges the "rising inequalities within and among

[6] Kim Brooks & Richard Krever, "The Troubling Role of Tax Treaties" in Geerten MM Michielse & Victor Thuronyi, *Tax Design Issues Worldwide* (Kluwer Law International: Alphen aan den Rijn, 2015) 159 at 166.
[7] See Dagan, *supra* note at 4.

countries" and that "eradicating poverty in all its forms and dimensions … is the greatest global challenge and an indispensable requirement for sustainable development" and aims to, among other goals, "combat inequalities within and among countries" and "end poverty and hunger everywhere".[8]

The current inequities of the international tax system and the simultaneous global concern about global inequality seem puzzling. On the one hand, there is a coordinated effort to promote some form of *redistribution* to address global poverty and inequality. On the other, the *distribution* of tax jurisdictions between countries significantly worsens international inequality. If it is correct to say that the current allocation of taxing rights between countries is inequitable, concerns about global inequality should not be limited to considering how to promote redistribution, but they should aim to distribute tax revenues more equitably in the first place.

2. Research Objectives and Theoretical Framework—International Taxation and Global Justice

This thesis is primarily theoretically driven. It builds on the literature in political theory, political economy and international taxation to propose a normative framework for international

[8] *Resolution on the 2030 Agenda for Sustainable Development*, UNGA, 7th Sess, UN Doc A/RES/70/1 (2015).

tax policy. This thesis aims to analyze the role of international tax policy in improving or worsening global inequality. It aims to address a significant shortcoming in the international tax law and policy literature, namely the lack of a connection between international tax theory and the contemporary developments in the global justice literature. In the last few years, many global justice theorists have pointed to the need for some degree of international distributive justice.[9] However, international tax theory is mostly built on a statist view of international relations. Such a view, applied to international taxation, considers the allocation of tax jurisdictions to be exclusively determined by the notion of sovereignty, with no consideration for the problem of global inequality.

The main objectives of this thesis are summarized in the following questions:

1. What institutions or mechanisms may be leading international tax policies to worsen global inequality?

2. What changes are required to make the international tax system more equitable?

[9] See, e.g., Charles Beitz, *Political Theory and International Relations* (Princeton: Princeton University Press, 1973); Thomas W Pogge, *Realizing Rawls* (Ithaca: Cornell University Press, 1989). More recently, see Joshua Cohen & Charles Sabel, "Extra Rempublicam Nulla Justitia?" (2006) 34:2 Phil & Pub Aff 147; Alexander Cappelen, "Responsibility and International Distributive Justice" in Andreas Follesdal & Thomas Pogge, eds, *Real World Justice: Grounds, Principles, Human Rights, and Social Institutions* (Dordrecht: Springer, 2005) 215; Jon Mandle, *Global Justice* (Cambridge, UK: Polity Press, 2006); Darrel Moellendorf, "Cosmopolitanism and Compatriot Duties" (2011) 94:4 Monist 535; Gillian Brock, ed, *Cosmopolitanism versus Non-Cosmopolitanism: Critiques, Defenses, Reconceptualizations* (Oxford: Oxford University Press, 2013).

The answer to question 1. is, to some extent, descriptive and requires understanding the current tax rules and the existing dynamics of tax policy design. Chapters 1 and 2 build on doctrinal work in international tax law and in the international political economy literature to address this question and analyze some procedural problems of international tax policy. Chapter 3 also considers some doctrinal questions about how tax jurisdictions are allocated between countries, but it builds on the political theory literature on global justice to discuss why the current international tax regime is problematic from a normative perspective and whether it should be changed to address concerns about global poverty and inequality.

The answer to question 2. is developed in Chapter 4 and the remaining chapters in the thesis. These chapters apply some normative developments from the global distributive justice literature to design a normative framework for allocating tax jurisdictions between nations. Chapters 5 and 6 also apply cross-legal analysis to compare normative developments in other areas of international law and understand how principles of global justice have been applied in these different areas.

3. Justification—The Importance of Normative Discussions in International Tax Law

Normative discussions on how to distribute tax jurisdictions are frequently met with skepticism. The realist view of international relations, where any agreements on normative principles are based on self-interest and bargaining power, still predominates in tax policy analysis. Yet, there is evidence that governments are, at least to some extent, motivated by a concern with

international justice. Initiatives such as the UN's SDGs,[10] the OECD's Task Force on Tax and Development,[11] and the inter-agency Platform for Collaboration on Tax,[12] seem to demonstrate a substantial effort to improve economic development in less affluent countries. Additionally, a meaningful concern with fairness in allocating international tax jurisdictions may be warranted to secure the cooperation of lower-income countries in undertaking obligations required for a coordinated effort to address the current international tax challenges. Insofar that this is the case, normative discussions about international tax justice should provide normative guidance for allocating the international tax base that meaningfully addresses global inequality and poverty while preserving nations' entitlements.

There is also reason to argue that addressing global inequality through the allocation of taxing rights is a viable option compared to alternative policies. For instance, there are doubts as to the effectiveness of development aid, especially considering its potential to exacerbate corruption and reduce incentives to develop sustainable policies.[13] Foreign aid also often limits

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[10] See *supra* note 8 (aimed, among other goals, to "combat inequalities within and among countries" and "end poverty and hunger everywhere").

[11] OECD, "OECD Work on Tax and Development 2018-2019", online: <www.oecd.org> at 32 (established to "build an environment in developing countries that will enable them to collect appropriate and adequate tax revenues and build effective states").

[12] United Nations Economic and Social Council, "Strengthening Tax Capacity in Developing Countries: Inter-agency Platform for Collaboration on Tax", online: <www.oecd.org> (a joint collaboration between the IMF, the OECD, the UN, and the World Bank Group established "to facilitate the participation of developing countries in the global dialogue on tax matters" and "strengthen domestic revenue mobilization in developing countries").

[13] See Stephen Knack, "Does Foreign Aid Promote Democracy?" (2004) 48 Int'l Stud Q 251 (suggesting that when aid dependence increases as a proportion of government consumption, recipient states will become less accountable for their own actions, and conflicts over aid funds increase); Stephen Knack &

recipient countries' fiscal autonomy because donor countries frequently impose direct control over the expenditure of aid toward specific projects.[14] Moreover, redistribution through foreign aid lacks uniformity since the choice of country recipients depends on reasons that are fairly arbitrary from a normative point of view, such as close economic ties or geographic proximity.[15] Compared to differentiated treatments adopted in other areas of law to allocate differentiated rights and duties to countries based on their different levels of capabilities, a differential approach in international tax law also seems to offer a more promising and direct form of addressing global inequality due to its less distortionary effects.[16] Improving the taxing rights of lower-income countries also contributes to their ability to mobilize revenue, which is a fundamental requirement to finance sustainable development goals.[17]

Aminur Rahman, "Donor Fragmentation and Bureaucratic Quality in Aid Recipients" (2007) 83 J Dev Econ 176.

[14] Miranda Stewart, "Redistribution between Rich and Poor Countries" (2018) 72 Bull Int'l Taxation 297 at 304–05.

[15] But see Ilan Benshalom, "The New Poor at Our Gates: Global Justice Implications for International Trade and Tax Law" (2010) 85 NYUL Rev 1 at 29 (arguing that arbitrary geographic proximity may a factor sufficiently relevant to trigger or intensify duties of justice).

[16] Differential approaches included in specific regulatory frameworks, such as the principle of common but differentiated responsibilities and respective capabilities adopted in the United Nations Framework Convention on Climate Change can potentially cause inefficiencies that impact its main goal, namely fighting climate change. The problem does not exist in international taxation, whose fundamental goal is to allocate taxing rights among jurisdictions. *See* Benshalom, *supra* note 15 at 328 ("In the international tax context, the distribution of the right to tax is the main objective, and there is no external, common good objective that can be distorted. Because the policy objective of the international tax regime is to achieve sustainable distribution of profits derived from international commerce, there may be less of a dichotomy between redistributive equity and efficiency.").

[17] See UN Committee of International Experts on International Cooperation in Tax Matters*, The Role of Taxation and Domestic Resource Mobilization in the Implementation of the Sustainable Development Goals*, Policy Note E/C.18/2018/CRP.19, 2018. See also Laurens van Apeldoorn, "BEPS, Tax Sovereignty and Global Justice" (2016) Crit Rev Int'l Soc Pol Phil 1 (arguing that allocating taxing rights in a way that

Recent developments in international tax policy seem to offer an unparalleled opportunity to reconsider the normative justification of long-standing criteria for the international allocation of taxing rights.[18] The relevance of multinational corporations and the global changes arising from digitalization have recently impelled a revision of the present distribution of taxing rights,[19] thus motivating a re-examination of the normative underpinnings for the division of the international tax base.[20]

4. Structure and Outline—A Manuscript-Based Thesis

This thesis adopts a manuscript-based style. It comprises four articles published or accepted for publication in leading academic law journals. The articles were organized and reformatted according to the requirements in McGill's Guidelines for the Preparation of a Doctoral Thesis in

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favours low-income states is fundamental to increasing their capacity to mobilize revenue while preventing double taxation that could disturb international investment).

[18] See Steven A Dean, "A Constitutional Moment for Cross-Border Taxation" (unpublished manuscript, on file with the author) (pointing out that for the first time in decades, international tax policy has entered a fluid phase in which fundamental reform becomes possible, and warning for the urgency in recognizing the opportunity for critical improvements before the moment passes by); Ruth Mason, "The Transformation of International Tax" (2020) 114 Am J Int'l L 353.

[19] See OECD, *Addressing the Tax Challenges of the Digitalisation of the Economy*, Public Consultation Document (Feb 13, 2019). For an overview of the context and political motivations of OECD's efforts to address this issue, see Allison Christians & Tarcisio Diniz Magalhaes, "A New Global Tax Deal for the Digital Age" (2019) 67:4 Can Tax J 1153.

[20] See, e.g., Christians & Apeldoorn, *supra* note 19; Michael P. Devereux & John Vella, "Value Creation as the Fundamental Principle of the International Corporate Tax System" (2018) European Tax Policy Forum Working Paper, online: <ssrn.com/abstract=3275759>; Wolfgang Schön, "One Answer to Why and How to Tax the Digitalized Economy" (2019) 47 Intertax 1003; J Scott Wilkie, "The Way We Were? The Way We Must Be? The 'Arm's Length Principle' Sees Itself (for What It Is) in the 'Digital' Mirror" (2019) 47 Intertax 1087; Svitlana Buriak, "A New Taxing Right for the Market Jurisdiction: Where Are the Limits?" (2020) 48 Intertax 301.

the Faculty of Law, approved on May 18, 2018. The thesis also contains additional text to connect the manuscripts in a logical progression from one chapter to the next, so as to produce a cohesive text and document a single program of research, as required in McGill's Guidelines.

The articles and respective locations in the thesis are as follows:

1) Ivan Ozai, *Tax Competition and the Ethics of Burden Sharing*, 42:1 FORDHAM INTERNATIONAL LAW JOURNAL (2018), pp. 61-100 – renamed and reformatted as Chapter 5;
2) Ivan Ozai, *Institutional and Structural Legitimacy Deficits in the International Tax Regime*, 12:1 WORLD TAX JOURNAL (2019), pp. 53-78 – renamed, reformatted, and divided as Chapters 1 and 2;
3) Ivan Ozai, *Two Accounts of International Tax Justice*, 33:2 CANADIAN JOURNAL OF LAW AND JURISPRUDENCE (2020), pp. 317-339 – renamed, reformatted, and divided as Chapters 3 and 4;
4) Ivan Ozai, *Origin and Differentiation in International Income Allocation*, 44:1 DALHOUSIE LAW JOURNAL (accepted, forthcoming 2021) – renamed and reformatted as Chapter 6.

The thesis is divided into two parts. Part I (*Legitimacy and Justice in International Tax Policy*) comprises Chapters 1 to 4, which introduce and analyze some of the problems with the present international tax regime that give rise to a significantly inequitable allocation of taxing rights to less affluent jurisdictions. The overall argument of Part I is that contemporary rhetoric

around justice in the international tax community demonstrates an outsize focus on political legitimacy to the exclusion of a concern for distributive justice, to the ultimate detriment of the pursuit of international tax justice. Part II (*Advancing International Tax Justice*) puts forth a research agenda focused on global distributive justice by considering the moral requirements for an equitable international tax system. Building on the normative framework laid out in Part I, Part II comprises Chapters 5 and 6, which analyze two of the main causes of the distributive justice deficits in the international tax system, namely tax competition and the rules for allocating taxing rights, and propose alternative normative principles to address these two policy areas. A more detailed outline follows.

Chapters 1 and 2 focus on the legitimacy deficits affecting the current decision-making processes that inform the international tax regime. Legitimacy deficit generally refers to the imbalance of power and influence between countries in the international tax policy decision-making. The international tax regime poses two types of legitimacy problems that directly affect developing countries. Chapter 1 analyzes the first type, which I call Institutional Legitimacy Deficit. It relates to how the design of international governance institutions and processes excludes the participation of many of the countries that are affected or subjected to its rules and standards. Chapter 2 introduces the other type of problem, which I call Structural Legitimacy Deficit. It involves long-standing, entrenched issues in the international tax regime that result in an unbalanced distribution of power and influence between jurisdictions.

Chapter 3 focuses on the distributive justice deficits affecting the current international tax regime. It explains how the current tax competition environment affects the ability of jurisdictions to set their tax regimes optimally to promote normative goals and to raise needed tax revenues. It demonstrates that tax competition produces relatively more severe effects on the world's poorest countries and thus worsens international inequality. This chapter also discusses how taxing rights are currently allocated between jurisdictions in a way that significantly disfavours lower-income countries. The chapter concludes by arguing that these features of the present international tax system render it morally unjust. It puts forth a view of global justice that requires that international rules and global institutional arrangements do not worsen the situation of the worst-off countries.

Chapter 4 argues that although the literature recognizes the existence of both legitimacy deficits (discussed in Chapters 1 and 2) and distributive justice deficits (discussed in Chapter 3) in the international tax regime, proposals to address these issues mainly focus on improving legitimacy, as if addressing legitimacy deficits would invariably solve distributive justice problems. The conflation of political legitimacy and distributive justice has resulted in what I call the Legitimacy-Justice Fallacy, that is, the tendency of policy prescriptions to seek either to solve legitimacy problems by addressing distributive justice concerns or, conversely, to solve distributive justice problems by addressing legitimacy concerns. The chapter concludes by calling for a greater discussion about the moral principles that should guide tax policy decision-making so that the resulting international tax rules produce a more equitable allocation of taxing rights for less affluent jurisdictions. Chapters 5 and 6 pursue this research agenda.

Chapter 5 proposes normative principles to address the problem of tax competition. It argues that the existing literature on international tax competition extensively points to the benefits of mitigating competition through global tax reform but generally fails to consider the negative impacts of reform on some lower-income countries. Borrowing from recent developments in the political theory of climate change, it puts forth some normative principles for sharing the burdens of institutional tax reform among the affected countries.

Chapter 6 proposes normative principles to attain a more equitable allocation of taxing rights. It examines the main tax theories that have defined international tax relations to date and demonstrates that they are increasingly limited in scope. Global tax policy discourse has long focused on deontological consensus but has recently moved to a consequentialist rationale. The chapter submits that this shift warrants a normative principle that integrate distributive justice considerations that the predominant normative framework fails to include. It further analyzes the practical implications of a revised normative principle for some of the most recent discussions in international tax policy.

Part I
Legitimacy and Justice in International Tax Policy

CHAPTER ONE
Institutional Legitimacy Deficits

1. Introduction

Mostly as a regulatory response to the financial crisis, world leaders are increasingly seeking multilateral cooperation to address challenges imposed by international corporate tax avoidance and offshore tax evasion. In the last few years, the Organisation for Economic Co-operation and Development (OECD) and the Group of Twenty (G20) have been leading efforts to promote international tax cooperation to address what is now commonly known as base erosion and profit shifting (BEPS). As these international institutions strengthen their central role in international tax policy decision-making, scholars and commentators begin to question their legitimacy to impose standards and norms worldwide.[1]

The political science literature suggests that most of the existing international institutions such as the World Trade Organization (WTO) and the United Nations (UN) do not meet democratic standards, for lack of transparency and accountability, limited participation of less powerful countries, and the overall absence of a transnational political

[1] See *infra* note 12. For a general perspective not limited to tax policy, see Ingo Take, "Legitimacy in Global Governance: International, Transnational and Private Institutions Compared" (2012) 18:2 Swiss Pol Sci Rev 220 at 220 (pointing out that the conceptualization of legitimate forms of governance beyond the nation-state has become a central concern of International Relations scholarly debate since the mid-1990s).

community.[2] Regarded for a long time as a purely academic issue, the democratic deficit of international institutions have more recently received increasing attention by civil society, political leaders, and national parliaments.[3]

In international tax policy discussions, increasing calls for greater participation of developing countries led the OECD and the G20 to introduce the Inclusive Framework on BEPS, a forum established to include the participation of non-OECD and non-G20 members on discussion of tax policy standards and implementation on an "equal footing".[4] The creation of such a forum illustrates the attention given by policy leaders to the potential legitimacy problems in the international tax system.

The legitimacy deficits that affect the current international tax regime fall into two categories. One set of legitimacy problems, which can be called *institutional legitimacy deficit*, speaks to the constraints on less powerful jurisdictions to participate in the central tax policy decisions taken in the existing international organizations. Another set of legitimacy problems, which can be called *structural legitimacy deficit*, derives from the significant economic, political and military differences among countries, which generate asymmetrical bargaining strength and produce unequal substantive outcomes. These two sets of legitimacy

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[2] See, e.g., Joseph S Nye Jr & John D Donahue, *Governance in a Globalizing World* (Washington, DC: Brookings Institution Press, 2000); Beat Habegger, "Democratic Accountability of International Organizations: Parliamentary Control within the Council of Europe and the OSCE and the Prospects for the United Nations" (2010) 45:2 Cooperation and Conflict 186.

[3] Michael Zürn, "Global Governance and Legitimacy Problems" (2004) 39:2 Gov Oppos 260 at 261.

[4] OECD, *Background Brief: Inclusive Framework on BEPS* (Paris: OECD Publishing, 2017).

problems impair developing countries in different ways, but both give rise to an unbalanced international system that hinders an equal-standing participation of weaker, developing countries and dismisses some of their central concerns and needs.

This chapter analyzes the institutional legitimacy deficits affecting the present international tax system by pointing to the limited participation of less powerful jurisdictions in the international tax policymaking process. Chapter 2 will focus on the structural legitimacy deficits and demonstrate that background imbalances of power and influence in international tax relations also contribute to producing unequal outcomes among countries. The central argument in these two chapters is that despite the importance of increasing the participation of less powerful countries in international tax policy decisions, improving inclusivity alone may not suffice in making the international tax regime responsive to the interests and needs of developing countries. Structural shortcomings in the institutional design of the international tax regime requires a deeper discussion on a normative framework that guides overall reform of the international tax system in a way that produces fairer allocation of rights and duties, especially for developing and the least developed countries.

2. Limited Participation of Developing Countries in OECD's Decision-Making Process

The first fundamental legitimacy deficit in the current international tax regime occurs at an institutional level. International tax policy decisions are increasingly coordinated by the

OECD, an international organization with limited membership and narrow mandate. In the last few years, the OECD has been regarded as a de facto world tax organization.[5] One of the most important examples of the influence the OECD exerts in international tax policy is its model tax treaty,[6] which is used not only in negotiations between two OECD countries or one OECD and one non-OECD countries but also in negotiations between two non-OECD countries.[7] However, OECD's influence in international tax policy goes far beyond the model

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[5] See, e.g., Yariv Brauner, "An International Tax Regime in Crystallization" (2003) 56 Tax L Rev 259 at 310; Arthur J Cockfield, "The Rise of the OECD as Informal 'World Tax Organization' Through National Responses to E-commerce Tax Challenges" (2006) 8 Yale JL Tech 136; Allison Christians, "Hard Law, Soft Law, and International Taxation" (2007) 25:2 Wis Int'l LJ 325 at 325.

[6] OECD, *Model Tax Convention on Income and on Capital* (Paris: OECD Publishing, 2017).

[7] Some non-OECD countries adopt the OECD model for political motivations, such as those seeking to become a member through the OECD's accession process (the general criteria and process for accession is detailed in OECD, *Report of the Chair of the Working Group on the Future Size and Membership of the Organisation to Council: Framework for the Consideration of Prospective Members* (Paris: OECD Publishing, 2017). However, in many cases, the adoption of the OECD model is the result of negotiation between the contracting countries, where political and economic power relations play a significant role. See Irma Johanna Mosquera Valderrama, "Legitimacy and the Making of International Tax Law: The Challenges of Multilateralism" (2015) 7:3 World Tax J 343 at 355–56.

Besides the text of the treaty articles, the extensive explanatory commentaries included in the OECD Model Tax Convention are also important legal sources in international tax law. Domestic courts of both OECD and non-OECD countries often rely on these technical commentaries as interpretive materials. For controversies about the role of the OECD Commentaries in tax law interpretation, see Michael Lang & Florian Brugger, "The Role of the OECD Commentary in Tax Treaty Interpretation" (2008) 23 Australian Tax Forum 95; Sjoerd Douma & Frank Engelen, *The Legal Status of the OECD Commentaries* (Amsterdam: IBFD, 2008); David A Ward, "The Role of Commentaries on the OECD Model in the Tax Treaty Interpretation Process" (2006) 60:3 Bull - Tax Treaty Monitor 97; Peter J Wattel & Otto Marres, The Legal Status of the OECD Commentary and Static or Ambulatory Interpretation of Tax Treaties (2003) 43:7 European Taxation 222; Klaus Vogel, The Influence of the OECD Commentaries on Treaty Interpretation (2000) 54: 12 Bull - Tax Treaty Monitor 612; Hugh J

treaty. It includes guidelines, recommendations, and specific tax policy reviews, ranging from transfer pricing to tax administration, from consumption taxes to exchange of information.[8] The central role assumed by the institution in formulating international tax policy is illustrated by its self-description as the "market leader in developing [tax] standards and guidelines."[9] Despite the recent emergence of other institutions in formulating international tax policy, such as the G20 and the EU,[10] the OECD still enjoys a central position in international tax policymaking.[11]

Ault, "The Role of the OECD Commentaries in the Interpretation of Tax Treaties" (1994) 22:4 Intertax 144.

[8] For a summary of topics and policy documents released by the OECD, see Tax - OECD, https://www.oecd.org/tax/ (last visited March 20, 2019).

[9] Allison Christians, "Taxation in a Time of Crisis: Policy Leadership from the OECD to the G20" (2010) 5:1 Nw JL Soc Pol'y 19 at 20. As Christians points out, despite the emergence of other institutions as tax policy leaders, such as the G20 and the EU, the OECD still enjoys a central position in formulating international tax policy. *See also* Brauner, *supra* note 5 (observing that throughout the years, it has become clear that the OECD has assumed leadership in international tax treaties practice); Reuven S Avi-Yonah, "International Tax as International Law" (2004) 57 Tax L Rev 483 (suggesting that the existing international tax regime, mostly based on the OECD model treaty, is widely accepted enough to constitute customary international). *But see* Rasmus Corlin Christensen, "The Rise of the EU in International Tax Policy" in George Christou & Jacob Hasselbalch, eds, *Global Networks and European Actors: Navigating and Managing Complexity* (London: Routledge, forthcoming) (describing the recent role of the EU as a "key challenger to the OECD" in international tax issues).

[10] See Christensen, *supra* note 9 (describing the recent role of the EU as a "key challenger to the OECD" in international tax issues).

[11] See Christians, *supra* note 9 (describing the central role of the OECD in formulating and disseminating international tax norms and pointing to the unlikelihood that the G20 provide an alternative policymaking space to the OECD in the near future).

Several commentators have pointed to the lack of institutional legitimacy of the OECD in designing international tax policy.[12] The first and main reason is its limited membership. The OECD has 36 members today, most of them developed countries, which explains its common label as a "rich country's club".[13] Membership to the organization is only available upon invitation and requires the candidate country to go through a rigorous and lengthy review process.[14] The terms, conditions, and process for accession are fixed by the OECD

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[12] See, e.g., Christians, *supra* note 9; Mosquera Valderrama, *supra* note 7; Michael Lennard, "Base Erosion and Profit Shifting and Developing Country Tax Administrations" (2016) 44:10 Intertax 740; I J J Burgers & I J Mosquera Valderrama, "Fairness: A Dire International Tax Standard with No Meaning?" (2017) 45:12 Intertax 767 at 771; Reuven S Avi-Yonah & Haiyan Xu, "Evaluating BEPS" (2017) 10:1 Erasmus L Rev 3; Sergio André Rocha, "The Other Side of BEPS: 'Imperial Taxation' and 'International Tax Imperialism'" in Sergio André Rocha & Allison Christians, eds, *Tax Sovereignty in the BEPS Era* (Alphen aan den Rijn: Wolters Kluwer, 2017) 179; Sissie Fung, "The Questionable Legitimacy of the OECD/G20 BEPS Project" (2017) 10:2 Erasmus L Rev 76; Allison Christians & Laurens van Apeldoorn, "The OECD Inclusive Framework" (2018) 72:4/5 Bull Int'l Tax 226; Irma Johanna Mosquera Valderrama, "Output Legitimacy Deficits and the Inclusive Framework of the OECD/G20 Base Erosion and Profit Shifting Initiative" (2018) 72:3 Bull Int'l Tax 160.

[13] See, e.g., Arkadiusz Myszkowski, "Mind the Gap: The Role of Politics and the Impact of Cultural Differences on the OECD BEPS Project" (2016) 70:5 Bull Int Tax 279 at 280; Matthias Schmelzer, "A Club of the Rich to Help the Poor? The OECD, 'Development', and the Hegemony of Donor Countries" in Marc Frey, Sönke Kunkel & Corinna R Unger, eds, *International Organizations and Development, 1945–1990* (London: Palgrave Macmillan, 2014) 171; Yariv Brauner, "What the BEPS?" (2014) 16:2 Florida Tax Rev 55; Thomas Rixen, "From Double Tax Avoidance to Tax Competition: Explaining the Institutional Trajectory of International Tax Governance" (2011) 18:2 Rev Int Polit Econ 197 at 208; Judith Clifton & Daniel Díaz-Fuentes, "From 'Club of the Rich' to 'Globalisation à la carte'? Evaluating Reform at the OECD" (2011) 2:3 Glob Policy 300; Cockfield, *supra* note 5, at 183; Reuven S Avi-Yonah, "Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State" (2000) 113:7 Harv Law Rev 1573 at 1664.

[14] Potential candidates for accession are assessed in four main criteria: like-mindedness, significant player, mutual benefit and global considerations. For a detailed explanation, see *Framework for the*

Council, which is made up of one representative from each member country and a European Commission representative.[15] They usually require significant changes to domestic legislation in a number of areas, including tax policy.[16]

The second problem is that the decision-making process has been exclusionary and opaque. Although the OECD has sought to include non-member countries in some of the tax policy discussions, commentators suggest the reasons have less to do with increasing their actual participation in setting the rules than securing their engagement and fostering a public perception of inclusivity.[17] Participation of developing countries is mostly circumscribed to the endorsement stage, with virtually no participation in idea conception and negotiation phases.[18]

3. The OECD/G20 BEPS Project and Its Inclusive Framework

In 2013, the OECD initiated what is commonly known as the Base Erosion and Profit Shifting ("BEPS") project.[19] The BEPS project is a comprehensive action plan to address tax

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Consideration of Prospective Members, http://www.oecd.org/mcm/documents/C-MIN-2017-13-EN.pdf.

[15] See *About the OECD*, http://www.oecd.org/about/whodoeswhat/.

[16] See *Framework for the Consideration of Prospective Members*, http://www.oecd.org/mcm/documents/C-MIN-2017-13-EN.pdf.

[17] Lennard, supra note 12, at 745; Irma Johanna Mosquera Valderrama, "The EU Standard of Good Governance in Tax Matters for Third (Non-EU) Countries" (2019) 47:5 Intertax 454 at 461.

[18] Christians, *supra* note 9, at 36.

[19] See OECD, *Addressing Base Erosion and Profit Shifting* (Paris: OECD, 2013).

avoidance and tax competition through a coordinated and collaboratively approach.[20] It has received political support and endorsement by the G20,[21] which has prompted some commentators to perceive it as the result of pressure by developing countries and a shift in the global power structure.[22]

However, from the outset, the project was very limited in including participation and addressing concerns of developing countries. First, the OECD acted as an independent partner to the G20 and took ownership of the BEPS project, with no supervision or control by the G20, and the project is said to be predominantly driven by the OECD's ambition than that of the G20.[23] Second, although the G20 has purportedly been established to bring together developed and developing countries to discuss key global economy issues,[24] participation of developing countries in the G20 is limited and do not represent their varied interests and goals.[25] Third, although some developing countries were consulted for the BEPS initiative, their main proposals were blocked by key OECD countries.[26] As a consequence,

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[20] *Ibid*, at 8–9.
[21] *Ibid*, at 5.
[22] Mosquera Valderrama, *supra* note 7, at 355.
[23] Rocha, *supra* note 12, at 182; Fung, *supra* note 12, at 78.
[24] Jan Wouters & Sven Van Kerckhoven, "The OECD and the G20: An Ever Closer Relationship?" (2011) 43 Geo Wash Int'l L Rev 345 at 346.
[25] Christians, *supra* note 9, at 38 ("Even if developing countries could be considered a consolidated group in terms of economic measurements such as per capita GDP, it is not clear whether the eight countries chosen to represent this group in the G20 adequately represent the range of tax policy issues that are of critical importance to other developing countries. While each of the eight countries may (or may not) have distinct tax policy goals, the over one hundred developing countries that have not been invited to participate in the G20 likely have distinct and divergent goals.").
[26] Avi-Yonah & Xu, *supra* note 12 at 9.

the project does not address some of the main complaints by developing countries, especially those relating to how the international tax base is shared among developing and developed jurisdictions.[27] Since major OECD countries dominated the discussions and negotiations around the BEPS package, some described the project as the result of a compromise between rich nations.[28]

Amid increasing concerns related to the legitimacy of the BEPS Project, the OECD and the G20 introduced in 2016 the "Inclusive Framework on BEPS", meant to allow other interested jurisdictions to participate on an equal footing in developing standards, review, and monitor the implementation of the BEPS package.[29] From a legitimacy perspective, this

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[27] Yariv Brauner, "BEPS: An Interim Evaluation" (2014) 6:1 World Tax J 10 at 29 ("Finally, despite the contribution of political pressure by developing and emerging economies that led to the BEPS project, there is little attention to the main sources of complaints by such countries against the current design of the PE [permanent establishment] regime by the OECD. The Action Item does follow a general direction of protecting source taxation, yet it does not address the specific issues that countries such as India and China have been raising in the last few years. There is no consideration of the service PE concept, no discussion of changes to construction PE rules, no mention of the digital PE option (although that may come up in Action Item 1, which is more generally devoted to the challenges posed by the digital economy) and, finally, no re-evaluation of the agency (or the subsidiary) PE concept as a whole.").

[28] See, e.g., Avi-Yonah & Xu, *supra* note 12, at 8. But see Richard M Bird, "Reforming International Taxation: Is the Process the Real Product?" (2015) 15:3 International Center for Public Policy Working Paper (adopting a more optimistic view and noting that the discussions on the BEPS project were "considerably more inclusive than earlier negotiations on international taxation").

[29] OECD, *OECD/G20 Inclusive Framework on BEPS: Progress Report July 2017-June 2018* (Paris: OECD Publishing, 2018) at 6. Along with the group of 46 countries (OECD and G20 members), 83 jurisdictions have joined the Inclusive Framework, amounting to a total of 129 participating jurisdictions. See OECD, *Members of the Inclusive Framework on BEPS*, available at https://www.oecd.org/ctp/beps/inclusive-framework-on-beps-composition.pdf (accessed April 5, 2019).

shows some progress, but it still does not seem to eliminate the existing legitimacy deficit of OECD's tax policy leadership. Despite its name, this initiative has shown not to be meaningfully inclusive and the role of participants who join is significantly restricted, which prompted commentators to suggest the Inclusive Framework could boil down to a mere rhetoric to circumvent calls for greater inclusivity.[30]

First, jurisdictions willing to join the Inclusive Framework are required to commit to all already established 15 Actions of the BEPS package,[31] which consist of a set of standards and recommendations on the most relevant areas of international tax, particularly to implementing the so-called four minimum standards, comprising requirements on harmful tax competition (Action 5), treaty abuse (Action 6), transfer pricing documentation (Action 13), and dispute resolution (Action 14).[32] Initial conditions and costs for joining any kind of institution are important because they lend credibility to the participants' commitment to the

[30] See Christians & Apeldoorn, *supra* note 12, at 233 (noting the risks of the Inclusive Framework being dismissed as mere rhetoric in the absence of greater transparency as to what goals the OECD aims to achieve with its initiative). See also Fung, *supra* note 12, at 84 (concluding that "only at the implementation stage of the BEPS Package are all countries treated as 'horizontal equals' in order to ensure its proper execution"); Dirk Maarten Broekhuijsen, *A Multilateral Tax Treaty: Designing an Instrument to Modernise International Tax Law* (PhD Dissertation, Leiden University, 2017) [unpublished] at 59–60 (arguing that participation of non-OECD countries have been mostly limited to the endorsement phase); Eurodad, *Q & A on the Intergovernmental Tax Body* (Brussels: Eurodad, 2016) (arguing that, at best, the Inclusive Framework provides a restricted influence of developing countries on a predetermined and very limited agenda).

[31] Requirements to join also include payment of an annual fee to cover the costs of the framework. See OECD, *supra* note 4 at 7.

[32] For an overview of the 15 Actions, see OECD, *OECD/G20 Base Erosion and Profit Shifting Project: Executive Summaries 2015 Final Reports* (Paris: OECD, 2015).

institution.[33] However, requiring that jurisdictions adhere to a set of rules that are not simple entry rules but are themselves the major products of the process they are striving to enter can hardly be considered reasonable or inclusive. Moreover, developing countries have demonstrated significant concerns about the costs and technical expertise required to implement the four minimum standards, which involve changes to their domestic legislation and tax treaties, particularly when they should be concentrating efforts to solve other more pressing problems regarding tax evasion and domestic tax collection.[34]

Second, despite the proclaimed equal-footing participation of non-OECD countries in the Inclusive Framework, the actual participation of these countries was mostly limited to implementing the BEPS four minimum standards.[35] The minimum component of democratic institutions is participation in the decision-making choices as to ensure both a protection of participants' interests and a protection from arbitrary decisions.[36] The BEPS project has already been delimited to 15 objectives (the 15 Actions) leaving no room for participation in *setting the agenda* to participants of the Inclusive Framework. Most of the final reports on these Actions have already been concluded in 2015, before the introduction of the Inclusive

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[33] Edward D Mansfield & Jon C Pevehouse, "Democratization and International Organizations" (2006) 60:1 Int'l Org 137 at 141–42.

[34] See Mosquera Valderrama, supra note 12, at 160 (reporting that many developing countries have been expressing concerns with the costs and consequences of implementing the four minimum standards, especially for countries with low-capacity tax administrations). For a detailed analysis of the issues for developing countries involving each of the four minimum standards, see *ibid*.

[35] OECD, *supra* note 4 at 13–14.

[36] Carole Pateman, *Participation and Democratic Theory* (Cambridge: Cambridge University Press, 1970) at 14.

Framework in 2016, leaving no room for participation in *decision-making choices* and in *setting the agenda*.

3.1. Output Legitimacy Deficit in the BEPS Project

The terms input and output legitimacy are now commonly used in the political science literature to refer to two complementary dimensions of the concept of democratic legitimacy.[37] On the input side, legitimacy requires procedures that connect political choices with citizens' preferences. On the output side, legitimacy implies that these political decisions achieve the goals set by these preferences.

The agenda and outcomes of the BEPS project demonstrate the lack of output legitimacy.[38] The project's outcomes predominantly reflect policy preferences of OECD

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[37] See Take, *supra* note 1, at 222–23 (noting that this systematization does not claim that the combination of these indicators comprises all necessary conditions for legitimacy). Take and other scholars suggest a third indicator called *throughput legitimacy*, which addresses procedural concerns and requires transparency of the decision-making process and accountability of decisionmakers. For simplicity purposes, this third indicator was deliberately omitted in adherence to the bipartite classification originally proposed by Scharpf (Fritz W Scharpf, "Economic Integration, Democracy and the Welfare State" (1997) 4:1 J Eur Pub Pol'y 18 at 19–20).

[38] For a detailed analysis of the BEPS project from the perspective of input and output legitimacy, see Mosquera Valderrama, *supra* note 7 (assessing input legitimacy according to the "transparency, participation, and representation of developing (non-OECD) countries in the setting of the agenda" and output legitimacy based on "the differences in objectives and resources between OECD and non-OECD (developing) countries" and "the shared goals i.e. to tackle tax fraud, tax evasion and aggressive tax planning and the solutions presented by the G20 and OECD, adopted by OECD and non-OECD countries").
Input and output legitimacy of the international tax regime has also been described significantly differently in the tax literature. See, e.g., Steven A Dean, "Neither Rules Nor Standards" (2011) 87:2

countries.[39] Many of developing countries' tax-related concerns with tax incentives for investment, the allocation of tax treaty rights, the role of withholding taxes, tax treaty cost-benefit analysis for negotiation of tax treaties, and the limited capacity of tax administrations remained mostly unaddressed by the BEPS project.[40]

One may argue that it would be unlikely to expect a different outcome. Since the project is still under the command of the OECD and the OECD's Secretariat is bound to defend the interests of its members, it could not depart much from OECD's institutional aims, which include "achiev[ing] the highest sustainable economic growth and employment and a rising standard of living in Member countries, while maintaining financial stability, and thus to contribute to the development of the world economy".[41]

This only suggests how difficult it is to envisage substantial improvement in terms of normative institutional legitimacy with the OECD ahead of the international policymaking decisions. It is hard to believe that the countries which currently exert significant power over

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Notre Dame L Rev 537 (adopting a compliance perspective to international legitimacy and associating input legitimacy deficit with unilateral enforcement measures undertaken by individual states and output legitimacy deficit with lack of states' embracement of extrajurisdictional enforcement obligations).

[39] Fung, *supra* note 12, at 87.

[40] See Mosquera Valderrama, *supra* note 7, at 377–78; Martin Hearson, "Developing Countries' Role in International Tax Cooperation" (2017) Intergovernmental Group of Twenty-Four Working Paper, online: G24 <https://www.g24.org/wp-content/uploads/2017/07/Developing-Countries-Role-in-International-Tax-Cooperation.pdf>.

[41] Convention on the Organisation for Economic Co-operation and Development.

international tax policy will easily accept handing it over to satisfy the interests of less powerful countries.[42]

3.2. OECD's Proposal for New Profit Allocation and Nexus Rules

In recent discussions on the taxation of the digital economy, the OECD has initiated what it called the "Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy".[43] The main goals of the project are to reconsider the current allocation of taxing rights between countries by reviewing the existing profit allocation and nexus rules (entitled "Pillar One") and to establish global anti-base erosion rules to ensure that all business income is subject to a minimum level of taxation. Although the original scope was to reallocate the international tax base of digitalized businesses, the programme now includes more broadly consumer-facing businesses.[44]

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[42] See J C Sharman, "Seeing Like the OECD on Tax" (2012) 17:1 New Pol Econ 17 (pointing out that from a political view point it is hard to imagine a global tax body coming into being); Cees Peters, "Global Tax Justice: Who's Involved?" in R. Van Brederode, ed, *Ethics and Taxation* (Singapore: Springer Nature, forthcoming) ("This concerns the current practice of a system that is dominated by a limited number of powerful states which take decisions about 'global tax justice' on behalf of the entire world. How will the states that are in power give consent to a new model of global tax governance with substantially less power for themselves?"). See also Tarcisio Diniz Magalhães, "What Is Really Wrong with Global Tax Governance and How to Properly Fix It" (2018) 10:4 World Tax J 499 at 514.

[43] OECD, *Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy* (Paris: OECD, 2019).

[44] OECD, *Secretariat Proposal for a 'Unified Approach' under Pillar One*, Public Consultation Document (9 October 2019 – 12 November 2019) at 5.

The OECD's proposal to review the current distribution of taxing rights is still designed at a conceptual level. The latest proposal to date (entitled the "Unified Approach" to Pillar One) was prepared by the OECD's Secretariat and was not yet approved by either the Inclusive Framework or the G20.[45]

The proposal seems to reflect the lack of legitimacy in the overall tax policy decision-making process. Although the new profit allocation and nexus rules could have some positive impacts on developing economies, it is unlikely that the final outcome will significantly change the status quo and overcome the legitimacy deficits in the international tax regime. First, it is still unclear whether low-income countries will largely gain from the new allocation as the new rules do not seem to apply to a significant portion of the international tax base. Moreover, any change in the existing rules will likely come with substantial costs for most low-income countries, such as having to agree to mandatory and binding dispute settlement procedures.[46]

4. Alternative Institutional Proposals

4.1. A Global Tax Organization with Universal Membership

[45] OECD, *supra* note 44, at 2.

[46] See Martin Hearson, "The OECD's Digital Tax Proposal: Untangling the Impact of 'Pillar One' on Developing Countries" (10 October 2019), ITCD Blog, available at <https://www.ictd.ac/blog/the-oecds-digital-tax-proposal-untangling-the-impact-of-pillar-one-on-developing-countries/>.

From different perspectives and for varying reasons, scholars, government officials and tax justice advocates have called for a world tax organization with universal membership. Such a global tax body would provide a forum for discussing international tax policy issues and likely replace the OECD in that capacity.

Some suggest that a global tax body with universal membership could be achieved by upgrading the existing UN Committee of Experts on International Cooperation in Tax Matters (UN Tax Committee).[47] The UN Tax Committee is a subsidiary body of the UN's Economic and Social Council (ECOSOC) and is currently composed of twenty-five members.[48] The UN Tax Committee is currently an expert body rather than an

[47] See e.g., Avi-Yonah & Xu, *supra* note 12, at 9 ("OECD and/or G20 is not the truly global platform for comprehensive reform of international tax law. To transform the current BEPS project into truly global, coherent, coordinated and inclusive actions, UN should undertake the leadership in the next stage of international tax law reform."); Annet Wanyana Oguttu, "Resolving Treaty Disputes: The Challenges of Mutual Agreement Procedures with a Special Focus on Issues for Developing Countries in Africa" (2016) 70:12 Bull Int'l Tax 724 at 741; "Statement on Behalf of the Group of 77 and China by Carola Íñiguez, Undersecretary of International Organizations of Ecuador, at the ECOSOC Special Meeting on International Cooperation in Tax Matters" (New York, 7 April 2017), online: <http://www.g77.org/statement/getstatement.php?id=170407b>; Oxfam, "Business Among Friends: Why Corporate Tax Dodgers Are Not Yet Losing Sleep Over Global Tax Reform" (2014) 185 Oxfam Briefing Paper at 15 (arguing for linking the BEPS project to the UN Tax Committee to improve inclusivity of non-OECD countries).

[48] ECOSOC Resolution 2004/69, UN Doc E/RES/2004/69. These members are nominated by governments but act in their expert capacity and are drawn from tax administrators of ten developed and fifteen developing countries "to reflect an adequate equitable geographical distribution, representing different tax systems" (UN, "Committee of Experts on International Cooperation in Tax Matters: Terms of Reference", available at https://www.un.org/esa/ffd/tax-committee/about-committee-tax-experts.html). The committee's current mandate is aimed at reviewing the UN Model Double Taxation Convention between Developed and Developing Countries and the Manual for the

intergovernmental body and cannot make political decisions on behalf of governments because it is composed by members speaking in their personal capacity, whose decisions have status of recommendations only. An intergovernmental tax body with universal membership under the UN would be a strengthened version of the UN Tax Committee and could assume a structure similar to the existing UN Climate Convention, the UN Convention on Biological Diversity, or the UN's Forum on Forests, all with universal or near-universal membership.[49]

A prominent call for upgrading the UN Tax Committee to an intergovernmental body took place during the UN's Third International Conference on Financing for Development in Addis Ababa in July 2015,[50] where developing countries and civil society organizations from across the world intensely advocated for the creation of a global tax body. The Group of 77 (G77), a coalition of 134 developing countries, requested that the creation of a new UN tax body be included in the final document to be signed at the closing of the conference, but the proposal was firmly opposed by some of the OECD countries.[51]

Negotiation of Bilateral Tax Treaties between Developed and Developing Countries and in giving commentaries and recommendations on various international tax policy issues.
The UN Tax Committee receives technical support from its ten ad hoc subcommittees.

[49] See Eurodad, *supra* note 30.

[50] "Addis Ababa Development Finance Summit: All You Need to Know" (July 13, 2015), online: The Guardian <https://www.theguardian.com/global-development/2015/jul/13/addis-ababa-development-finance-summit-all-you-need-to-know-sustainable-development-goals>.

[51] Katy Migiro, "Development Finance Talks in Ethiopia Close to Collapse" July 15, 2015, online: Thomson Reuters Foundation <http://news.trust.org/item/20150715173042-1m3ya>. Among others, the proposal is strongly supported by the Independent Commission for the Reform of International

Similar proposals are occasionally advanced or suggested by different actors. In 2019, the European Parliament's special committee on tax evasion and avoidance (TAX3) has recommended that a global tax body be established within the UN.[52] The European Network on Debt and Development (Eurodad), a network of 47 non-governmental organizations from 20 European countries, has been calling for a similar idea.[53] Tax scholars and commentators have also argued for a global tax body under the UN, noting that the OECD and the G20 are not inclusive enough for comprehensive international tax reform.[54]

However, setting up a global tax organization requires significant agreement among the most powerful international actors, and the reason why an intergovernmental tax body under the UN did not take hold yet is largely because it was rejected by the world's most influential countries. The United States, for example, vigorously rejected a proposal for a UN global tax body arguing that it "would substantially overlap with work that is already taking

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Corporate Taxation (ICRICT), a coalition endorsed by a number of renowned economist and public figures. ICRICT's commission includes Edmund Valpy Fitzgerald, Eva Joly, Gabriel Zucman, Ifueko Okauru, Jayati Ghosh,José Antonio Ocampo, Joseph Stiglitz, Irene Ovonji-Odida, Kim Henares, Léonce Ndikumana, Magdalena Sepúlveda Carmona, Suzanne Membe Matale, Ricardo Martner, Thomas Piketty, and Wayne Swan. See ICRICT, "The Comission", available at <https://www.icrict.com/the-commission>).

[52] "Special Committee Calls for European Financial Police Force (February 28, 2019), online: EU Reporter <https://www.eureporter.co/frontpage/2019/02/28/taxcrimes-special-committee-calls-for-european-financial-police-force/>.

[53] Eurodad, *supra* note 30.

[54] See Avi-Yonah & Xu, *supra* note 12, at 9 ("OECD and/or G20 is not the truly global platform for comprehensive reform of international tax law. To transform the current BEPS project into truly global, coherent, coordinated and inclusive actions, UN should undertake the leadership in the next stage of international tax law reform."). See also Oguttu, *supra* note 47, at 741.

place in other contexts, such as the IMF, World Bank, African Tax Administration Forum (ATAF), CIAT and the OECD" and that "the work undertaken in these other contexts already takes into account the policy positions of both developed and developing countries."[55]

Additional constraints seem to dismiss the proposal to upgrade the UN Tax Committee to an intergovernmental tax body. Some argue that the experience and expertise of the OECD makes it the most appropriate forum for leading global tax policy.[56] Others point to the lack of needed funds to measure up to the work presently carried out by the OECD.[57] Others question the viability of an international tax body with universal membership in terms of workable size.[58] A more critical perspective might suggest that the UN is not the solution to resolve the democratic deficits in the international tax regime, since the UN itself has been criticized for lack of electoral representation, transparency and broad public participation.[59]

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[55] U.S. Statement to ECOSOC Special Meeting on International Cooperation in Tax Matters (April 22, 2015), online: UN <https://www.un.org/esa/ffd/wp-content/uploads/2015/04/2015esm-usa.pdf>.
[56] See, e.g., Brauner, *supra* note 5, at 310–15.
[57] Hearson, *supra* note 40.
[58] Christians, *supra* note 9, at 38 (pointing out that the UN has been rejected as a viable alternative policymaking space and that even the temporary G33 was deemed too large to be effective). See also Dries Lesage, "Global Taxation Governance after the 2002 UN Monterrey Conference" (2008) 6:3 Oxford Dev Stud 281 (noting the limits of achieving global consensus on the most controversial issues in international taxation).
[59] See Fung, *supra* note 12, at 81 (pointing out that proposals to hand the BEPS Project over to the UN do not solve all the democratic deficits of international law-making and is most likely utopian); Magalhães, *supra* note 42, at 533 (noting the UN has repeatedly failed to act on behalf of poor countries); Robert O Keohane, "Global Governance and Legitimacy" (2011) 18:1 Rev Int Polit Econ 99 (pointing to the lack of transparency and accountability of the UN). See also Rafael Domingo, *The New Global Law* (Cambridge: Cambridge University Press, 2010) at 59 (arguing that the UN hand over the governance of the world to an exclusive club of sovereign powers and excludes an entire group of global actors who are dismissed as simple consultants).

4.2. Regional International Tax Forums

Some commentators propose that rather than centralizing the decision-making process in the UN, developing countries should improve their own capacity to engage in international tax policy by strengthening regional tax administration bodies such as the African Tax Administration Forum (ATAF) in Africa and the Inter-American Center of Tax Administrations (CIAT) in Latin America.[60]

Regional arrangements may provide a more effective forum for developing countries, since it is easier to achieve cooperation among smaller groups with common interests.[61] They may be fundamental in assisting developing countries build capacity to interact with developed countries on a more equal footing.[62] A more optimistic view suggests that these regional agreements may become a starting point for influencing the outcome of global negotiations, as happened with the OECD model bilateral tax treaty.[63]

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[60] Paddy Carter, "Row Over UN Tax Body Is a Needless Distraction for Developing Nations," *The Conversation* (21 July 2015), online: <https://theconversation.com/row-over-un-tax-body-is-a-needless-distraction-for-developing-nations-44943>. See also Magalhães, *supra* note 42 (arguing that creating another techno-bureaucratic supranational body will not solve the political legitimacy deficit of global tax governance and that marginalized countries should not have to wait for a major UN reform).

[61] Hearson, *supra* note 40. But see H David Rosenbloom, Noam Noked, & Mohamed Helal, "The Unruly World of Tax: A Proposal for an International Tax Cooperation Forum" (2014) 15:2 Fla Tax Rev 57 at 75–76 (arguing that membership of regional organizations is generally based on geography and members might not have shared interests in tax policy).

[62] Carter, *supra* note 61.

[63] Hearson, *supra* note 61.

Regional solutions constitute important alternative arrangements for allowing greater participation and increasing negotiating capacity of less powerful, developing countries.[64] However, it remains to be seen how these alternative regional forums would effectively interact to each other and whether they would gain sufficient political support at a global level. One discouraging example frequently mentioned in the literature is the Andean Model Tax Convention, developed in 1971 by five South American countries, members of the Cartagena Agreement of 1969.[65] The Andean model was designed to be used by member states in tax treaty negotiating with non-member countries and attributed almost unlimited taxing rights to developing (source) countries. Despite being in force for many decades, it did not succeed as a basis for bilateral tax treaties because no developed country would accept giving comprehensive taxing powers to source jurisdictions.[66] As for the existing regional forums such as the ATAF and the CIAT, they are mostly coordinated through tax administration officials and would require support at the political level to be effective.

5. Conclusion

[64] See Lesage, *supra* note 58 (arguing that regional arrangements are the optimal level for dealing with disputed international tax issues but also pointing out that the Global South remains highly divided).

[65] See, e.g., Eduardo A Baistrocchi, "The Use and Interpretation of Tax Treaties in the Emerging World: Theory and Implications" (2008) 4 Brit Tax Rev 352 at 372–73.

[66] *Ibid*, at 372–73 (pointing out that the Andean model became virtually irrelevant in international taxation).

This chapter has so far discussed the political and economic constraints that might prevent the two most common alternative institutional proposals from materializing, namely the call for a global tax body and the movement towards stronger regional international tax forums. However, even if one of these alternatives were fully implemented, they would likely not suffice to ensure a balanced distribution of taxing rights between developed and developing countries.

Merely ensuring that countries have a formally equal say in the decision-making process does not necessarily lead to a fair outcome that includes the interests of the less powerful stakeholders, primarily because of background inequalities in resources, technical knowledge, and general bargaining position.[67] The main problem with equating legitimacy with equal participation in the decision-making process is that it neglects that giving all stakeholders an equal opportunity to express their preferences frequently leads to an unfair aggregation of these preferences, as the problem of entrenched minorities often reveals.[68] This is illustrated by the ongoing BEPS project, in which the OECD has managed to

[67] Participation in international governance itself is questioned as genuinely voluntary, considering the costs weaker states would suffer by not participating. See Allen Buchanan & Robert O Keohane, "The Legitimacy of Global Governance Institutions" (2006) 20:4 Ethics Int'l Aff 405 at 414 ("Of course, there may be reasonable disagreements over what counts as substantial voluntariness, but the vulnerability of individual weak states is serious enough to undercut the view that the consent of democratic states is by itself sufficient for legitimacy").

[68] Steven Wall, "Democracy and Equality" (2007) 57:228 Phil Q 416 at 437.

monopolize the reform process through a top-down approach with agenda-setting on a higher level.[69]

However important these alternative institutional approaches are, they do not address the more structural problems in the international system, which will be further discussed in Chapter 2. As Chapter 2 will demonstrate, improving normative legitimacy requires not only institutional change but also a normative framework that puts the existing international inequalities as a central concern in international tax reform.

[69] Tim Büttner & Matthias Thiemann, "Breaking Regime Stability? The Politicization of Expertise in the OECD/G20 Process on BEPS and the Potential Transformation of International Taxation" (2017) 7:1 Accounting Econ L.

CHAPTER TWO
Structural Legitimacy Deficits

1. Introduction

Aside from the problem of limited institutional participation in international tax policy decision-making, the international tax regime seems to be unfair to developing countries in another respect. Even if formal equality were achieved through greater participation at some point, some long-standing rules and concepts already established in favour of developed countries might be hard to change. In addition, significant economic, political and military differences among jurisdictions might make it hard for less powerful countries to meaningfully advance their interests. This kind of problem can be characterized as *structural legitimacy deficit*. As the term suggests, improvement of developing countries' participation would not solve more structural inequalities resulting from years of dominance of developed countries over international tax policy which are hard to overcome and underlying differences between developing and developed economies. This chapter outlines some of these legitimacy issues.

2. First-Movers, Standard-Setting and Distributional Outcomes

The historical institutionalist approach to international political economy describes international policymaking as an incremental process that develops over time and argues that

timing and sequencing of events play a fundamental role in determining distributional outcomes for the different actors.[1]

One of the most significant aspects of the role of timing in international law has to do with first-mover advantages. Foundational institutional arrangements commonly produce significant advantage in setting agendas and standards. Once they are set by first-moving countries, the remaining stakeholders are pressured to either converge or adapt, generating asymmetrical bargaining strength between participants.[2] This is not to say that one single event in time will definitively seal the fate of the international tax regime, but it suggests that first-mover advantage increasingly constrain processes of institutional change.[3] The phenomenon relates to the notion of *path dependence*, which refers to the "causal relevance of preceding stages in a temporal sequence".[4] It suggests that once institutions have started down a track, the costs of reversal become significantly high due to the entrenchments of certain institutional arrangements.[5]

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[1] Henry Farrell & Abraham L Newman, "Making Global Markets: Historical Institutionalism in International Political Economy" (2010) 17:4 Rev Int'l Pol Econ 609.

[2] Elliot Posner, "Sequence as Explanation: The International Politics of Accounting Standards" (2010) 17:4 Rev Int'l Pol Econ 639 at 650.

[3] Farrell & Newman, *supra* note 1, at 342.

[4] Paul Pierson, "Increasing Returns, Path Dependence, and the Study of Politics" (2000) 94:2 Am Pol Sci Rev 251 at 252.

[5] Margaret Levi, "A Model, a Method, and a Map: Rational Choice in Comparative and Historical Analysis" in Mark I Lichbach & Alan S Zuckerman, *Comparative Politics: Rationality, Culture, and Structure* (Cambridge: Cambridge University Press, 1997) 19 at 28.

Throughout decades of tax policymaking, stakeholders who have become involved at an early stage tend to enjoy greater influence over international tax policy due to the lock-in effect and the costs associated with changing the existing standards and the ongoing process. This suggests the existing agenda, concepts and standards of the international tax regime not only tend to favour more powerful countries but are also less likely to change to a more balanced regime even if participation over tax policymaking were equalized.[6] Having entered the discussion as latecomers, developing countries also have reduced experience and resources to keep pace with developed countries.[7]

One of the most commonly pointed inequalities of the existing international tax regime is the imbalance of taxing rights between residence (mostly, developed countries) and source jurisdictions (mostly, developing countries). From a historical perspective, the tax treaty model was mainly designed by developed countries and based on economic principles that favoured simplicity and reduced barriers for international trade and investment. The model came to dominate the international tax arena, and the costs of not being part of the network gradually increased for late-coming developing countries. The result is that the tax treaty

[6] See Ranjit Lall, "Timing as a Source of Regulatory Influence: A Technical Elite Network Analysis of Global Finance" (2015) 9 Reg & Gov 125 (pointing out the importance of first-mover position in setting the agenda in global rulemaking, especially in influencing distributional outcomes by ensuring that proposals made by first movers are increasingly difficult to change at later stages of rulemaking).
[7] Irene Burgers & Irma Mosquera, "Corporate Taxation and BEPS: A Fair Slice for Developing Countries?" (2017) 1 Erasmus L Rev 29 at 38.

regime produces a 'cartelistic effect' that allows developed (residence) countries to benefit from a model so widespread that it is unlikely to change.[8]

Although a competing network may provide a fairer distribution of tax revenues to developing countries, many countries might be unwilling to join for fears of decrease in cross-border investment.[9] This is also a result of what in economic theory is known as the 'network effect', in which participants in a regulatory network reap greater benefits as the network expands.[10] Even if, for example, a unitary tax system based on formulary apportionment might provide a more efficient and fair solution to the taxation of multinational enterprises, the costs of a complete overhaul of a long-established system make

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[8] Tsilly Dagan, *International Tax Policy: Between Competition and Cooperation* (Cambridge: Cambridge University Press, 2018) at 173–74 ("In other words, in designing the treaty mechanism to favor countries of residence in the allocation of tax revenues, the network initiators were able to extract monopolistic rents at the expense of late-coming developing (host) countries.").
Some suggest that this is why the UN tax treaty model, which differs from the OECD model mostly for being more favourable to source countries, has not gained significant support (see Dagan, *ibid*). See also Veronika Daurer & Richard Krever, "Choosing between the UN and OECD Tax Policy Models: an African Case Study" (2012) European University Institute Working Paper RSCAS 2012/60, online: <http://cadmus.eui.eu/bitstream/handle/1814/24517/RSCAS_2012_60rev.pdf?sequence=3>
(analyzing African countries tax treaties and noting that due to domestic ideology regarding potential economic benefits and bargaining power of treaty partners, African countries treaties are mostly based on the OECD model, even when this means they retain fewer taxing rights compared to the UN model). For a detailed comparison between the two models, see Michael Lennard, "The UN Model Tax Convention as Compared with the OECD Model Tax Convention: Current Points of Difference and Recent Developments" (2009) 15:1 Asia-Pacific Tax Bull 4.
[9] Dagan, *supra* note 8, at 175.
[10] Kal Raustiala, "The Architecture of International Cooperation: Transgovernmental Networks and the Future of International Law" (2002) 43:1 Va J Int'l L 1.

it hard for such a solution to be implemented, as path dependence theory suggests.[11] Replacing the increasingly criticized separate-entity system, arm's length principle, and transfer pricing methods by a unitary tax system would require overcoming the lock-in effect over the tax treaty network, as it would ultimately require renegotiating many of the existing treaties.[12]

3. Imbalance of Resources and Expertise

The international tax regime is mostly structured through the more than 3,000 bilateral tax treaties in force today.[13] One of the main reasons for signing tax treaties is—as was in the 1920s, when the first model tax treaty was formulated—to encourage foreign investments.[14] Tax treaties tend to provide certainty and stability for foreign investors, as well as protection for residents for investment abroad in treaty partner countries.[15] They also generally include

[11] See Rixen, *supra* note 13 (explaining how the institutional trajectory of the ITR is characterized by the simultaneous stability of core principles and only incremental changes of the existing rules in the form of *rule stretching*, that is, subsuming new understandings under traditional notions, and *layering*, in which new arrangements are layered on top of an existing one).

[12] See Reuven S Avi-Yonah & Zachee Pouga Tinhaga, "Formulary Apportionment and International Tax Rules" in Sol Picciotto, *Taxing Multinational Enterprises as Unitary Firms* (Brighton, UK: Institute of Development Studies, 2017) 67.

[13] Julia Braun & Martin Zagler, *The True Art of the Tax Deal: Evidence on Aid Flows and Bilateral Double Tax Agreements*, Department of Economics Working Paper 242 (2017).

[14] For a brief historical account of how bilateral tax treaties developed, see Rixen, *supra* note 13.

[15] Ariane Pickering, "Why Negotiate Tax Treaties?" in UN, *Papers on Selected Topics in Negotiation of Tax Treaties for Developing Countries* (New York: United Nations, 2014) 1 at 22.

information exchange clauses, which provide local tax authorities with information from treaty partners residents, as well as from domestic taxpayers who invest abroad.[16]

However, entering into tax treaties bring significant costs. Both negotiating and administering tax treaties involve opportunity costs in terms of human resources and expenses.[17] Negotiation, interpretation, and administration of tax treaties is resource-intensive and requires highly skilled staff, which for developing countries means diverting scarce resources away from other important tax priorities.[18] Tax treaties also frequently require changes in domestic laws and may also restrict existing domestic legislation and limit future tax policy options because of specific rules and provisions, especially as a country's treaty network grows.[19]

More importantly for developing countries, there are significant immediate revenue costs in signing tax treaties. Treaties limit source taxation of income derived by non-residents (inbound income), and since most developing countries are capital-importing jurisdictions, they effectively lose taxing rights as they enter into tax treaties. Developing countries

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[16] See Eric M Zolt, "Tax Treaties and Developing Countries" (2018) 72 Tax Law Review 111 (pointing out that historically the information exchange mechanism proved to be of little use to developing countries due to difficulties in actually obtaining and accessing the information, but that the recent transition to automatic exchange of information through common reporting standard should provide developing countries with greater access as long as they can satisfy privacy and data protection obligations).

[17] Victor Thuronyi, "Tax Treaties and Developing Countries" in Michael Lang et al, eds, *Tax Treaties: Building Bridges Between Law and Economics* (Amsterdam: IBFD, 2010) 441 at 442–43.

[18] Pickering, *supra* note 15, at 26.

[19] *Ibid*, at 23–25.

generally accept three main constraints when they sign tax treaties with developed countries.[20] First, tax treaties determine the maximum tax rate at which source countries can impose withholding tax on treaty partner residents. These rates are usually lower than the rates established under domestic law and can sometimes be zero. Second, treaties generally settle a permanent establishment threshold, which determines the minimum level of activity that a foreign resident must have in the source country to have their profits taxed in the source country. Three, depending on negotiation, specific clauses can include or exclude certain types of income from taxation in the source country.[21]

Although there seems to be correlation between tax treaties and foreign direct investment in developing countries, empirical research suggests that signing tax treaties are mostly effective for middle-income, not low-income developing countries.[22] Moreover, tax treaties alone do not ensure increased foreign investment, especially because effective legal framework and stable economic institutions are also required to support investments.[23]

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[20] Martin Hearson, "When Do Developing Countries Negotiate Away Their Corporate Tax Base?" (2018) 30:2 J Int Dev 233 at 235–36.

[21] For an empirical study of the historical evolution of tax treaty negotiation outcomes between developing and developed countries, see Martin Hearson, "Measuring Tax Treaty Negotiation Outcomes: The Actionaid Tax Treaties Dataset (2016) International Centre for Tax and Development Working Paper 47 (noting that while treaties between developing and OECD countries today are curbing more source taxing rights than in the past, treaties signed between developing and non-OECD developing countries follow the opposite trend, leaving more source taxing rights intact).

[22] Eric Neumayer, "Do Double Taxation Treaties Increase Foreign Direct Investment to Developing Countries?" (2007) 43:8 J Dev Stud 1501.

[23] Pickering, *supra* note 15, at 21. But see Zolt, *supra* note 16 (arguing that tax treaties may have a greater impact in terms of foreign investment in countries with a history of political and economic instability).

Commentators often suggest that tax treaties are mainly geared to the interests of richer (residence) countries,[24] and some argue that the decision for developing countries as to whether sign tax treaties must be based on country-specific and treaty-specific determination of their economic consequences.[25]

However, the issue most frequently raised by commentators is the lack of technical negotiating capacity and expertise of low-income countries for negotiating treaties.[26] Treaty negotiation requires knowledge of international tax law, treaty principles, and other technical issues from the tax authorities involved.[27] Many developing countries end up signing treaties that are not in their best interests.[28] For this reason, some suggest that many developing countries would be better off without signing treaties.[29]

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[24] See, e.g., Bird, *supra* note 28, at 14. See also Hearson, *supra* note 40 (noting that most of the limits placed by tax treaties are imposed on the capital-importing country, but that the extent to which this is the case depends on the terms of each treaty). But see Braun & Zagler, *supra* note 13 (arguing that in asymmetric tax treaties, capital-exporting countries should compensate capital-importing countries and submitting that they actually do through development assistance, which increases on average by six million US$ in the year tax treaty is signed).

[25] Zolt, *supra* note 16.

[26] Hearson, *supra* note 20, at 249.

[27] Annet Wanyana Oguttu, "OECD' s Action Plan on Tax Base Erosion and Profit Shifting: Part 1 - What Should Be Africa's Response?" (2015) 69:11 Bull Int Tax 653.

[28] UN, *Papers on Selected Topics in Negotiation of Tax Treaties for Developing Countries* (New York: United Nations, 2014) at iii (pointing out that developing countries, in particular the least developed ones, often lack the adequate skills and experience to efficiently negotiate tax treaties, which may result in time-consuming and unsuccessful negotiation that do not address their policy priorities).

[29] See, e.g., Thuronyi, *supra* note 17. Some commentators more strongly advise developing countries not to enter into new tax treaties with developed countries, as tax revenues shift to developed countries

Considering the potential costs for developing countries to enter into tax treaties, one may ask why developing countries conclude treaties. One of the most important reasons is the worldwide recognition the treaty regime provides. Especially for countries with low reputation regarding stable economy and legal certainty, tax treaty signals a more reliable tax environment for foreign investors.[30] Tax treaties provide greater certainty to investor as to reduction of double taxation and ensure an effective mechanism for disputes between the taxpayer and tax authorities.[31] Another reason might is the belief that having treaties will increase foreign investment, even with no clear evidence that it may be the case. Empirical studies have found a mixed effect of tax treaties on investment flows.[32]

A broader perspective of the tax treaty network may suggest a different narrative as to why many developing countries not only enter into tax treaties but also accept adopting the OECD model, which is arguably the less advantageous of all existing treaty models available to developing countries. As any network, the OECD-based tax treaty network produces

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with no equivalent benefit (such as increased level of foreign investment) to developing countries. See, e.g., Kim Brooks & Richard Krever, "The Troubling Role of Tax Treaties" in Geerten MM Michielse & Victor Thuronyi, *Tax Design Issues Worldwide* (Kluwer Law International: Alphen aan den Rijn, 2015) 159. But see Zolt, *supra* note 16 (arguing that developing countries might have a reason to enter into treaties if they are able to secure meaningful withholding rates and safeguards against treaty abuse and suggesting an alternative view where tax revenues are not transferred from developing to developed countries but picked up by foreign investors in form of tax incentives).

[30] Tsilly Dagan, "The Tax Treaties Myth" (2000) 32:939 NYU J Int'l L Pol 1. See also Zolt, *supra* note 16 (arguing that tax treaties may have a greater impact in terms of foreign investment in countries with a history of political and economic instability).

[31] Zolt, *supra* note 16.

[32] Hearson, *supra* note 20 at 236.

standard features of externalities, expectations, and lock-in effects. First, the tax treaty network creates positive externalities only for countries (developed or developing countries) that participate in network, such as lower average communication cost (for being based on one same model), lower average enforcement cost (by referring to legal sources and case law produced by foreign domestic courts interpreting OECD-based tax treaties), greater reputation (by committing to keep local international tax system consistent with the international tax regime), and provision of generalized procedures for minimising double taxation (such as the advance pricing agreement and the secondary adjustment procedure).[33]

Second, the acceptance of the OECD Model creates positive market expectations over other standards available to developing countries. The widespread adoption of the OECD model and the fact that it is sponsored by the world's most developed countries generates the expectation that it would prevail over other available standards.[34] Third, the tax OECD-based treaty network has locked in a standard that impedes alternative, more balanced taxing right allocations. This lock-in effect directly relates to the path dependence and first-mover position explored in Section 2.

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[33] Eduardo A Baistrocchi, "The Structure of the Asymmetric Tax Treaty Network: Theory and Implications" (2007) Bepress Legal Series Working Paper 1991, online: < https://law.bepress.com/expresso/eps/1991/>.

[34] *Ibid*. See also Tsilly Dagan, "Tax Treaties as a Network Product" (2016) 41:3 Brook J Int'l L 1089 ("This behavior of developing countries can be explained by their incentive to 'join the club' and enjoy the compatibility of mechanisms that offer network-type advantages of the tax treaties system").

This account explains the behaviour of developing countries in concluding treaties as a prisoner's dilemma, where developing countries are left with little options confronted with the fear of driving foreign investments away to competing jurisdictions.[35] It suggests that the tax treaties regime allows "residence countries—the network originators—to extract cartelistic profits" at the expense of developing countries.[36] These structural issues suggest that even if institutions were put in place to ensure equal-footing participation between developed and developing countries in designing international tax policy, the current institutional design of the international tax regime prevents them from entering into treaties on an equal footing.

4. Sanctions, Blacklists, and Threats of Great Powers

Another source of constraints to less powerful countries is how sanctions operate in the present international legal system. Although theories of international tax cooperation and competition commonly assume a lack of hierarchy among countries, competitive strategies are significantly constrained by a credible threat of a great power.[37] Great powers can effectively coerce into cooperation jurisdictions that would otherwise be unwilling to

[35] Dagan, *supra* note 34, at 1101.
[36] *Ibid*, at 1100.
[37] Lukas Hakelberg, "Coercion in International Tax Cooperation: Identifying the Prerequisites for Sanction Threats by a Great Power" (2016) 23:3 Rev Int'l Pol Econ 511.

cooperate.[38] The outcome of international bargaining is significantly determined by the material resources available to the states, which enables them to issue more or less credible threats to others.[39]

Some commentators note that the US has been successful in forcing the Swiss government to hand over data on US-held accounts by threatening to indict major Swiss banks for servicing US tax evaders, and the OECD and the G20 have effectively coerced tax-haven countries to comply with its standards for information exchange upon request through the use of blacklist.[40] Research demonstrate that blacklisting can produce both reputational and financial costs on a state.[41]

However, although blacklisting may in some cases impose justified pressure on uncooperating states,[42] it may result in unprincipled coercion by the most powerful states if there are no transparent and objective criteria as to what factors countries should have to be included on the list. For example, although half of the top ten countries on the Tax Justice

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[38] Lukas Hakelberg & Max Schaub, "The Redistributive Impact of Hypocrisy in International Taxation" (2018) 12 Reg & Gov 353.

[39] See Hakelberg, *supra* note 37, at 514 (pointing out the importance of market size and vulnerability to trade disruptions as factors for determining coercive power in international tax cooperation and suggesting that although the EU, US, and China all control sizable consumer markets, the EU and the US dominate China in both inbound and outbound foreign investments and it would be much costlier for a capital exporting country to lose market access to the former than to the latter).

[40] Lukas Hakelberg, "The Power Politics of International Tax Co-operation: Luxembourg, Austria and the Automatic Exchange of Information (2015) 22:3 J Eur Pub Pol'y 409 at 421.

[41] Katrin Eggenberger, "When Is Blacklisting Effective? Stigma, Sanctions and Legitimacy: The Reputational and Financial Costs of Being Blacklisted (2018) 25:4 Rev Int'l Pol Econ 483.

[42] Peter Dietsch, *Catching Capital: The Ethics of Tax Competition* (New York: Oxford University Press, 2015) at 192–93.

Network's 'Financial Secrecy Index' are OECD countries, some of the most powerful countries such as the US, the UK, and Germany are spared from appearing on any of the black or grey lists produced by the OECD and the G20.[43] A more recent example is the EU's release of a blacklist of "non-cooperative tax jurisdictions."[44] It has sparked criticism for lack of both transparency and objective criteria, as it omits EU members and countries commonly regarded as tax havens.[45]

The somewhat arbitrary and obscure way these lists were put together poses a serious problem in terms of institutional legitimacy. Blacklisting as a legal tool has generally been criticized as they challenge existing logics of evidence, culpability and proportionality.[46] From a political perspective, blacklists are also criticized for being charged, biased and open to lobbying.[47] But more fundamentally, the fact that these sanctions are the only mechanism

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[43] See, e.g., *ibid*, at 209 (arguing that given the role some of these countries have played in the past in promoting tax competition, they should set an example before expecting anyone else to join in).

[44] The original list and subsequent adjustments are available at https://ec.europa.eu/taxation_customs/tax-common-eu-list_en.

[45] Lena Angvik, "Grey Is the New Black in EU's Tax Haven Blacklist" (Dec. 6, 2017), online: TP Week, <https://www.tpweek.com/articles/grey-is-the-new-black-in-eus-tax-haven-blacklist/aroexjiu>. See also Allison Christians, "Sovereignty, Taxation and Social Contract" (2009) 18:1 Minnesota J Int Law 99 at 101 (observing that the naming and shaming in the OECD's work on harmful tax competition is problematic and represents the determination of taxing rights of sovereign nations by a relatively small and elite group of individuals). For general criticism of the practice of blacklisting, particularly by supranational institutions, see Lucas de Lima Carvalho, "The Ills of Blacklisting for International Taxation" (Sep. 20, 2018), online: Kluwer International Tax Blog <http://kluwertaxblog.com/2018/09/20/ills-blacklisting-international-taxation>.

[46] Marieke de Goede, "Blacklisting and the Ban: Contesting Targeted Sanctions in Europe" (2011) 42:6 Sec Dialogue 499.

[47] Eggenberger, *supra* note 41, at 486.

in place to compel compliance on international tax norms raises an additional issue as to how the powers to impose sanctions are unequal among jurisdictions. Whereas the United States, for example, might be reasonably free to ignore the power of peer pressure exerted by international organizations if threatened with blacklisting and defensive measures, most countries are arguably much more susceptible to these forms of sanction.[48]

Governments powerful enough to use coercion have exploited tax cooperation to their own benefit.[49] Undermining norms of state sovereignty, self-determination, and international equity, they redistribute wealth to their own shores at the expense of less powerful actors by subjecting other countries to "hypocritical standards that they do not apply themselves".[50] Although the lack of a transparent and inclusive process in creating blacklists may point to an *institutional* legitimacy deficit, the fact that the international tax regime currently have no legal mechanisms available for enforcing compliance other than unilateral sanctions and blacklisting points to a *structural* legitimacy deficit. It portrays an imbalance of power that constitutes an additional structural problem of the international tax regime.

5. Improving Normative Legitimacy in the International Tax Regime

Chapter 1 demonstrated that the institutional design of the international tax system considerably excludes the participation of less powerful countries—which I have called the

[48] Fung, *supra* note 12, at 84.
[49] Hakelberg & Schaub, *supra* note 38.
[50] *Ibid*, at 367.

institutional legitimacy deficit.[51] This chapter has so far argued that first-mover advantages and differences in economic, political and military power prevent weaker states to negotiate and advance their interests at an equal standing, even if formally allowed to participate with the same formal rights as more powerful states—which I have called the *structural legitimacy deficit*.

The OECD, especially with the BEPS Inclusive Framework, has sought to address the institutional legitimacy deficit by allowing jurisdictions that agree to certain conditions to participate in the decision-making process. The outputs of the project have so far demonstrated that tackling the institutional legitimacy deficit alone does not succeed at answering the main concerns and interests of less powerful jurisdictions, mostly because the underlying structural legitimacy deficit remains unaddressed.

This section discusses the concept and conditions of normative legitimacy and argues that although institutional arrangements are needed to overcome the institutional legitimacy deficit, the structural legitimacy deficit can only be addressed if there are clear normative principles establishing fair outcomes for less powerful jurisdictions.

[51] I leave aside the fundamental question in democratic theory of who should be included in the collective decision-making process—commonly known as the boundary problem, the problem of inclusion, or the problem of constituting the demos—, not only because it goes beyond the scope of this thesis, but also because most would agree that at least those who are subjected to the decision should take part in making it. For an overview, see Robert E Goodin, "Enfranchising All Affected Interests, and Its Alternatives" (2007) 35:1 Phil & Pub Aff 40.

5.1. Dimensions of Legitimacy

The political science literature frequently underlines the importance of distinguishing legitimacy as a normative concept (an institution has the right to rule) from legitimacy as a descriptive concept (an institution is generally believed to have the right to rule).[52] Much of the literature on political economy and political science analyzes legitimacy in international tax governance from a *descriptive* perspective and regards legitimacy as the ability to gain consent of relevant stakeholders.[53] These studies are mostly concerned with issues such as the OECD's ability to facilitate effective global tax cooperation,[54] the feasibility of alternatives institutional frameworks,[55] the influence of great powers in global tax governance,[56] the role and prerequisites of coercion in tax cooperation,[57] the dynamics of expertise and lobbying in influencing frames and policies,[58] the recent power shifts in international tax governance,[59] how domestic political pressure from corporate capital and

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[52] See, e.g., Buchanan & Keohane, *supra* note 67, at 405. Although Buchanan and Keohane label the latter 'sociological' legitimacy, 'descriptive' seems a less equivocal term.
[53] Richard Eccleston & Richard Woodward, "Pathologies in International Policy Transfer: The Case of the OECD Tax Transparency Initiative" (2014) 16:2 J Comp Pol'y Analysis 216 at 227.
[54] Robert T Kudrle, "The OECD and the International Tax Regime: Persistence Pays Off" (2014) 16:3 J Comp Pol'y Analysis 201.
[55] Lesage, *supra* note 58.
[56] Hakelberg, supra note 40, at 421; Wouter Lips, "Great Powers in Global Tax Governance: A Comparison of the US Role in the CRS and BEPS" (2019) 16:1 Globalizations 104.
[57] Hakelberg, *supra* note 37.
[58] Leonard Seabrooke & Duncan Wigan, "Powering Ideas through Expertise: Professionals in Global Tax Battles (2015) 23:3 J Eur Pub Pol'y 357.
[59] Wouter Lips, *Power and Interests in International Tax Governance: Explaining the CRS and BEPS Regimes* (Zelzate: Uitgeverij University Press, 2019).

conflicts of interest among countries determine the institutional trajectory of the international tax regime,[60] how the transnational policy community interacts with interest groups at the domestic level to implement transnational norms as hard law,[61] the role and position of the BRICS countries in the recent developments of international tax policy,[62] and compromise strategies used by the OECD to circumvent deep-seated political resistance.[63] This strand of research generally focuses on the factors that determine an international organization's vulnerability to criticism and protest, and how formal rules and attributes, as well as informal behavioural regularities, influence societal acceptance of these institutions.[64]

This section is concerned with a different set of questions. It focuses on the *normative* conditions of legitimacy and asks what requirements international institutions must meet to be entitled to impose norms on international actors. It is less concerned with how the global tax governance institutions are *perceived* by the international community than whether they are *normatively justified* in exerting political power. Although these two conceptions of legitimacy may coincide in practice, they are not always convergent. A regime that is acknowledged and followed by most participants may be descriptively legitimate, but it is

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[60] Rixen, *supra* note 13.
[61] Martin Hearson, "Transnational Expertise and the Expansion of the International Tax Regime: Imposing 'acceptable' Standards" (2018) 25:5 Rev Int'l Pol Econ 647.
[62] Dries Lesage, Wouter Lips & Mattias Vermeiren, "The BRICs and International Tax Governance: The Case of Automatic Exchange of Information" (2019) 24 New Pol Econ.
[63] Eccleston & Woodward, *supra* note 53.
[64] Randall W Stone, "Informal Governance in International Organizations" (2013) 8:2 Rev Int'l Org 121.

likely normatively illegitimate if it is significantly limited to advancing the interests of the most powerful stakeholders at the expense of others.

5.2. Agency and Interest Accounts of Normative Legitimacy

A well-established account of normative legitimacy summarizes its conditions in two indicators, input and output legitimacy, which refer to the inputs and outputs of the political system.[65] *Input legitimacy* addresses the question of who is entitled to participate in the decision-making process and requires the equality of access to and consideration of interests of stakeholders.[66] *Output legitimacy* requires international institutions to be effective in achieving the stakeholders' goals.[67]

The dissociation of legitimacy in its input and output dimensions reflects the dispute about whether consent (government by the people) or utility (government for the people) should prevail.[68] The dissociation also relates to two common accounts of democracy. The *agency account* takes democracy as requirement of autonomy and maintains that stakeholders should be able to determine their own fates rather than be regulated by decisions

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[65] See *supra* note 37.

[66] Arthur Benz & Yannis Papadopoulos, "Actors, Institutions and Democratic Governance: Comparing across Levels" in Arthur Benz & Yannis Papadopoulos, eds, *Governance and Democracy: Comparing National, European and International Experiences* (Abingdon, Oxon: Routledge, 2006) 273 at 275.

[67] Scharpf, supra note 37, at 19–20.

[68] Klaus Dieter Wolf, "Contextualizing Normative Standards for Legitimate Governance beyond the State" in Jürgen Grote & Bernard Gbikpi, eds, *Participatory Governance: Political and Societal Implications* (Wiesbaden: Springer Fachmedien Wiesbaden, 2002) 35 at 39.

over which they have no control or participation.[69] The *interest account* see democratic participation as instrumental to realizing people's interests. According to this view, the democratic character of certain institutions is determined by their ability or propensity to deliver the stakeholders' interests.[70]

In national democracies, the distinction becomes clear when we consider the institutions commonly put in place to control the exercise of power. Some of the public officials acting either in the judiciary or in auditing bodies, because not directly elected by citizens, cannot be said to enact democratic agency—thus, they would not be realizing an agency-account type of democracy. However, they act to exert control over political power and protect citizens' interests. The interest account would suggest that it is important for democratic government to have officials who, not subject to recall by citizens, act independently from popular opinion and with longer-term view of the public interest.[71]

The distinction is relevant to determine what conditions an international institution should fulfill to be considered legitimate. The agency account leads to the thought that an international institution is legitimate once it allows stakeholders to adequately participate in the decision-making process so that they appropriately exercise political agency.[72] From the perspective of the interests account, legitimate institutions are those that reliably realize

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[69] Daniel M Weinstock, "The Real World of (Global) Democracy" (2006) 37:1 J Soc Phil 6 at 6.
[70] *Ibid* at 7.
[71] *Ibid* at 13–14.
[72] It is irrelevant for our purposes here to determine what the adequate level of political agency should be.

stakeholders' interests.[73] Rather than ensuring that everyone has a meaningful participation in the decision-making process, the interests account suggests making institutions more responsive to their interests and evaluate institutions based on their propensity and effectiveness in advancing stakeholders' fundamental interests.[74]

5.3. The Need for a Normative Framework

The OECD/G20 Inclusive Framework on BEPS was an attempt to address concerns relating to normative legitimacy and allow non-OECD, developing countries to participate in international tax policy decisions on an "equal footing". Likewise, the alternative institutional approaches proposed in the tax literature focus on improving inclusivity in the decision-making process. However, the main problem with an exclusive concern with the current institutional legitimacy deficit (participation of developing countries in the tax policy decision-making process) is that it does not address the underlying differences in power and bargaining position between jurisdictions (structural legitimacy deficit).

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[73] See Weinstock, *supra* note 69, at 7.

[74] *Ibid*, at 9 (pointing out that the interests account is aligned with the real-world democracies and "involve things like forced saving (to counteract akrasia and ignorance of our long-term good), provision of public goods (to offset collective action problems), public insurance schemes, child protectors and environmental impact assessment mechanisms (to enact democracy's commitment to the interests of all concerned by a given policy, including future generations), expert panels, auditors general, and the like. These mechanisms complement democratic institutions' ability to realize citizens' interests, but they are not themselves democratic. In fact, many of them are overtly paternalistic in their rationale and in their operation. They protect certain interests, when necessary against the tendency of democratic decision-making procedures to ignore or overlook them.").

Improving participation of developing countries in the decision-making process alone will likely not suffice to ensure a balanced distribution of taxing rights between developed and developing countries. Aside from granting weaker states with equal participation in democratic procedures, normative legitimacy also requires that the outcomes are fair, as the interest account of normative legitimacy submits.[75]

The first step to address the structural legitimacy deficit in the international tax regime is to create awareness of the problem among the affected stakeholders. An intermediary position on global justice suggests that international cooperation requires minimal mutual respect between political communities, which might not imply full global distributive justice but demands the absence of grave injustices.[76] The minimum base for international cooperation involves respect for human rights worldwide, prevention of international exploitation of weaker political communities, and opportunities for political self-determination.[77] Cooperation thus requires that institutions do not worsen the situation of the least advantaged, and the strength of the duty to reduce poverty and inequality is positively related to the capabilities of the different countries.[78]

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[75] See Section 5.2 above. See also Richard J Arneson, "Defending the Purely Instrumental Account of Democratic Legitimacy" (2003) 11:1 J Pol Phil 122 at 124.
[76] David Miller, "Against Global Egalitarianism" (2005) 9:1-2 J Ethics 55 at 77–78.
[77] Ibid at 78.
[78] See Jon Mandle, *Global Justice* (Cambridge, UK: Polity Press, 2006) at 102 (arguing that this duty of justice is stronger among wealthy states and those that played a historical role in making the social order unjust such as through colonialism).

The second and main step is to acknowledge the need for a normative framework with differentiated rights and duties for developing countries. Differential treatment in international law is an exception to the traditional principle of formal sovereign equality.[79] It can be generally defined as non-reciprocal arrangements which seek to foster substantive equality in the international community. The normative foundations for differential treatment in international law lies on the notion that formal equal treatment can only secure equality only among parties at an identical or similar level of economic and political power, and that an unequal treatment is needed to correct underlying inequalities among different parties.[80] Differentiation is also seen as a way to foster cooperation and facilitate the effective implementation of international norms.[81]

A survey in other fields of international law shows that differentiation has been applied differently in the various regulatory areas.[82] One noteworthy example of differentiation is the principle of common but differentiated responsibilities and respective capabilities within the

[79] Philippe Cullet, "Differential Treatment in International Law: Towards a New Paradigm of Inter-state Relations" (1999) 10:3 EJIL 549 at 550.

[80] Eduardo Tempone, "Special and Differential Treatment" in Rüdiger Wolfrum, eds, *Max Planck Encyclopedia of Public International Law* (Oxford: Oxford University Press, 2014).

[81] Cullet, *supra* note 79; Tempone, *supra* note 80.

[82] Forms of differential treatment vary from granting different groups of countries different implementation timetables (see, e.g., the Montreal Protocol on Substances that Deplete the Ozone Layer) to implement their to supporting capacity building in least developed countries commitments (see, e.g., the Nagoya Protocol on Access to Genetic Resources and the Fair and Equitable Sharing of Benefits Arising from their Utilization to the Convention on Biological Diversity) and to allowing different trade barriers between developing and developed countries (the Uruguay Round of multilateral trade negotiations conducted within the framework of the General Agreement on Tariffs and Trade – GATT).

United Nations Framework Convention on Climate Change.[83] This principle warrants that any solution for climate change must consider differentiated levels of responsibility according to the different capabilities of each jurisdiction. The concept of differentiation and the principle of common but differentiated responsibilities and respective capabilities will be analyzed in greater detail in Chapters 5 and 6.

It was not the purpose of this chapter to draw any concrete policy proposal. The main argument advanced here is that the discussion on the allocation of taxing rights between jurisdictions should take a normative perspective that considers the existing international inequality. An in-depth discussion on global justice is necessary to ensure fairness in international tax policy. Increased participation of developing countries in the international tax policy decision-making process may address the problem of *institutional* legitimacy deficit, but overcoming the *structural* legitimacy deficits requires a normative framework that provides a differential treatment to developing and the least developed countries.

6. Conclusion

Political theory submits that international institutions positively or negatively affect democracy in three ways.[84] They can enhance democracy when they limit special interests through public regulatory rules on a global basis, protect minority rights through human

[83] United Nations Framework Convention on Climate Change, A/RES/48/189.
[84] Robert O Keohane, "Global Governance and Legitimacy" (2011) 18:1 Rev Int'l Pol Econ 99 at 103.

rights institutions, and foster collective deliberation through less parochial discussions.[85] But they can also hinder democracy if they do the opposite by promoting special interests, violating minority rights, and reducing opportunity for and quality of collective deliberation, in which case they are deemed illegitimate.[86]

This and the previous chapter demonstrated that the existing international tax regime is illegitimate in two main respects.

First, international tax policy is mostly advanced by international institutions with limited membership that allows only restricted participation of non-members. Not surprisingly, those at the top hinder the emergence of alternative regimes both by employing rhetoric measures to circumvent calls for greater inclusivity and by directly opposing any attempts to creating a more inclusive forum for international tax policymaking. This legitimacy problem is recurrent in authoritative international institutions and is largely caused by the weak separation of power within the global governance system. Central decisionmakers in international institutions are representatives of the most powerful economies and generally hold formal mechanisms to assure special consideration of great power interests.[87] Thus, authoritative international institutions institutionalize inequality among states by incorporating stratification between different states.[88] As international

[85] *Ibid*.
[86] *Ibid*.
[87] Michael Zürn, "A Theory of Contested Global Governance" (2018) 9:1 Global Pol'y 138 at 140.
[88] *Ibid*.

institutions increase in their authority, as is the case with the OECD in international tax policy, powerful states have greater incentives to allocate resources to shape these institutions to their benefit, widening political inequality.[89]

Second, as the historical institutionalist account suggests, the institutional design of the international tax regime also poses structural legitimacy issues. The development of the international tax regime as a complex network of bilateral treaties produces unbalanced outcomes among countries with different levels of expertise and resources. Moreover, foundational institutional arrangements give first-movers significant advantage in setting agendas and standards. Once they have been set largely by developed countries, late-coming developing countries are pressured to either converge or adapt, generating asymmetrical bargaining strength among jurisdictions.

Most of the international tax literature on legitimacy focus on ways to improve inclusivity of weaker states, either through a global organization or via regional arrangements. Despite the relevance of these initiatives, this chapter has argued that normative legitimacy is not solely determined by inclusive procedures on the input side. It also requires that international institutions produce fair outcomes to countries that need them the most. Merely identifying legitimacy with inclusivity fails to consider that, first, participation of weaker states in global governance institutions is hardly voluntary due to the

[89] Lora Anne Viola, Duncan Snidal & Michael Zürn, "Sovereign (In)equality in the Evolution of the International System" in Stephan Leibfried et al, eds, *The Oxford Handbook of Transformations of the State* (Oxford: Oxford University Press, 2015) 221 at 233.

relevant costs they would suffer for not participating and, second, inclusivity alone does not suffice to solve the structural legitimacy issues of the international tax regime.

Improving legitimacy requires additional institutional commitments to overcome the significant differences among countries in terms of resources and bargaining positions. The lack of a normative framework that challenges the dominant theoretical model impairs the ability of less powerful stakeholders to discuss and negotiate policy with equal standing. Reviewing the normative foundations for allocating taxing rights among countries fairly is necessary for improving distributive justice, but it is also vital to allow developing countries to counter a hegemonic rhetoric that significantly disfavours them.

Achieving equal-standing negotiation requires expanding the discussion on the normative criteria to determine the allocation of taxing rights. Proper theoretical framework and language based on the concept of differentiation, which suggests differentiated rights and duties based on the different needs and capabilities of each jurisdiction, should help developing and the least developed countries make a case for improving their taxing rights. A serious discussion on distributive justice is critical to provide a counter-hegemonic framework to shift the balance toward a more equitable division of rights for less powerful countries.

CHAPTER THREE
Distributive Justice Deficits

1. Introduction

Aside from legitimacy problems, the international tax regime poses some distributive issues that significantly affect developing countries. The institutional design of the current system has resulted in two main distributive problems that directly affect less affluent countries. First, the present system allows for a competitive environment between governments that produces significant negative impact on the world's poorest countries. Second, the current allocation of taxing rights between countries significantly favours the most affluent economies, thereby producing a distributive impact that is relatively worse for the worst-off. This chapter will briefly introduce these two problems. Chapters 5 and 6 will provide a more in-depth analysis of each of these problems.

2. The Challenges and Constraints from Tax Competition

One key challenge facing today's international tax policy is the pervasiveness of tax competition, which significantly affects the distribution of income and tax revenue availability among countries. Although some have argued that there might be a potential

benefit in tax competition, especially in creating global locational efficiency,[1] most of the tax literature suggest otherwise. First, by turning countries into competitive players, tax competition undermines the ability of countries to set their tax regimes optimally to promote normative goals.[2] Second, the main problem with tax competition is not about governments competing to attract direct investment and jobs, but about their assigning of paper profits irrespective of where real economic activity occurs.[3]

Third, the problem of tax competition is not only the underprovision of public goods but its distributional implications.[4] Tax competition can negatively affect tax equity in three different dimensions.[5] First, as the ability for relocating income facilitated by tax competition is mostly enjoyed by the rich, tax competition hinders vertical equity.[6] Second, as the tax burden shifts from capital to labor, taxpayers with the same level of income, one from capital

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[1] Mitchell B Weiss, "International Tax Competition: An Efficient or Inefficient Phenomenon?" (2001) 16 Akron Tax J 99; David C Elkins, "The Merits of Tax Competition in a Globalized Economy" (2016) 91 Indiana LJ 905.

[2] See e.g, Reuven S Avi-Yonah, "Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State" (2000) 113:7 Harv L Rev 1573; Peter Dietsch, Catching Capital: The Ethics of Tax Competition (New York: Oxford University Press, 2015); Laura Seelkopf & Hanna Lierse, "Taxation and Inequality: How Tax Competition Has Changed the Redistributive Capacity of Nation-States in the OECD" in Melike Wulfgramm, Tonia Bieber & Stephan Leibfried, eds, *Welfare State Transformations and Inequality in OECD Countries* (London: Palgrave Macmillan, 2016) 89 at 96–97.

[3] Thomas Rixen, "Tax Competition and Inequality: The Case for Global Tax Governance" (2011) 17:4 Global Governance 447.

[4] Hans-Werner Sinn, *The New Systems Competition* (Malden, MA: Blackwell Publishing, 2003) at 56.

[5] Seelkopf & Lierse, *supra* note 2 at 92–93.

[6] Anthony C Infanti, "Tax Equity" (2008) 55 Buff L Rev 1191 at 2000.

and the other from labor, are taxed differently, which affects horizontal equity.[7] Third, as countries have different sets of advantages and disadvantages in competing for capital and income, tax competition changes the income distribution not only within but also between countries involved. Because tax competition affects countries with different characteristics differently, it impacts equity between countries (inter-nation equity). This latter problem is the main concern of this section.

Economic models demonstrate that larger countries have more to lose with tax competition, mostly because the benefits resulting from capital inflows (tax base effect) in proportion to the revenue lost from the lower taxation of domestic capital (tax rate effect) are higher in smaller countries.[8] Nonetheless, many studies also show that, in relative terms, tax competition has produced more severe effects on the world's poorest countries for three main reasons. First, economists have long observed the dependence of developing economies on corporate income tax revenues as a share of all revenues. While in developed countries personal income tax revenues are often three to four times the corporate income tax revenues, in developing countries personal income tax revenues are often lower than corporate income revenues.[9] Corporate income tax provides a larger contribution to overall revenue in developing countries compared to its much smaller relative contribution to overall revenue

[7] Seelkopf & Lierse, *supra* note 2 at 92–93.

[8] See, e.g., S Bucovetsky, "Asymmetric Tax Competition" (1991) 30:2 J Urban Econ 167; John D Wilson, "Theories of Tax Competition" (1999) 52:2 Nat'l Tax J 269.

[9] See Richard M Bird & Eric M Zolt, "Redistribution via Taxation: The Limited Role of the Personal Income Tax in Developing Countries" (2005) 52 UCLA Law Rev 1627 at 1656.

in developed countries.[10] As tax competition is primarily driven by corporate tax cuts, fiscal performance in developing countries is significantly more vulnerable to pressures from tax competition.[11] Most estimates of the revenue losses suffered by developing countries due to tax avoidance and tax competition exceed by some distance the amount these countries receive in development aid.[12]

Second, developing countries are also more vulnerable to tax competition because of the tax-sensitivity of firms. Some studies indicate that multinationals' investment and profit levels in developing countries are more sensitive to taxation than in the developed world, making them more vulnerable to increasing capital mobility.[13] Indeed, while the global decrease of corporate tax rates has not significantly affected corporate tax revenues in developed countries—whether as a share of GDP or as a share of total tax revenues—, it has considerably reduced corporate tax revenues in some of the poorest and most vulnerable of the developing countries.[14] Third, in the tax competition scenario, some types of tax

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[10] See Michael Carnahan, "Taxation Challenges in Developing Countries" (2015) 2:1 Asia Pacific Pol'y Stud 169 at 176.

[11] See International Monetary Fund, "Spillovers in International Corporate Taxation" (2014) IMF Policy Paper at 7.

[12] OECD, *Promoting Transparency and Exchange of Information for Tax Purposes: A Background Information Brief* (9 January 2010), online: <http://www.oecd.org/newsroom/44431965.pdf>.

[13] Clemens Fuest & Nadine Riedel, "Tax Evasion, Tax Avoidance and Tax Expenditures in Developing Countries: A Review of the Literature" (2009) Report Prepared for the UK Department for International Development, online: <http://www.sbs.ox.ac.uk/sites/default/files/Business_Taxation/Docs/Publications /Reports/TaxEvasionReportDFIDFINAL1906.pdf>.

[14] Michael Keen & Alejandro Simone, "Is Tax Competition Harming Developing Countries More Than Developed?" (2004) 34 Tax Notes Int'l 1317.

incentives are likely to be more successful than others in attracting investments and generating benefits for the host country. Since designing effective tax incentives is already a challenge for well-resourced tax administrations in developed countries, the risks of serious revenue leakages and negative consequences in developing countries are likely more significant.[15]

Tax competition poses a significant distributional problem that widely plagues most countries due to its race-to-the-bottom effect, but poorer countries are comparatively more affected. Tax competition results in what, for a matter of simplicity, I call the Revenue Problem.

3. The Inequitable Allocation of Taxing Rights

Another important distributional problem for developing countries is that the present allocation of taxing rights among countries significantly favours wealthier nations. The international tax regime consists of a network of bilateral tax treaties—most, to some extent, based on the OECD Model Tax Convention—that determine how taxing rights are divided between residence (mostly, developed) and source (mostly, developing) countries in cross-border transactions.

These treaties arguably aim to reduce double taxation. However, in the absence of treaties, a residence country could easily eliminate double taxation by providing its residents

[15] Carnahan, *supra* note 10 at 177.

with relief for the tax levied by the source country. This is why many commentators have noted that the main role of tax treaties, rather than address double taxation, is to reallocate taxing rights from source (which in the absence of a treaty would enjoy primary tax jurisdiction) to residence countries.[16] Some have gone as far as to advise developing countries not to enter into tax treaties with developed countries, arguing that tax treaties are a 'poisoned chalice'[17] which shift tax revenues to developed countries with often no equivalent benefit (such as increased level of foreign investment) to developing countries.[18]

The OECD tax treaty model was generally based on the goals of favouring simplicity and reducing barriers for international trade and investment. The model came to dominate the international tax arena, and the costs of not being part of the network gradually increased for late-coming developing countries. The result is that the tax treaty regime has allowed residence (developed) countries to benefit from a model so widespread that it is unlikely to

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[16] See, e.g., Kim Brooks & Richard Krever, "The Troubling Role of Tax Treaties" in Geerten MM Michielse & Victor Thuronyi, *Tax Design Issues Worldwide* (Kluwer Law International: Alphen aan den Rijn, 2015) 159 at 166.

[17] The description of tax treaties as a 'poisoned chalice' for developing countries has been first suggested by Martin Hearson in a presentation at Strathmore University Business School in Nairobi in September 2013. See Martin Hearson, "Double Tax Treaties: A Poisoned Chalice for Developing Countries?" (12 September 2013), online: <https://martinhearson.net/2013/09/12/double-tax-treaties-a-poisoned-chalice-for-developing-countries/>.

[18] Brooks & Krever, *supra* note 16. But see Eric M Zolt, "Tax Treaties and Developing Countries" (2018) Oxford University Centre for Business Taxation Working Paper 18/05 (arguing that developing countries might have a reason to enter into treaties if they are able to secure meaningful withholding rates and safeguards against treaty abuse and suggesting an alternative view where tax revenues are not transferred from developing to developed countries but picked up by foreign investors in form of tax incentives).

change.[19] Although competing treaty models may provide a fairer distribution of tax revenues for developing countries, many might be unwilling to join for fears of a decrease in cross-border investment due to the path-dependence effect.[20]

More fundamentally, the tax treaty network provides the legal infrastructure for the principles and concepts that shape the international tax regime today, so that the overall structure of international tax law is based on standards, principles, and methods that lead to an inequitable distribution of taxing rights between developing and developed countries. This results in what I call the Allocation Problem.

4. Global Distributive Justice

As noted in this chapter, the existing international tax regime harms developing countries in two different but related ways. First, the current institutional design allows for tax competition, which significantly reduces the collective revenue of countries and more severely affects the poorest ones (the Revenue Problem). Second, the existing regime produces an unbalanced allocation of taxing rights among developing and developed countries (the Allocation Problem). It is beyond the scope of this chapter to engage in the

[19] See Tsilly Dagan, *International Tax Policy: Between Competition and Cooperation* (Cambridge: Cambridge University Press, 2018).
[20] For a review of path dependence in international tax governance, see Section 2 of Chapter 2.

global justice debate.[21] However, because this chapter argues that the current international tax system poses global distributive justice problems, some elaboration on what I understand as the normative baseline for global justice is warranted.

One does not need to embrace a non-relational global cosmopolitanism[22] to hold the current international tax system as morally unjust. An intermediary position on global justice implies that international cooperation requires minimal mutual respect between political communities, which might not imply full global distributive justice but demands the absence of grave injustices. The main normative requirement deriving from the view of international distributive justice adopted here is that international rules and global institutional arrangements do not worsen the situation of the worst-off countries. There are three main reasons why this is so.

First, the international tax regime increasingly constitutes a strong and largely non-voluntary economic association between countries, which raises special associative duties,

[21] This is one the most discussed topic in the recent political philosophy literature. For a brief summary, see Samuel Scheffler, "The Idea of Global Justice: A Progress Report" (2014) 20 Harvard Rev Phil 17. For a more comprehensive account, see Gillian Brock, ed, *Cosmopolitanism versus Non-Cosmopolitanism: Critiques, Defenses, Reconceptualizations* (Oxford: Oxford University Press, 2013).

[22] I borrow this term from Andrea Sangiovanni, "Global Justice, Reciprocity, and the State" (2007) 35:1 Phil & Pub Aff 3, which refers broadly to the works of early, global egalitarians such as Charles Beitz, *Political Theory and International Relations* (Princeton: Princeton University Press, 1973); Thomas W Pogge, *Realizing Rawls* (Ithaca: Cornell University Press, 1989).

that is, duties owed to parties with whom one stands in a robust relationship or interaction.[23] One of these is the requirement that international institutions do not become sources of privileges to wealthier, more powerful participants.[24]

The second reason relates to the first but is independent and broader. The current level of economic integration of nations has made the global economy a substantial presence in the lives of all states, and economic regulation and policy decisions today take place in a global setting that is inescapably interdependent. The fact that rules made by a state (or by supranational rule-making body) are consequential to other states raises the need for some degree of coordination and equity beyond the national level.[25]

A third reason for distributive justice at the international level points to the causal relationship of globalization to global poverty. Although the argument relies on empirical premises, it seems uncontroversial today that economic globalization is at least partially a

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[23] These duties are sometimes called *relational* duties. See Andrea Sangiovanni, "On the Relation Between Moral and Distributive Equality" in Gillian Brock, ed, *Cosmopolitanism versus Non-Cosmopolitanism: Critiques, Defenses, Reconceptualizations* (Oxford: Oxford University Press, 2013) 55.

[24] Darrel Moellendorf, "Cosmopolitanism and Compatriot Duties" (2011) 94:4 Monist 535. See also Darrel Moellendorf, "Human Dignity, Associative Duties, and Egalitarian Global Justice" in Gillian Brock, ed, *Cosmopolitanism versus Non-Cosmopolitanism: Critiques, Defenses, Reconceptualizations* (Oxford: Oxford University Press, 2013) 222.

[25] Joshua Cohen & Charles Sabel, "Extra Rempublicam Nulla Justitia?" (2006) 34:2 Phil & Pub Aff 147 at 165.

factor in global poverty.[26] This causal relationship implies that some degree of partial correction is required to reduce or eliminate inequalities stemming from global factors.[27]

On this last point, one could argue that the current global economic system has shown a tendency to minimize extreme poverty in the world.[28] Similarly, one could point to the decrease in global inequality in the last decades and ask whether a change in the current international tax regime is called for. There are two main reasons why reform of current international institutions is still required to address the existing global poverty and inequality. As for global poverty, although extreme poverty has decreased in the last decades, independent projections by the World Bank and various research institutes suggest that we are a long way from eradicating global poverty.[29] Moreover, the number of people in extreme poverty in Sub-Saharan Africa has risen, and various projections expect that extreme poverty

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[26] This view is sometimes called "explanatory pluralism" and rejects that global poverty can be *wholly* explained as either a product of domestic factors (explanatory nationalism) or a result of global factors (explanatory globalism). See Chris Armstrong, "Defending the Duty of Assistance?" (2009) 35:3 Soc Theory & Prac 461 at 468–69.

[27] Building on luck egalitarianism, Cappelen argues for what he calls a principle of equalization at the international level, according to which the opportunities different countries have to pursue their goals be equalized, so that differences stemming from global factors be eliminated. See Alexander Cappelen, "Responsibility and International Distributive Justice" in Andreas Follesdal & Thomas Pogge, eds, *Real World Justice: Grounds, Principles, Human Rights, and Social Institutions* (Dordrecht: Springer, 2005) 215. See also Jon Mandle, *Global Justice* (Cambridge, UK: Polity Press, 2006) at 102 (arguing that this duty of justice is stronger among wealthy states and those that played a historical role in making the social order unjust such as through colonialism).

[28] This is shown, e.g., in Max Roser & Esteban Ortiz-Ospina, "Global Extreme Poverty" (2019), online: OurWorldInData.org <https://ourworldindata.org/extreme-poverty>.

[29] Ibid.

will be increasingly concentrated in Africa.[30] As for global inequality, although the world has seen a dramatic decrease in global inequality when countries' population sizes are taken into account (mostly due to the economic growth of China and India, the two most populous countries in the world), inequality between nations (without population-weighting) has risen in the last decades.[31]

Going back to the view of international justice endorsed in this thesis, its main normative requirement is that international rules and global institutional arrangements do not worsen the situation of the worst-off countries. Both the Revenue and the Allocation Problems demonstrate that the present international tax regime violates this normative requirement. First, by allowing the tax competition to continue (the Revenue Problem), it produces significant negative impact on the world's poorest countries. Second, by allocating taxing rights between countries in a manner that favours the most affluent ones (the Allocation Problem), it produces a distributive impact that is relatively worse for the worst-off.[32]

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[30] Ibid.

[31] See Branko Milanovic, "Global Income Inequality by the Numbers: in History and Now – An Overview" (2012) The World Bank Policy Research Working Paper 6529, online: The World Bank <http://documents.worldbank.org/>.

[32] Even a less generous account of global justice, such as the one espoused in Rawls's *Law of Peoples*, will concede that international institutions should be set in a way that is non-exploitative, so that wealthier economies would not benefit from unjustified distributive effects between nations. The current inequitable allocation of taxing rights between developing and developed countries, to the extent that it results in a distribution that significantly favours the latter at the expense of the former, likely violates what Rawls would consider as a "duty of non-exploitation".

5. Conclusion

This chapter provided only a brief introduction to these two main distributive justice problems in the present international tax system, namely the tax competition background that in many ways affect and restrain the ability of most countries to advance their domestic tax policies (the Revenue Problem) and the inequitable division of taxing rights between countries (the Allocation Problem). Chapters 5 and 6, respectively, will provide a more extensive account of these two problems and propose normative principles that should guide the existing attempts to address them. But before discussing these issues, it is important to take a step back and consider the broader picture of how legitimacy and distributive justice issues relate to one another and whether addressing one would entail addressing the other. This is the purpose of Chapter 4.

CHAPTER FOUR
Reconciling Legitimacy and Justice in International Tax Policy

1. Introduction

Chapters 1 and 2 examined political justice problems in the international tax regime and pointed to some of its institutional and structural legitimacy deficits. Chapter 1 argued that the institutional design of the international tax regime lacks legitimacy because international tax policy is mostly advanced through international institutions with limited membership which allows only restricted participation of non-members. Chapter 2 demonstrated that foundational institutional arrangements give first-movers significant advantage in setting agendas and standards, and late-coming developing countries are pressured to either converge or adapt, generating asymmetrical bargaining strengths between jurisdictions. Whereas these two chapters addressed legitimacy problems in the present international tax regime, chapter 3 focused on distributive justice issues. Chapter 3 showed that the international tax regime poses distributive justice problems by allowing for tax competition between countries, which reduces overall tax revenues and more significantly affects developing countries, and allocating taxing rights in a way that disfavours less affluent countries.

This chapter will submit that legitimacy and distributive justice are not substitutes and that justice requires the simultaneous improvement of international tax policy in both

normative realms. It will argue that contemporary rhetoric around justice in the international tax community demonstrates an outsize focus on political legitimacy to the exclusion of a genuine concern for distributive justice, to the ultimate detriment of the pursuit of international tax justice.

Over the last few years, the contemporary international tax regime has been increasingly criticized from varied perspectives. Some commentators argue it is unjust due to the lack of participation of developing countries in the policymaking process on an equal footing. Others suggest the international tax regime was designed by affluent countries to respond to self-interested goals. Some note that its current institutional design creates opportunities for tax competition and avoidance, which more seriously affect developing economies due to their relative dependence on corporate income tax and their greater vulnerability to capital mobility. Others specifically criticize how taxing rights, that is, the entitlement of countries to tax cross-border transactions, are currently allocated between home and host countries and how they disfavour capital-importing, developing countries.

These common criticisms reflect a familiar set of accounts in how justice is perceived and discussed in the political philosophy literature. One account centres around distributive justice, which relates to how burdens and benefits should be distributed throughout society. The other account focuses primarily on political justice and examines the conditions for the democratically legitimate exercise of political power, on the grounds that justice is to be pursued by altering the processes and institutions that produce tax rules and systems. The

two accounts are related since democratic legitimacy should comprise, to some extent, the set of conditions for any institution to pursue a just distribution of burdens and benefits.[1] However, each account builds on distinct normative foundations and entails different requirements.[2]

Relatively modest attention is given to the relationship between these accounts in the political philosophy literature,[3] and this gap carries over to scholarship on international tax

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[1] Keith Dowding, "Are Democratic and Just Institutions the Same?" in Keith Dowding, Robert E Goodin, Carole Pateman, eds, *Justice and Democracy: Essays for Brian Barry* (Cambridge: Cambridge University Press, 2004) 25.

[2] The distinction adopted in this thesis between *justice* and *legitimacy* is not to be confused with the distinction between *input* (process) and *output* (outcome) legitimacy. Similar to an assessment based on justice, output legitimacy is concerned about outcomes of institutional processes. However, output legitimacy is still about legitimacy in the sense that it requires outcomes of institutional processes to be aligned with stakeholders' interests. It is still a democratic question of how well institutions connect with interests. In other words, conditions for legitimacy focus either on including individuals' inputs in the process (input legitimacy) or achieving results that realize those same interests (output legitimacy). On the other hand, distributive justice follows a different philosophical tradition and, despite also focusing on outcomes, speaks to how benefits and burdens can be fairly distributed throughout society. Whereas outcome legitimacy builds on the democratic tradition and speaks to the accountability of a given institution to stakeholders, distributive justice consists of a moral evaluation of a given distribution rather than on whether such a distribution aligns with stakeholders' interests. For a more comprehensive discussion on the legitimacy-justice distinction, see Keith Dowding, Robert E Goodin, Carole Pateman, eds, *Justice and Democracy: Essays for Brian Barry* (Cambridge: Cambridge University Press, 2004).

[3] See Keith Dowding, Robert E Goodin & Carole Pateman, "Between Justice and Democracy" in Keith Dowding, Robert E Goodin & Carole Pateman, eds, *Justice and Democracy: Essays for Brian Barry* (Cambridge: Cambridge University Press, 2004) 1 at 1 (noting that political philosophy has historically focused on one and then the other of these two themes and rarely succeeded in holding them jointly); Simon Thompson, "On the Circularity of Democratic Justice" (2009) 35:9 Phil & Soc Criticism 1079 at 1080 (pointing out that little attention has been given to the relationship between these two normative dimensions).

policy, resulting in what may be described as the Legitimacy-Justice Fallacy, that is, the tendency of policy prescriptions to seek either to solve legitimacy problems by addressing distributive justice concerns or, conversely, to solve distributive justice problems by addressing legitimacy concerns. International institutions such as the Organisation for Economic Co-operation and Development (OECD) and the European Union (EU) seem to have historically resorted to this fallacy, first, by imposing allegedly just standards on non-member countries without legitimate decision-making procedures and, more recently, following criticism of that approach, by arguing that an inclusive institutional structure should be seen as delivering just outcomes.

This chapter examines the impact of this fallacy on international tax discourse and argues that global tax reform discussions should give greater consideration to distributive justice concerns. It will consider legitimacy and justice as two paths to evaluate fairness in the international tax regime and focus on the interaction between these normative dimensions, namely how they relate to one another and whether solving one problem dismisses the need for dealing with the other. Do international tax institutions that produce reasonably just outcomes need to be democratically legitimate? From the opposite perspective, do we need to discuss distributive principles of international tax justice in a scenario where international tax institutions are regarded sufficiently legitimate?

2. The Need for Legitimacy in International Tax Policy

Discussions on global distributive justice frequently leave aside any consideration of the institutions required to deliver the form of justice they support.[4] Yet, most would arguably agree that democratic values are an important requirement of justice and would hardly favour autocracy even if it may lead to a better outcome in the long run.[5] One could ask whether a normative evaluation of the international tax regime can preclude matters of legitimacy when it has passed the test for distributive justice. More concretely, if we determine that some normative standards in international tax policy are just, can we apply them to all stakeholders even if they are not derived from democratic institutions and through democratic procedures? Can distributive justice replace democratic legitimacy as a measure for normative evaluation?

Substantive discussions on distributive justice are effective for determining principles of justice, but they are limited when it comes to translating principles into concrete and specific solutions for real-world problems. The problem with a substantive approach that overlooks normative conditions for legitimacy is that it tends to be insensitive to context and

[4] Dowding, Goodin & Pateman, *supra* note 3 at 5.

[5] For a different position, see Richard J Arneson, "Democracy Is Not Intrinsically Just" in Keith Dowding, Robert E Goodin & Carole Pateman, eds, *Justice and Democracy: Essays for Brian Barry* (Cambridge: Cambridge University Press, 2004) 40 (arguing that the value of democracy is dependent on its ability to produce justice according to an independent standard of assessment and that the choice between autocracy and democracy should be determined based on which delivers morally superior results).

frequently fails to appreciate that institutional implementation requires political judgment.[6] Even if we are able to determine guiding principles for international taxation based on specific conceptions of justice, we still need to discuss how they should apply and be implemented. Given the considerable disagreements on what justice entails, participation in the decision-making process of those affected by policy decisions is necessary to avoid arbitrariness and favouritism. There are several potential solutions for international tax problems which can be justified by a standard of justice. Determining which of these justifiable solutions should be adopted requires a broader discussion through inclusive procedures.[7]

One example of what the lack of an inclusive process could lead to is the imposition of unilateral sanctions on countries that do not follow standards based on unilateral understandings of what international tax justice entails. A recent case is the EU list of non-cooperative tax jurisdictions,[8] which aims at addressing the Revenue Problem and includes

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[6] As Nancy Fraser points out, adopting a "mindset of latter-day philosopher kings" implies ignoring the political aspect of justice and the plurality of reasonable perspectives on how best to interpret the requirements of justice. See Nancy Fraser, "Social Justice in the Age of Identity Politics: Redistribution, Recognition, and Participation" in Nancy Fraser & Axel Honneth, *Redistribution or Recognition?: A Political-Philosophical Exchange* (London and New York: Verso, 2003) 7 at 71. For a similar position in international tax policy, see Tarcisio Diniz Magalhães, "What Is Really Wrong with Global Tax Governance and How to Properly Fix It" (2018) 10:4 World Tax J 499.

[7] See Allen Buchanan & Robert O Keohane, "The Legitimacy of Global Governance Institutions" (2006) 20:4 Ethics Int Aff 405 at 410, n 10 (arguing that legitimacy provides a "focal point" that helps stakeholders select one equilibrium solution among others).

[8] The original list and subsequent adjustments are available in European Commission, "Common EU List of Third Country Jurisdictions for Tax Purposes", online: <https://ec.europa.eu/taxation_customs/tax-common-eu-list_en>.

countries that do not follow specific standards relating to tax competition.[9] The list is not limited to a 'naming and shaming' approach but is expected to result in the application of defensive measures in case the listed jurisdiction does not make the changes requested by the EU.[10] The EU's initiative was based on an idea of 'fair taxation'[11] and the selection of criteria for determining the standards for the list did not include the participation of non-EU member countries. Based on a unilateral conception of distributive justice, the initiative is problematic from the standpoint of normative legitimacy.[12]

3. The Need for Distributive Justice in International Tax Policy

From the opposite perspective, one may ask whether we need to discuss distributive justice principles or whether we should leave justice to be determined by the outcomes of

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[9] EC, *Council Conclusions on the criteria for and process leading to the establishment of the EU list of non-cooperative jurisdictions for tax purposes*, [2016] OJ, C 461/02.

[10] Ibid.

[11] EC, *Council Conclusions on the EU list of non-cooperative jurisdictions for tax purposes*, [2017] OJ, C 438/04.

[12] The list has sparked criticism for lack of both transparency and objective criteria as it omits EU member states as well as some countries that are commonly viewed as tax havens. See, e.g., Daniel Boffey, "EU Blacklist Names 17 Tax Havens and Puts Caymans and Jersey on Notice", *The Guardian* (5 December 2017), online: <www.theguardian.com> [perma.cc/3ZZL-ACKY]; Francesco Guarascio, "EU Adopts Tax Haven Blacklist, British Territories Spared", *Reuters* (5 December 2017), online: <www.reuters.com>. See also Allison Christians, "Sovereignty, Taxation and Social Contract" (2009) 18:1 Minnesota J Int Law 99 at 101 (observing that the naming and shaming in harmful tax competition is problematic and represents the decision of taxing rights of sovereign nations by a relatively small and elite group of individuals). For general criticism of the practice of blacklisting, particularly by supranational institutions, see Lucas de Lima Carvalho, "The Ills of Blacklisting for International Taxation" (20 September 2018), online (blog): *Kluwer International Tax Blog* <http://kluwertaxblog.com/2018/09/20/ills-blacklisting-international-taxation>.

democratic procedures. Some philosophers focusing on conditions for fair decision-making procedures forswear detailed accounts of justice on the grounds that stakeholders should themselves decide what justice is.[13] They argue that since any conception of justice can be disputed and politicized, concerns about global justice should give rise to a quest to democratize systems of global governance.[14]

This section challenges that assumption in the context of international tax policy and argues that legitimacy and justice are not interchangeable. It is true that principles of justice cannot be imposed without proper democratically legitimate procedures. Nonetheless, greater legitimacy in the tax policy decision-making process will not necessarily lead to a just outcome, and an in-depth discussion on distributive justice is also necessary to ensure fairness in international tax policy.

3.1. The Gap between Political Equality and Substantive Equity

[13] Thompson, *supra* note 3.

[14] See, e.g., Heikki Patomäki, "Global Justice: A Democratic Perspective" (2006) 3:2 Globalizations 99. A similar argument is advanced in the international tax literature in Magalhães, *supra* note 6 ("Philosophers, like the ones discussed below behave as experts when they put disagreement and political deliberation aside and perform the monological role of enlightened philosopher kings, offering her (or, more usually, his) own view of what justice consists in, what rights we have, what fair terms of social co-operation would be, and what all of this is based on.").

As noted earlier, in 2016, the OECD introduced the BEPS Inclusive Framework to address institutional legitimacy concerns.[15] The framework aims to allow non-OECD jurisdictions to participate on an 'equal footing' in developing standards, reviewing, and monitoring the implementation of the Base Erosion and Profit Shifting (BEPS) project, which is a comprehensive action plan put forward by the OECD to address tax avoidance and tax competition through a coordinated and collaborative approach.[16]

The Inclusive Framework has been criticized because it limits the participation of non-OECD and non-G20 jurisdictions to reviewing and monitoring the implementation of standards that were in great part already determined through the development of the BEPS project.[17]

However, the main issue with improving the participation of developing countries in those terms is determining what 'equal footing' means. The BEPS Inclusive Framework seems to confine the notion of democracy to the idea of equality in the decision-making

[15] OECD, *OECD/G20 Inclusive Framework on BEPS: Progress Report July 2017-June 2018* (Paris: OECD, 2018) at 6. Along with the group of 46 countries (OECD and G20 members), 83 jurisdictions have joined the Inclusive Framework, amounting to a total of 129 participating jurisdictions. See OECD, *Members of the Inclusive Framework on BEPS*, available at https://www.oecd.org/ctp/beps/inclusive-framework-on-beps-composition.pdf (accessed April 5, 2019).

[16] See OECD, *Addressing Base Erosion and Profit Shifting* (Paris: OECD, 2013).

[17] See, e.g., Irma Johanna Mosquera Valderrama, "Legitimacy and the Making of International Tax Law: The Challenges of Multilateralism" (2015) 7:3 World Tax J 343 at 350.

process, dismissing any consideration of its outcomes.[18] Instrumentalist defenses of democracy suggest, however, that democratic legitimacy requires that decision-making procedures lead to just outcomes or to the morally best among the alternative policies.[19]

The main problem with equating democracy with equal participation in the decision-making process is that it neglects that giving all stakeholders an equal opportunity to express their preferences sometimes lead to an unfair aggregation of these preferences, as the problem of entrenched minorities often reveals.[20] Despite the importance of equal participation in democratic procedures, the fairness of the consequences of a decision should also determine its justifiability.[21]

One may suggest that developing countries constitute the great majority of the global community, and therefore giving them an equal say in the decision-making process would ultimately result in a regime that favours less over more affluent economies. However, developing countries face increasing competition for access to foreign investment and markets and are divided by significant levels of political, social, and economic heterogeneity

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[18] This conception of democracy is sometimes known as the proceduralist perspective. For a firm defense of the proceduralist account of normative legitimacy, see Fabienne Peter, "Democratic Legitimacy and Proceduralist Social Epistemology" (2007) 6:3 Pol Phil & Econ 329.

[19] See, e.g., Richard J Arneson, "Defending the Purely Instrumental Account of Democratic Legitimacy" (2003) 11:1 J Pol Phil 122; Steven Wall, "Democracy and Equality" (2007) 57:228 Phil Q 416.

[20] Wall, supra note 19 at 437.

[21] Arneson, *supra* note 19 at 124. Arneson does point out that the instrumentalist approach takes various forms and argues for a specific version which holds that a political decision is legitimate only if over the long haul it produces morally superior results to ones that would result from any feasible alternative.

which prevents them from acting collectively. As commentators note, strong economic or political stakeholders, such as powerful states or wealthy investors, frequently take advantage of these divergences to practice 'divide and rule' strategies and erode the capacity of weak countries for collective actions by confining them to "different 'cells' in a maze of prisoners' dilemmas."[22]

Merely ensuring that countries have an equal say in the decision-making process might not suffice to produce a fair result or to include the interests of the less powerful stakeholders, primarily because of background inequalities in resources, technical knowledge, and general bargaining position.[23] This is illustrated in the ongoing BEPS project, in which the OECD has managed to monopolize the reform process through a top-down approach with agenda-setting on a higher level.[24] Even within the Inclusive Framework, the project is still under the command of the OECD, and since its secretariat is bound to defend the interests of the OECD, it should not depart much from its institutional aims, which includes "achiev[ing] the highest

[22] Eyal Benvenisti, *The Law of Global Governance* (The Hague: The Hague Academy of International Law, 2014) at 208–09 (also noting that the term 'global governance' in itself indicates that global regulators do not simply implement consensual commitments but rather 'govern' through the exercise of discretion).

[23] Participation in international governance itself is questioned as genuinely voluntary, considering the costs weaker states would suffer by not participating. See Buchanan & Keohane, *supra* note 7 at 414 ("Of course, there may be reasonable disagreements over what counts as substantial voluntariness, but the vulnerability of individual weak states is serious enough to undercut the view that the consent of democratic states is by itself sufficient for legitimacy").

[24] Tim Büttner & Matthias Thiemann, "Breaking Regime Stability? The Politicization of Expertise in the OECD/G20 Process on BEPS and the Potential Transformation of International Taxation" (2017) 7:1 Accounting Econ L.

sustainable economic growth and employment and a rising standard of living in Member countries, while maintaining financial stability, and thus to contribute to the development of the world economy".[25] Moreover, political decisions are generally based on the technical work put forward by technical bodies primarily composed by nationals from OECD member countries[26] who are expected to hold at least informal commitments to represent the institution's interests.

An additional problem, discussed in Chapter 2, is the role of path dependence and first-mover advantage in policy decision-making. Initial institutional arrangements commonly produce a significant advantage in setting agendas and standards. Once institutions have started down a track, the costs of reversal become significantly high due to the entrenchments of particular institutional arrangements. Even if an alternative policy could be considered fairer and more efficient from an ideal perspective, the existing institutional arrangements might make it an infeasible alternative. In this respect, commentators frequently note the OECD's recent use of rhetorical strategy based on the notions of economic substance and value creation not only to strengthen its epistemic and governance authority but primarily to evade committing to a more substantial overhaul of the current system.[27]

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[25] Convention on the Organisation for Economic Co-operation and Development.

[26] See OECD, *Frequently Asked Questions – Jobs*, http://www.oecd.org/general/frequentlyaskedquestionsfaq.htm#JOBS.

[27] See, e.g., Büttner & Thiemann, *supra* note 24.

In short, political equality does not ensure substantive equity. Improving participation of countries on an equal footing with no consideration to background inequalities and differences in bargaining position might not lead to a fair allocation of taxing rights, particularly for the least developed countries. Unless there is a more serious discussion on distributive justice and substantive equity in how taxing rights are allocated, poorer countries might be left with only a formal right to participate in the policymaking process.

3.2. A Normative Framework for Equal-Standing Negotiation

Most international tax reform proposals discussed today, aimed at addressing the allocation of taxing rights among jurisdictions, have an underlying concern with economic substance. They reflect an implicit assumption that states are entitled to benefit from (and thus to tax) resources they control and the wealth created in their territory.[28] However, what frequently goes unnoticed is that the commitment to economic substance is ultimately based on a fundamental conception about justice, that is, on a specific moral standard for determining how the rights to tax should be allocated among countries. Such standard is so entrenched in the literature and the policymaking debates that commentators rarely acknowledge it as a contentious matter of distributive justice.[29]

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[28] For a discussion on this assumption and a critique from a philosophical standpoint, see Laurens van Apeldoorn, "Exploitation, International Taxation, and Global Justice" (2019) 77:2 Rev Soc Econ 163.
[29] For a critical assessment, see Allison Christians, "Taxing According to Value Creation" (2018) 90 Tax Notes Int'l 1379 (portraying economic substance and value creation as well-worn tax mantras

Policy negotiations involving technical concepts and significant distributional outcomes often result in stakeholders supporting technical arguments which will maximize their share of benefits.[30] The lack of a normative framework that challenges the dominant theoretical model impairs the ability of less powerful stakeholders to discuss and negotiate policy with equal standing. Reviewing the normative foundations for allocating taxing rights among countries fairly is necessary for improving distributive justice, but it is also vital to allow developing countries to counter rhetoric based on entrenched principles that significantly disfavours them.

Even for an equal-standing negotiation, there is a need for expanding the discussion on the normative criteria to determine the allocation of taxing rights. Limiting discussions to legitimacy concerns might not suffice given the lack of proper theoretical framework and language that help developing countries make a case for improving their taxing rights. A serious discussion on distributive justice is critical to provide a counter-hegemonic framework to shift the balance toward a more equitable division of rights.

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and noting it camouflages the distributive nature of the international tax system as neutral and apolitical).

[30] From the perspective of political legitimacy, the lack of distance between 'author' and 'subject' of international law is sometimes seen as problematic and resulting in states proceeding in a self-interested manner when crafting legal obligations for themselves. See Jaye Ellis, "Stateless Law: From Legitimacy to Validity" in Helge Dedek and Shauna Van Praagh, eds, *Stateless Law: Evolving Boundaries of a Discipline* (Ashgate, 2015) 133.

3.3. Bleak Prospects of Global Democratic Institutions

Another reason why legitimacy discussions should not replace the need for distributive justice concerns is that a scenario where normative conditions for the legitimacy of global governance institutions are fully met seems remote. First, a pervasive problem in international governance institutions is the long chain of delegation from the individual citizen to the international policy decision-making arena, where the impact of popular will on the decision-making process is nominal at the international level.[31] Second, there is no political structure today that could ensure democratic control over global governance institutions.[32] Third, an attempt to create such a structure in the form of a global democratic federation would have to rely on existing states as federal units, but since many states themselves lack conditions for state legitimacy, they could not confer legitimacy to a global governance institution.[33]

As noted in Chapters 1 and 2, the prospects for legitimacy in international tax policymaking are poor. The OECD's BEPS Inclusive Framework, an attempt to increase inclusiveness, has been severely criticized for limiting the participation of non-OECD and non-G20 members to the implementation phase. Calls for a global tax body under the United Nations (UN) are systematically rejected and undercut by the world's most influential

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[31] Buchanan & Keohane, *supra* note 7 at 414–15. See also Ellis, *supra* note 30 (arguing that access to the structures and processes of international law by civil society remains limited and concentrates on organizations rather than on individuals and informal groups).
[32] Buchanan & Keohane, *supra* note 7 at 416.
[33] Ibid.

countries, and the UN itself is decried for lacking democratic procedures.[34] Regional arrangements are another possible solution for improving legitimacy, but it is unclear whether they will gain enough influence at a global level and how they will connect to each other in a way that leads to global cooperation. Given this scenario, even if we were to concede that legitimate institutions should necessarily lead to fair outcomes, forgoing discussions on distributive justice in international tax policy in favour of a democracy-oriented solution implies waiting for legitimate structures to take place when it is not clear if they ever will.

3.4. The Reciprocally Supportive Roles of Consent and Content in Stakeholders' Protection

In most democratic countries, the relationship between distributive justice and political legitimacy is regulated by constitutional rules that lay down certain substantive rights and principles, as well as procedural rules for judicial review.[35] In a domestic context, such rules are expected to ensure a minimum level of distributive justice when political democracy fails

[34] See Sissie Fung, "The Questionable Legitimacy of the OECD/G20 BEPS Project" (2017) 10:2 Erasmus L Rev 76 at 81 (pointing out that proposals to hand the BEPS Project over to the UN do not solve all the democratic deficits of international law-making and are most likely utopian); Tarcisio Diniz Magalhães, "What Is Really Wrong with Global Tax Governance and How to Properly Fix It" (2018) 10:4 World Tax J 499 at 533 (noting the UN has repeatedly failed to act on behalf of poor countries); Robert O Keohane, "Global Governance and Legitimacy" (2011) 18:1 Rev Int Polit Econ 99 (pointing to the lack of transparency and accountability of the UN). See also Rafael Domingo, *The New Global Law* (Cambridge: Cambridge University Press, 2010) at 59 (arguing that the UN hands over the governance of the world to an exclusive club of sovereign powers and excludes an entire group of global actors who are dismissed as simple consultants).

[35] For an interesting analysis of some of the perils of this type of constitutional choice, see Charles Delmotte, "Tax Uniformity as a Requirement of Justice" (2020) 33:1 Can JL & Jur 59.

to protect certain individuals due to, for example, unrestrained majorities or institutional corruption.[36] Similarly, in domestic tax systems, stakeholders have historically relied on fixing substantive principles of tax justice (content) whenever there were constraints in participation and democratic procedures (consent).[37] Taking consent and content as mutually complementary ways of protecting weaker stakeholders, protection by content acquires an even more critical role where protection by consent is limited.[38]

Given the absence of a global constitution or an international central authority today to ensure the fulfilment of minimum requirements of justice, discussing distributive justice at the international level seems even more relevant than in domestic democracies. In the lack of formal, binding constitutional rules, an ethical normative framework is paramount in the event of inadequate functioning of international institutions. The absence of greater consideration of distributive justice in discussions of international tax policy is likely to lead to a system where consent (political legitimacy) is absolute, with no counter-majoritarian measures or similar devices to protect weaker stakeholders.

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[36] For an overview of recent theories of institutional corruption, see Dennis F Thompson, "Theories of Institutional Corruption" (2018) 21 Ann Rev Pol Sci 495.

[37] See Wolfgang Schön, "Taxation and Democracy" (2019) 72 Tax L Rev (noting that while decision-making in tax matters is hardly constrained by any material constitutional limitations in the UK and the US, European and Latin American countries have largely resorted to hard-wired constitutional constraints on tax legislation to ensure a high degree of judicial review by constitutional courts).

[38] Ibid (arguing that a content-oriented principle of tax equity should take charge of those who are not entitled to make tax policy dependent on their consent). See also Thompson, *supra* note 3 (arguing that justice and legitimacy stand in a circular relationship, where democratic political arrangements constitute a requirement of justice, but democratic deliberations should meet the standards of justice).

4. The Legitimacy-Justice Fallacy and Its Role in International Tax Policy

Although the distributive justice issues presented in Chapter 3 have long been identified and acknowledged in the relevant literature,[39] we still lack a broader discussion on the normative implications of global justice for addressing these tax policy problems.[40] One important reason for this scholarly gap is that the literature tends to conflate legitimacy (discussed in Chapters 1 and 2) with distributive problems (discussed in Chapter 3).[41] Proposals to address the latter (that is, reducing the existing inequities of the international tax regime) frequently focus on improving the former (that is, securing greater participation of developing countries in tax policy decision-making). Whereas improving legitimacy in the

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[39] For the Revenue Problem, see, e.g., Reuven S Avi-Yonah, "Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State" (2000) 113:7 Harv L Rev 1573; Nita Rudra, *Globalization and the Race to the Bottom in Developing Countries: Who Really Gets Hurt?* (Cambridge: Cambridge University Press, 2008); Peter Dietsch, *Catching Capital: The Ethics of Tax Competition* (New York: Oxford University Press, 2015). For the Allocation Problem, see, e.g., Thuronyi, Victor, "Tax Treaties and Developing Countries" in Michael Lang et al, eds, *Tax Treaties: Building Bridges Between Law and Economics* (Amsterdam: IBFD, 2010) 441; Tsilly Dagan, *International Tax Policy: Between Competition and Cooperation* (Cambridge: Cambridge University Press, 2018); Martin Hearson, "When Do Developing Countries Negotiate Away Their Corporate Tax Base?" (2018) 30:2 J Int'l Dev 233.

[40] Two notable exceptions are Dietsch, *supra* note 39; Dagan, *supra* note 39.

[41] The tax literature rarely discusses separate solutions for these two issues. Calls for improving legitimacy in the international tax regime frequently eclipses an in-depth discussion on solutions focused on distributive justice. See, e.g., Richard Collier & Nadine Riedel, "The OECD/G20 Base Erosion and Profit Shifting Initiative and Developing Countries" (2018) 72:12 Bull Int'l Tax 704; Richard M Bird, *Reforming International Taxation: Is the Process the Real Product?*, International Center for Public Policy Working Paper 15–03 (2015);
Irene JJ Burgers & Irma J Mosquera Valderrama, "Corporate Taxation and BEPS: A Fair Slice for Developing Countries?" (2017) 1 Erasmus L Rev 29
; Avi-Yonah, Reuven S & Haiyan Xu, "Evaluating BEPS" (2017) 10:1 Erasmus L Rev 3.

international tax regime by strengthening the participation of developing countries in the decision-making process is expected to result in distributive improvements, this is not a necessary implication, and addressing legitimacy deficits may not suffice to meet the requirements of global justice.[42]

There is a logical gap between the moral requirements for distributive justice and the solutions for addressing legitimacy. Democratic legitimacy primarily focuses on procedural requirements to formally capture the interests of stakeholders and translate them into outcomes and has only tangential connections to just outcomes.[43] Conditions for legitimacy and justice are grounded in related but different moral values and justifications, as well as imply different requirements. Improving legitimacy is likely to help to advance distributive justice due to the mutually supportive roles of consent and content mentioned in the last section, but attempting to address one issue (a distributive justice problem) with the solution for another (a legitimacy problem) neglects the distinct nature of these issues.

Conflating the two normative realms produces what I call the Legitimacy-Justice Fallacy. Whereas distributive justice focuses on how burdens and benefits should be distributed, political justice (or legitimacy) considers who should exercise power and how

[42] See Dowding, Goodin & Pateman, *supra* note 3 at 5 (noting that there is nothing inherent in democracy that necessarily makes it just).
[43] Ibid at 5–6.

they should do so.[44] Collapsing the notion of legitimacy into one of distributive justice undermines the social function of legitimacy assessments.[45] On the other hand, the problem with an exclusive concern with democratic legitimacy is that it does not seem able to legitimate every result it generates, and it neglects that "outcomes that are undeniably democratic can be palpably unjust."[46]

The OECD seems to have particularly relied on this fallacy when promoting its goals and standards in international tax policy. In an earlier attempt to tackle tax competition, it built on a unilateral conception of justice to impose specific standards for 'acceptable' tax competition and called for defensive measures and economic sanctions against countries that would not comply with its standards.[47] Although such standards were unilaterally established by the OECD, they applied to both OECD and non-OECD members. The lack of legitimacy

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[44] Simon Caney, "Justice and the Basic Right to Justification" in Rainer Forst, ed, *Justice, Democracy and the Right to Justification: Rainer Forst in Dialogue* (London: Bloomsbury Academic, 2014) 147 at 152–56.

[45] See Buchanan & Keohane, *supra* note 7 at 412 (arguing that there are two reasons not to mistake legitimacy for justice, the first being that there is sufficient disagreement on what justice entails so that a standard for legitimacy requires a different concept for securing coordinated support for valuable institutions, and the second that withholding support from institutions because they fail to meet the demands of justice would mean ignoring that progress toward justice requires effective institutions).

[46] Robert E Goodin, "Democracy, Justice and Impartiality" in Keith Dowding, Robert E Goodin & Carole Pateman, eds, *Justice and Democracy: Essays for Brian Barry* (Cambridge: Cambridge University Press, 2004) 97 at 98. See also Lukas H Meyer & Pranay Sanklecha, "Legitimacy, Justice and Public International Law: Three Perspectives on the Debate" in Lukas H Meyer, ed, *Legitimacy, Justice, and Public International Law* (Cambridge: Cambridge University Press, 2009) 1 at 12.

[47] See OECD, *Harmful Tax Competition: An Emerging Global Issue* (Paris: OECD Publications, 1998). For a comprehensive and critical analysis of the OECD's harmful tax practices initiative, see Christians, *supra* note 12.

in the decision-making process was seemingly taken by the OECD as justified based on its own understanding of 'fairness' and 'neutrality.'[48]

More recently, the focus has shifted toward legitimacy. The OECD seems to rely on the Legitimacy-Justice Fallacy to circumvent discussions on distributive issues when it suggests that the BEPS Inclusive Framework, aimed at addressing the Legitimacy Problem, might resolve the Distributive Justice Problem. Although not making the argument that the framework aims to produce a fair allocation of taxing rights among jurisdictions, it seems to suggest that it eventually will.[49] Similarly, when describing its Inclusive Framework, the OECD seemingly takes for granted that it "ensures [developing countries] can influence norms and standards in their favour."[50]

Generally, the exclusive focus on creating an inclusive framework when discussing fairness for developing countries seemingly indicates an attempt to sidestep a more serious discussion on a fair allocation of taxing rights for developing countries. In a recent public consultation document, the OECD discussed different proposals to reconsider the current allocation of taxing rights by revising profit allocation and nexus rules.[51] Although acknowledging that the proposals "chiefly relate to the question of how taxing rights …

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[48] See OECD, *supra* note 47.

[49] OECD, *supra* note 15 at 14 (pointing out that although "BEPS measures do not necessarily resolve the question of how rights to tax are shared between jurisdictions … the OECD/G20 Inclusive Framework will continue working towards a consensus-based long-term solution").

[50] Ibid at 28.

[51] OECD, *Addressing the Tax Challenges of the Digitalisation of the Economy*, Public Consultation Document (Feb 13, 2019). See Appendix A below.

should be allocated among countries", the document provided no discussion on how to make the allocation fairer to poorer countries or how the proposed changes would affect their existing rights.[52] Nonetheless, the Inclusive Framework was mentioned 20 times throughout the 29-page document, apparently as a way to emphasize that the fairness of the discussion is implicit in its purported inclusiveness and sidestep distributive justice concerns by framing the process as normatively legitimate.

Similarly, a more recent document released by the OECD in May 2019 acknowledges that the international tax reform proposals currently discussed "will have an impact on revenues and the overall balance of taxing rights" and mentions the Inclusive Framework 43 times throughout its 40 pages. See Appendix A. However, the report gives no consideration to whether or how reform could address the existing inequities in the current allocation of taxing rights between developed and developing countries.[53]

Normative evaluation of the international tax regime requires that both the legitimacy and the distributive justice dimensions be considered and that specific solutions be discussed for each of them. This chapter has emphasized that given the considerable disagreements on what justice entails, participation in the decision-making process of those affected by policy decisions is necessary to avoid arbitrariness and favouritism. On the other hand, political equality does not ensure substantive equity, and an inclusive decision-making process might

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[52] Ibid at 5.

[53] OECD, *Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy* (Paris: OECD, 2019). See Appendix B below.

still lead to an unfair allocation of taxing rights due to existing inequalities and differences in bargaining position among countries. Moreover, an equal-footing negotiation requires a counter-hegemonic framework based on distributive justice grounds to shift the balance toward a more equitable division of rights. Furthermore, given the bleak prospects for democratic legitimacy in the existing international governance institutions, forgoing discussions on distributive justice in favour of a democracy-oriented solution implies waiting for institutional changes that might never take place.

5. Conclusion

This chapter's main argument is that justice requires not only improving inclusivity of less affluent countries in the current tax policy decision-making (political justice) but also establishing a normative framework that provides them with differentiated taxing rights based on their different levels of development (distributive justice). One noteworthy example is how responsibilities in addressing climate change are shared between countries. In climate change discussions, countries agreed to a general normative principle according to which responsibilities should be distributed among countries based on their different capabilities.[54]

[54] The Paris Agreement provided that a solution for climate change should "recogniz[e] the specific needs and special circumstances of developing country Parties" and that it should be implemented "to reflect equity and the principle of common but differentiated responsibilities and respective capabilities, in the light of different national circumstances." (The Paris Agreement, Apr. 22, 2016, T.I.A.S. No. 16-1104). The agreed principle is now broadly known as the Common but Differentiated Responsibility and Respective Capabilities ("CBDR-RC") principle and stands in contrast to the idea

Stating a similar principle in international tax policy will not alone shift how taxing rights are presently allocated, especially because the power differences and political constraints that have led to the current international tax regime will remain influencing the outcomes of the decision-making process. That said, establishing such a principle should help lower-income countries to make a case for improving their taxing rights and gradually shift the focus from political equality to substantive equity.

International organizations, including the OECD, have made increasing efforts to demonstrate a concern for addressing global inequality in the last few years.[55] Nonetheless, an allocation of taxing rights among countries based (completely or partially) on their different levels of development have not so far been advanced in international tax policy discussions. If it becomes clear that addressing international inequality requires differentiated taxing rights for developing countries rather than simply greater inclusivity in the decision-making process, prospective reform proposals should eventually benefit less affluent countries.

The next part of the thesis comprises two chapters which will address the two main distributive justice problems identified in Chapter 3. More specifically, Chapter 5 will

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that the burden of climate justice should be shared equally by all societies regardless of background conditions. For discussions on the moral justifications of the CBRD-RC principle, see Simon Caney, "Climate Change and the Duties of the Advantaged" (2010) 13 Crit Rev Int'l Soc Pol Phil 203; Henry Shue, "Global Environment and International Inequality" (1999) 75 Int'l Aff 531, 534–35. For more detail, see Chapter 5.

[55] The UN's 2030 Agenda for Sustainable Development (Res 71/1 A/70/L1), particularly its Goal 10 to "reduce inequality within and among countries", is but one example.

propose ethical principles that should guide overall reform aimed at addressing tax competition (the Revenue Problem). In turn, Chapter 6 will focus on the current allocation of taxing rights (the Allocation Problem). It will point to the weaknesses of the prevailing normative principle guiding the allocation of taxing rights and propose an alternative principle based on the idea of differentiation.

Part II
Advancing International Tax Justice

CHAPTER FIVE
Normative Principles for Curbing Tax Competition

1. Introduction

Right and responsibility are commonly conceived of as two sides of the same moral coin. However, determining the existence of a right might not easily lead to who bears the responsibility to ensure it. It has long been argued that tax competition should be mitigated, as it results in more regressive national tax systems and impairs countries' capacity to redistribute wealth.[1] Scholars observe that tax competition undermines the autonomy of countries[2] and curtails national identity and democratic participation.[3] These consequences seem to suggest that countries that suffer the most have the right against the negative impacts of tax competition. A question should immediately follow: who ought to bear the responsibility of fulfilling these rights? Although an intuitive answer might point to the countries that presently engage in tax competition, a deeper examination of the institutional history of the existing international tax regime and a broader look at the background conditions of the global economy might suggest otherwise.

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[1] Reuven S Avi-Yonah, "Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State" (2000) 113:7 Harv Law Rev 1573 at 1578–79.

[2] Peter Dietsch, *Catching Capital: The Ethics of Tax Competition* (New York: Oxford University Press, 2015) at 46–54.

[3] Tsilly Dagan, "The Tragic Choices of Tax Policy in a Globalized Economy" in Yariv Brauner & Miranda Stewart, eds, *Tax, Law and Development* (Cheltenham: Edward Elgar, 2013) 57 at 63.

Any solution for curbing tax competition entails important consequences to all countries involved and generates winners and losers. Even if mitigating tax competition were to lead to collective benefits for all states, it would still create costs in the short run.[4] A normative analysis of tax competition should not be limited to the ethics of tax competition in itself. It also needs to include a broader ethical examination of how the losses resulting from institutional reform should be distributed among countries. This chapter analyzes this question by borrowing from a similar discussion in the context of climate change. Since a reduction in carbon emissions involves opportunity costs relating to economic development and growth, the prospects of a global solution to tackle anthropogenic climate change have generated a number of philosophical questions about how the burden of a solution should be shared among nations.[5]

Tax competition and climate change are similar in that they are both problems of collective action.[6] In collective action problems, all individuals would benefit from a

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[4] See Allison Christians, "Spillovers and Tax Sovereignty" (2017) 85 Tax Notes Int'l 831 at 833 (arguing that although all countries may stand to lose from tax competition, all countries may equally stand to lose from curbing tax competition, depending on how tax competition is defined and how it is to be regulated); Ilan Benshalom, "The New Poor at Our Gates: Global Justice Implications for International Trade and Tax Law" (2010) 85:1 NYUL Rev 1 at 79 (noting that unlike the developed countries, which stand only to gain from effective tax coordination, developing countries may fear to enter such a cooperative scheme because the short-term costs may outweigh the long-term (speculative) benefits").

[5] For a comprehensive collection of essays on the topic, see Stephen Gardiner et al, eds, *Climate Ethics: Essential Readings* (Oxford: Oxford University Press, 2010).

[6] See Thomas Rixen, *The Political Economy of International Tax Governance* (Basingstoke: Palgrave Macmillan, 2008) at 43–46 (analyzing tax competition as a collective action problem from a game-theoretical perspective). See also Elinor Ostrom, "Polycentric Systems for Coping with Collective

solution, but the associated costs make it implausible that anyone would undertake it individually. The rational choice is to solve the problem cooperatively and share the costs.[7] Studies in climate change have extensively discussed the costs resulting from a collective solution, as well as the need for an equitable distribution of these costs in a way that does not undermine growth and poverty reduction in developing countries.[8] In contrast, debates on tax competition hardly explicitly acknowledge that a collective solution for tax competition will create costs for some countries while favouring others.[9] A look at the debates surrounding

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Action and Global Environmental Change" (2010) 20:4 Global Envtl Change 550 (addressing climate change as a problem of global collective action and arguing that a combination of collective action theory and behavioural theory suggests approaches that might achieve a more effective solution).

[7] Robert E Goodin, "The Collective Action Problem" in Marion Danis et al, eds, *Fair Resource Allocation and Rationing at the Bedside* (Oxford: Oxford University Press, 2014) 224 at 224.

[8] Nicholas Stern, "What is the Economics of Climate Change?" (2006) 7:2 World Econ 1 at 6.

[9] There are, however, notable exceptions. Peter Dietsch discusses a number of ethical questions arising from the implementation of a solution for tax competition (Dietsch, *supra* note 2 at 188–218). Laurens Van Apeldoorn suggests that a solution for tax competition that disregards the different fiscal constraints faced by low-income and high-income countries will result in unequal (and unjust) levels of fiscal self-determination (See Laurens Van Apeldoorn, "BEPS, Tax Sovereignty and Global Justice" (2016) Crit Rev Int'l Soc Pol Phil 1 at 11). Allison Christians emphasizes that curbing tax competition is not a win-win scenario for all jurisdictions and argue for the need of a fair normative framework (Christians, *supra* note 4). Martin Hearson argues that reforming international tax rules in a way that realizes equity among countries requires not only tackling tax competition, but also looking at the distributional impacts of those rules (Martin Hearson, "The Challenges for Developing Countries in International Tax Justice" (2017) J Dev Stud at 5). Tsilly Dagan argues that the shift from competition to negotiated coordination produces unjust inequalities that derive from asymmetries in the relative bargaining power of the negotiating states and suggests that restricting tax competition might produce severe distributive effects on poor countries. See Tsilly Dagan, *International Tax Policy: Between Competition and Cooperation* (Cambridge: Cambridge University Press, 2017) at 142–184.

Interestingly, discussions on climate change seem to suffer from the opposite deficiency. It has been argued that there is too little focus on the economic advantages of tackling climate change (Paul G

the efforts to mitigate climate change helps illustrate the different ethical perspectives on the burden sharing of curbing tax competition and offers possible alternatives of a fair distribution of costs resulting from institutional reform.

Section 2 provides an overview of how the changes in the global economy resulting from globalization have intensified competition between governments and suggests that, contrary to market competition, competition between jurisdictions is likely to fail. It then discusses how globalization has exacerbated tax competition and presents some of the negative consequences resulting from tax competition. Section 3 points to particular implications for developing countries and describes some of the challenges and constraints they face in the global economy. Section 4 discusses normative questions involving what I call the rights side of curbing tax competition and introduces some theoretical developments in the literature aimed at justifying the need to tackle tax competition. Section 5 analyzes the costs side of the problem and argues that a just solution for tax competition requires an equal concern with fairness in the upshot of institutional reform. It then describes how a similar problem has been discussed in the context of climate change and outlines four normative principles that could independently or jointly guide the burden sharing of curbing tax competition: the responsible party pays principle, the retrospective beneficiary pays principle, the prospective beneficiary pays principle, and the ability to pay principle. The

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Harris, "Collective Action on Climate Change: The Logic of Regime Failure" (2007) 47 Nat'l Resources J 195 at 223).

chapter concludes by suggesting that the complexity of tax competition might require a combination of principles rather than the sole application of one of them.

2. Globalization, the Competition State, and International Taxation

2.1. From the Welfare State to the Competition State: Globalization and Tax Competition

In recent decades, reduced costs of transportation and communication, combined with reduced policy barriers to trade and investment, have heavily facilitated cross-border investment.[10] Economic decisions are less and less constrained by national boundaries, as multinational corporations can easily shift capital and profits to any country where they operate. As a political phenomenon, globalization translates as a shift in the playing field of politics from isolated units (the state) to a multilayered, complex arena.[11] Governments are pressed to adapt to an intricate economic and political environment of international institutions, multinational corporations, and cross-border flows of all kinds.[12] To cope more

[10] Jeffrey Frankel, "Globalization of the Economy" in Joseph S Nye Jr & John D Donahue, eds, *Governance in a Globalizing World* (Washington, DC: Brookings Institution Press, 2000) 45 at 45–46.

[11] See Philip G Cerny, "Paradoxes of the Competition State: The Dynamics of Political Globalization" (1997) 32:2 Gov Oppos 251. See also David Held, *Democracy and the Global Order: From the Modern State to Cosmopolitan Governance* (Stanford: Stanford University Press, 1995) at 92, 98 ("the meaning of national decision-making institutions today has to be explored in the context of a complex international society, and a huge range of actual and nascent regional and global organizations which transcend and mediate national boundaries.").

[12] Kate Nash, *Contemporary Political Sociology: Globalization, Politics, and Power*, 2nd ed (Chichester: Wiley-Blackwell, 2010) at 44.

effectively with the complex changes in institutional, cultural, and market structures, governments have reinvented themselves as quasi-market actors.[13] Since states cannot allow mobile capital to be driven away by the inadequate design of their institutions, government policies have shifted focus towards how domestic institutions influence the cross-border transfer of economic activities.[14]

Globalization puts countries under pressure to improve their attractiveness, since more competitive countries attract the influx of mobile factors—labour and capital—and leave other economies in a relatively inferior position, similar to competition between private firms.[15] However, as the political economy literature suggests, contrary to market competition, competition between governments is likely to fail in two respects. First, since governments mostly undertake economic activities that cannot be handled satisfactorily by markets—, i.e., as governments act as public insurers for when markets fail—, competition between states is likely to bring about the same kind of market failure that justified government intervention in the first place.[16] Second, government competition imposes an important shift in the focus of governmental politics away from the general maximization of welfare within a nation—particularly redistributive transfer payments and social service

[13] Cerny, *supra* note 11 at 251.
[14] Hans-Werner Sinn, *The New Systems Competition* (Malden, MA: Blackwell, 2003) at 4.
[15] Viktor Vanberg & Wolfgang Kerber, "Institutional Competition among Jurisdictions: An Evolutionary Approach" (1994) 5:2 Const Polit Econ 193 at 204.
[16] Hans-Werner Sinn, "The Selection Principle and Market Failure in Systems Competition" (1997) 66:2 J Public Econ 247 at 248.

provision—towards the promotion of enterprise and profitability.[17] This shift tends to lead to what is known as a "race to the bottom," that is, a downward convergence of policies and practices that preclude adequate protection of the social and economic well-being of citizens, especially the poor.[18]

This phenomenon is typically seen in international taxation. The increasing ease and volume of cross-border activity have shaped the international tax scene, as multinationals can choose among countries in which to locate investments and shop among potential host countries for the most attractive investment "package," which includes the tax regime as one important element.[19] Governments, in turn, aim their policies at attracting both portfolio and direct investment by lowering their tax rates on income earned by foreigners.[20] On the one

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[17] Cerny, *supra* note 11 at 260.

[18] Nita Rudra, *Globalization and the Race to the Bottom in Developing Countries: Who Really Gets Hurt?* (Cambridge: Cambridge University Press, 2008) at 3. Even some types of competition—such as strategic infrastructural investment—that might be considered beneficial, as they tend to lead countries to a "race to the top" (Dietsch, *supra* note 2 at 96–97, 101–102) might be problematic in some cases for wasting more resources in local expenditures than would be reasonable or necessary. See Leon Taylor, "Infrastructural Competition among Jurisdictions" (1992) 49:2 J Pub Econ 241 (observing that if competition is long and involve many contestants it can produce net social loss, especially in the case of identical jurisdictions that compete by building infrastructure with no alternative value).

[19] Michael C Durst, "Poverty, Tax Competition, and Base Erosion" (2018) 89 Tax Notes Int 1189 at 1194. See also Philipp Genschel & Peter Schwarz, "Tax Competition: A Literature Review" (2011) 9 Socio-Economic Rev 339 at 340–341 (explaining that, for a long time, taxes were simply too low and cross-national tax differentials too small to trigger significant cross-border movements of taxpayers and bases, which changed in the twentieth century with the increase of tax burdens and the erosion of mobility barriers).

[20] Avi-Yonah, *supra* note 1 at 1575–76. See also Dagan, *supra* note 3 at 58 ("Competition provides taxpayers with an alternative: to shift either their capital, their residency, or even their citizenship, to

hand, nations have their tax revenues reduced by aggressive maneuvering of taxpayers and, on the other, each nation seeks to benefit by embracing behaviour, against other nations, intended to capture as much global capital as possible.[21]

Tax policy decision-making and the relationship between state and its subjects are then reversed. Rather than making compulsory demands from its residents to promote collective goals, as traditional tax policy would, governments increasingly act as "recruiters" of residents and investments from the global arena.[22] As tax competition turns countries into competitive players, it undermines the focus on setting tax regimes optimally to promote normative goals.[23]

2.2. Negative Consequences of Tax Competition

another country. In the extreme case, tax competition changes taxation from the mandatory regime it used to be, to a regime that is basically elective, or more precisely, elective for some.").

[21] Allison Christians, "Putting the Reign Back in Sovereign" (2013) 40 Pepperdine Law Rev 1373 at 1375. See also Tsilly Dagan, "International Tax and Global Justice" (2017) 18 Theor Inq L 1 at 13–15 ("Competition increasingly is turning states into market players that offer their goods and services to potential 'customers.' In this market for sovereignty goods, states compete for capital and residents, while (at least some) individuals 'shop around' for sovereign-provided privileges, public goods, and social and cultural goods. […] [T]he tax policymaking process has gradually transformed under competition, and states increasingly operate as recruiters of mobile investments and residents from other states, while at the same time striving to retain their own residents and investments.").

[22] Dagan, *supra* note 3 at 58.

[23] *Ibid* at 63.

The effects of tax competition are not zero-sum. They reduce the collective revenue of countries as taxable income is moved from high-tax to low- or no-tax jurisdictions, decreasing total tax payments.[24] As taxes represent the principal means for governments to allocate resources, the decrease in tax revenues directly affects the ability of states to provide citizens with services and benefits. As tax scholars observe, countries have responded in two ways to tax competition. First, by shifting the tax burden from more mobile economic factors (such as business profits and capital income) to less mobile ones (mainly, wages and consumption),[25] and second, when the increase of taxation of labour has become politically and economically problematic, by reducing the social safety net.[26]

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[24] International Monetary Fund, *Spillovers in International Corporate Taxation* (Washington, DC: IMF, 2014) at 14. In terms of macroeconomic policy, one country's domestic tax decisions may affect other countries' policies in different ways: by affecting growth and macroeconomic stability, due to the impacts of shift of real (foreign direct investments) and financial flows (corporate financing arrangements); by constraining the corporate tax base, as the reflection of changes in multinationals' investments decisions; by creating pressure to reduce tax rates, in response lower tax rates abroad; and by modifying world prices, as tax policies affect investment and saving behaviour, changing interest rates and wages around the globe (*ibid* at 12–13).

[25] Alex Easson, "Fiscal Degradation and the Inter-Nation Allocation of Tax Jurisdiction" (1996) 3 EC Tax Rev 112 at 112; Diane Ring, "Democracy, Sovereignty and Tax Competition: The Role of Tax Sovereignty in Shaping Tax Cooperation" (2009) 9:5 Fla Tax Rev 555 at 576; Allison Christians, "How Nations Share" (2012) 87 Indiana Law J 1407 at 1408; Thomas Rixen, "Tax Competition and Inequality: The Case for Global Tax Governance" (2011) 17 Glob Gov 447 at 452. For a more detailed explanation, suggesting three distinct categories of taxpayers (the relatively "easy-to-tax," the relatively "hard-to-tax," and the virtually "impossible-to-tax"), see Allison Christians, "Drawing the Boundaries of Tax Justice" in Kim Brooks, ed, *The Quest for Tax Reform Continues: The Royal Commission on Taxation Fifty Years Later* (Toronto: Carswell, 2013) 53 at 72–74.

[26] Avi-Yonah, *supra* note 1 at 1576.

This means that tax competition negatively affects tax equity in three different dimensions.[27] First, as the ability for relocating income facilitated by tax competition is mostly enjoyed by the rich, tax competition hinders *vertical equity*, which requires that individuals with unequal incomes should be taxed differently, according to their abilities to pay. As higher-income taxpayers contribute less to the tax burden than those with lower income, the burden shifts to the poor. Moreover, since the tax and transfer system is traditionally conceived as the most powerful policy instrument for income redistribution,[28] tax competition also imposes adverse effects on vertical equity taken as a broader notion of distributing goods among residents according to their needs and capabilities, as it reduces countries' tax revenues to concerning levels. Second, as the tax burden shifts from capital to labour, taxpayers with the same level of income, one from capital and the other from labour, are taxed differently. This affects *horizontal equity*, according to which the same income should be taxed at the same rate, independently of its source. Third, as countries have different sets of advantages and disadvantages in competing for capital and income, tax competition changes the income distribution not only within but also between countries involved. Depending on the income levels of each concerned country, tax competition might

[27] Laura Seelkopf & Hanna Lierse, "Taxation and Inequality: How Tax Competition Has Changed the Redistributive Capacity of Nation-States in the OECD" in Melike Wulfgramm, Tonia Bieber & Stephan Leibfried, eds, *Welfare State Transformations and Inequality in OECD Countries* (London: Palgrave Macmillan, 2016) 89 at 92–93.

[28] Richard A Musgrave, *The Theory of Public Finance: A Study in Public Economy* (Bombay: TATA-McGraw-Hill Book, 1959) at 18.

worsen international inequality, precluding *inter-nation equity*—i.e., equity between countries.[29]

Another important consequence of tax competition is that it tends to undermine the autonomy of countries regarding the size of the public budget and the desired level of redistribution.[30] A country's taxing choices (what, who and how much to tax) is classically based on political factors such as fairness and distribution of political power. Tax policy choices, however, depend not only on what the country wants to tax but also on what it *can* tax.[31] As tax competition pushes countries to lower their tax rates, it limits their fiscal policy choices and curtails national identity and democratic participation.[32]

The risk of a "race to the bottom" in the tax competition scenario is evident. As investors can freely choose where to invest in the world, they choose the country with the most favourable tax regime. Governments, in turn, have the incentive to attract foreign capital by undercutting each other's tax rates. This race leads to mobile incomes being taxed less or not at all[33] and results in the underprovision of public goods.[34] In terms of justice, tax

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[29] For an overview of the definition and importance of the concept of inter-nation equity, see Jinyan Li, "Improving Inter-Nation Equity Through Territorial Taxation and Tax Sparing" in Arthur J Cockfield, ed, *Globalization and Its Tax Discontents: Tax Policy and International Investments* (Toronto: University of Toronto Press, 2010) 117.

[30] Dietsch, *supra* note 2 at 46–54.

[31] Richard M Bird & Eric M Zolt, "Tax Policy in Emerging Countries" (2008) 26 Environ Plan C Gov Pol'y 73 at 75.

[32] Dagan, *supra* note 3 at 63.

[33] Seelkopf & Lierse, *supra* note 5 at 95.

[34] See George R Zodrow & Peter Mieszkowski, "Pigou, Tiebout, Property Taxation, and the Underprovision of Local Public Goods" (1986) 19:3 J Urban Econ 356. For an overview of the baseline model of tax competition and some variations, see also Genschel & Schwarz, *supra* note 19.

competition undermines the ability of states to maintain the necessary conditions for promoting justice and for providing their constituents with the assurances required for social cooperation.[35]

3. Implications and Challenges for Developing Countries

Developing countries face more significant tax policy constraints in an increasingly globalized world. Due to weak revenue administrative capacity, they have great difficulty in collecting enough tax revenues to support the desired level of expenditures.[36] Moreover, the average cost of collecting taxes in the developing world is substantially higher than in developed countries.[37] In this respect, commentators suggest that three potential constraints hinder the ability of developing countries to improve their tax administrations: the availability of funds, the domestic political will, and the speed with which capability can be built.[38] Developing countries with weak administrations also face major challenges from international outflows of capital and profits, as in many cases they are simply unaware of the revenue they are losing.[39]

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[35] Tsilly Dagan, *supra* note 21 at 4.
[36] See Bird & Zolt, *supra* note 31 at 76 (explaining that, in principle, revenues should grow at the same rate as desired expenditures, but that emerging and developing countries hardly achieve this target, which leads to frequent tax reforms aimed primarily at closing short-term revenue gaps).
[37] *Ibid*.
[38] See, e.g., Michael Carnahan, "Taxation Challenges in Developing Countries" (2015) 2:1 Asia Pacific Pol'y Stud 169 at 179.
[39] *Ibid*.

Inefficient tax administrations create additional difficulties for developing economies. First, the inability to effectively collect income tax hinders the tax and transfer system that support lower-income population.[40] Second, taxpayer compliance costs (i.e., costs incurred by taxpayers to comply with tax regulations) in developing countries is often high compared to the developed world. Research suggests the average compliance costs in developing countries are 4 to 5 times higher than in developed countries, [41] discouraging investment and impeding productivity and competitiveness.[42] Third, tax revenues in developing countries is significantly low compared to the developed world. While the average tax revenue to GDP ratio in developed countries is approximately 35%, tax revenues in developing countries is approximately 15% of GDP, and in the poorest of these countries it is about 12%.[43]

An important factor affecting developing countries' tax systems is the substantial size of the informal economy. The literature suggests that the tax regime in developing economies can be split in two systems: one has relatively high tax-compliance rates and comprises

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[40] Bird & Zolt, *supra* note 31 at 80.

[41] Roy W Bahl & Richard M Bird, "Tax Policy in Developing Countries: Looking Back—and Forward" (2008) LXI:2 Nat'l Tax J 279 at 291. See also International Monetary Fund, *Revenue Mobilization in Developing Countries* (Washington, DC: IMF, 2011) at 21 (suggesting more modestly that while a typical firm spend 210 hours preparing and paying taxes in high-income countries, the time spent by firms in developing countries exceeds 300 hours).

[42] Empirical research on tax compliance cost also shows significant regressivity in tax compliance costs in the developing world (Jacqueline Coolidge, "Findings of Tax Compliance Cost Surveys in Developing Countries" (2012) 10:2 eJournal Tax Res 250).

[43] Clemens Fuest & Nadine Riedel, "Tax Evasion, Tax Avoidance and Tax Expenditures in Developing Countries: A Review of the Literature" (2009) Report Prepared for the UK Department for International Development, online: <http://www.sbs.ox.ac.uk/sites/default/files/Business_Taxation/Docs/Publications /Reports/TaxEvasionReportDFIDFINAL1906.pdf> at 1.

medium and large corporations, which are subject to strict reporting requirements and keep relatively accurate records; the other is comprised of many small enterprises operating in great part in the informal sector, with low compliance rates.[44] Efforts to bring this sector into compliance are difficult and expensive.[45] Besides, a large informal sector makes it almost impossible to tax income consistently, which is problematic from an equity point of view. Furthermore, the elasticity of taxable income with respect to the level of taxes is high, which means that when the government of a country with a large informal sector tries to raise taxes, the taxable income reported drop substantially.[46]

Tax competition has arguably produced more severe effects on the world's poorest countries[47] for three main reasons. First, economists have long observed the dependence of developing economies on corporate income tax revenues as a share of all revenues. While in developed countries personal income tax revenues are often three to four times the corporate income tax revenues, in developing countries personal income tax revenues are often lower than corporate income revenues.[48] Revenues from personal income tax in developing countries amount to only 1–2 per cent of gross domestic product (GDP), compared with 9–

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[44] Bird & Zolt, *supra* note 31 at 80.
[45] *Ibid*.
[46] Timothy Besley & Torsten Persson, "Why Do Developing Countries Tax So Little?" (2014) 28:4 J Econ Persp 99 at 110. See also Ernesto Crivelli, Ruud De Mooij & Michael Keen, "Base Erosion, Profit Shifting and Developing Countries" (2015) 15:118 International Monetary Fund Working Paper at 23.
[47] International Monetary Fund, *supra* note 24 at 7.
[48] Richard M Bird & Eric M Zolt, "Redistribution via Taxation: The Limited Role of the Personal Income Tax in Developing Countries" (2005) 52 UCLA Law Rev 1627 at 1656.

11 per cent in developed countries.[49] As tax competition is primarily driven by corporate tax cuts, fiscal performance in developing countries is significantly more vulnerable to pressures from tax competition. Studies suggest that developing countries might lose from tax competition three times as much as they receive in development aid.[50]

Second, developing countries are also more vulnerable to tax competition because of tax-sensitivity of firms. Some studies indicate that multinationals' investment and profit levels in developing countries are more sensitive to taxation than in the developed world, making them more vulnerable to increasing capital mobility.[51] Indeed, while the global decrease of corporate tax rates has not significantly affected corporate tax revenues in developed countries—both as a share of GDP and as a share of total tax revenues—, it has considerably reduced corporate tax revenues in some of the poorest and most vulnerable of the developing countries.[52] Third, in the tax competition scenario, some types of tax incentives are likely to be more successful than others in attracting investments and generating benefits for the host country. Since designing effective tax incentives is already a challenge for well-resourced tax administrations in developed countries, the likelihood for serious revenue leakages and negative consequences in developing countries is much greater.[53]

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[49] Carnahan, *supra* note 38 at 176.
[50] See Dietsch, *supra* note 2 at 192.
[51] Fuest & Riedel, *supra* note 43 at 40, 43.
[52] Michael Keen & Alejandro Simone, "Is Tax Competition Harming Developing Countries More Than Developed?" (2004) 34 Tax Notes Int'l 1317.
[53] Carnahan, *supra* note 38 at 177.

Another important challenge for developing countries is that the present international tax regime was designed in a way that favours richer nations. Today, most of the treaties countries enter into to avoid double taxation—i.e., to avoid that two countries tax the same income in cross-border transactions—follow the OECD Model Tax Convention, which allocates more taxing rights in favour of capital-exporting countries (mostly, developed countries), at the expense of capital-importing countries (mostly, developing countries).[54]

Finally, tax policy choices in many developing countries have also been limited by their reliance on foreign trade and investment and by the constraints imposed by outsiders, such as international lenders and major trading partners.[55] One important example is tax conditionalities required by international financial institutions to provide needed financial and technical support. Commentators argue that tax conditionalities imposed by the International Monetary Fund (IMF) ignores domestic equity concerns by focusing solely on economic efficiency and administrative efficacy, and that the secretive and expert-driven process of tax conditionality is conducted by the IMF staff directly with a government or technical "elite," whose goals and values may differ from those of the country's population.[56]

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[54] Hearson, *supra* note 9 at 5; Kevin Holmes, *International Tax Policy and Double Tax Treaties: An Introduction to Principles and Application*, 2nd ed (Amsterdam: IBFD, 2014) at 62–63.

[55] See Allison Christians, "Global Trends and Constraints on Tax Policy in the Least Developed Countries" (2010) 42:2 UBC L Rev 239 at 274 ("Decisions made by and for the developed world about how to foster and encourage globalization through international tax policy limit the range of tax policy strategies available to the world's least developed countries.").

[56] Miranda Stewart & Sunita Jogarajan, "The International Monetary Fund and Tax Reform" (2004) 2 Brit Tax Rev 146. See also Christians, *supra* note 55 at 263 (observing that institutional assistance is available only to support tax policy strategies that are favoured by the international community of

4. The Rights Side of Curbing Tax Competition: Fairness in Fiscal Self-Determination

As tax competition leads to more regressive national tax systems, decreased capacity for redistribution of wealth, and reduced ability of the world's poorest countries to pursue sustainable development, tax scholars question whether limits should be imposed on the sovereignty of countries in designing domestic policies that, although beneficial for their constituents, may impose harms and constraints on other countries.[57] As tax competition undermines the autonomy of countries in determining their fiscal policies (i.e., in establishing their desired level of taxation and redistribution), it has been noted that governments must give up some of their *de jure* sovereignty (the legal right to design their tax systems) through cooperation if they want to retain *de facto* sovereignty (i.e., their ability to achieve policy goals).[58]

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finance experts); Richard M Bird, "Foreign Advice and Tax Policy in Developing Countries" (2013) 13:7 International Center for Public Policy Working Paper, online: <https://scholarworks.gsu.edu/cgi/viewcontent.cgi?article=1037&context=icepp> at 15 (suggesting that, at least to some extent, such tax policies were accepted because they coincided with elite interests).

[57] Allison Christians, "Sovereignty, Taxation and Social Contract" (2009) 18:1 Minnesota J Int Law 99; Ring, *supra* note 25; Peter Dietsch, "Rethinking Sovereignty in International Fiscal Policy" (2011) 37:5 Rev Int'l Stud 2107.

[58] Rixen, *supra* note 25 at 448. See also Easson, *supra* note 25 at 112 (explaining that the apparent defence of national fiscal sovereignty has brought about a real loss of sovereignty by virtue of tax erosion and that states cannot protect their tax bases without cooperation); Diane M Ring, "What's at Stake in the Sovereignty Debate?: International Tax and the Nation-State" (2008) 49:1 Va J Int Law 155 at 233 (suggesting that cooperation itself may be the key to preserving sovereignty); Daniel Shaviro, "Why Worldwide Welfare as a Normative Standard in U. S. Tax Policy?" (2007) 60 Tax Law Rev 155 at 178 (arguing that cooperation with other countries rather than following beggar-your-neighbor strategies should make all countries better off if adherence to the agreed norms is sufficiently reciprocal); Li, *supra* note 29 at 129 (suggesting that in the age of globalization many international

Contemporary conceptions of sovereignty suggest that it comprises two related ideas, one of autonomy and another of duty.[59] The right of a state to make autonomous choices—its sovereign autonomy—, as happens with any other kind of right, is constrained by the rights of others to make their own autonomous choices. The right of a state in interaction with others conceptually implies the notion of a duty to respect the similar right of other states—sovereign duty.[60] Contemporary conceptions of sovereignty seem to suggest a shift from a notion of absolute autonomy towards an idea of restraint.[61] Sovereignty is redefined as responsibility, both in the state's internal functions (responsibility towards citizens) and in international relations (responsibility towards fellow nations).[62]

This new conception of sovereignty implies ethical constraints to the autonomy of states in designing their domestic tax policies. Recent developments in the political

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problems can only be addressed effectively by international cooperation). From a broader perspective, not limited to taxation, see, e.g., Miriam Ronzoni, "Two Conceptions of State Sovereignty and Their Implications for Global Institutional Design" (2012) 15:5 Crit Rev Int'l Soc & Pol Phil 573 (arguing that, in certain circumstances, only the establishment of supranational institutions with some sovereign powers can allow states to exercise sovereignty in a meaningful way and suggesting that tax competition is one of these circumstances); Robert O Keohane, *Power and Governance in a Partially Globalized World* (London and New York: Routledge, 2002) at 204 ("If world government is unfeasible and laissez-faire a recipe for a backlash, we need to search for an intermediate solution: a set of practices for governance that improve coordination and create safety valves for political and social pressures, consistent with the maintenance of nation-states as the fundamental form of political organization.").

[59] See Christians, *supra* note 57.

[60] *Ibid* (suggesting the term "sovereign duty" to express the duty of a state to respect the sovereign right of other states to tax).

[61] *Ibid* at 99 ("But this view of sovereign autonomy over taxation is increasingly inconsistent with a global economic reality in which market and regulatory relationships have been and are being fundamentally reformulated.").

[62] Dietsch, *supra* note 57 at 2112–14.

philosophy literature on tax competition suggest that strategic fiscal policy decisions that produce negative impacts on the fiscal autonomy of other states are ethically unacceptable.[63] This means that countries are able to compete, but competition that is aimed at capturing capital from abroad and produces a collectively suboptimal outcome should be condemned from an ethical perspective.[64] Moreover, it has been noted that the fact that tax competition has a deeper impact upon developing economies brings about additional normative concern.[65] In this respect, a human rights analysis might suggest that tax competition should be mitigated as it tends to undermine the opportunities of the disadvantaged around the world.[66]

[63] Dietsch, *supra* note 2 at 80. In his book, Dietsch develops a comprehensive normative framework for tax competition. He proposes two principles of global tax justice: the membership principle and the fiscal policy constraint. According to the membership principle, individuals and corporations are liable to pay tax in the state of which they are a member, i.e., one cannot enjoy public services of one country and "choose" to pay taxes to another. According to the fiscal policy constraint principle, a fiscal policy undertaken by a state is unjust if it is *both* strategically motivated (to attracting foreign corporations) *and* has a negative impact on the aggregate fiscal self-determination of other states. In contrast, Laurens Van Apeldoorn criticizes Dietsch's conception of fiscal self-determination and argues that an adequate concept should consider the existing policy constraints of low-income countries rather than assume that, eliminated tax competition, the levels of fiscal self-determination of high- and low-income countries would be the same (what he terms the "equality interpretation") or at least satisfy a minimum baseline (what the calls the "baseline interpretation"). See Van Apeldoorn, *supra* note 9 at 8–13.

[64] Dietsch, *supra* note 2 at 97–102.

[65] Miriam Ronzoni, "Global Tax Governance: The Bullets Internationalists Must Bite – And Those They Must Not" (2014) 1:1 J Moral Phil & Pol 37 at 43.

[66] Allison Christians, "Fair Taxation as a Basic Human Right" (2009) 9:1 Int'l Rev Const 211 at 228.

Commentators have proposed different solutions for curbing tax competition.[67] The Organisation for Economic Co-operation and Development (OECD) has been leading efforts to achieve international cooperation to address tax competition.[68] In 1998, the OECD issued a report entitled *Harmful Tax Competition: An Emerging Global Issue*,[69] which established criteria for what the OECD regards as harmful tax competition and recommended counteractive measures.[70] In 2013, the OECD initiated a more comprehensive project aimed at tackling different forms of tax avoidance, now commonly known as the Base Erosion and Profit Shifting (BEPS) project.[71] This ongoing initiative proposes different measures to address tax base erosion by adopting a collaborative-based rather than a competition-based paradigm.[72] One of its sections (Action 5) is aimed at tackling tax competition. As a continuation of OECD's 1998 initiative, it condemns countries' tax regimes that are

[67] An analysis of these proposals would be beyond the scope of this chapter. For an overview of the most prominent proposals, see Sol Picciotto, "Unitary Alternatives and Formulary Appointment" in Sol Picciotto, ed, *Taxing Multinational Enterprises as Unitary Firms* (Brighton: The International Centre for Tax and Development, 2017) 27.

[68] See Allison Christians, "Taxation in a Time of Crisis: Policy Leadership from the OECD to the G20" (2010) 5:1 Nw JL & Soc Pol'y 19 at 20 (pointing out that the OECD has long enjoyed a position of central importance in formulating and disseminating international tax policy norms).

[69] OECD, *Harmful Tax Competition: An Emerging Global Issue* (Paris: OECD Publications, 1998). For a comprehensive and critical analysis of the OECD's harmful tax practices initiative, see Christians, *supra* note 57.

[70] In the same year, the European Union (EU) published a code of conduct for business taxation, which, similarly to the OECD's report, aimed at curbing what it considered harmful tax competition. For more details on the EU's code of conduct and on the OECD's report, see Michael Keen, "Preferential Regimes Can Make Tax Competition Less Harmful" (2001) 54:4 Nat'l Tax J 757.

[71] OECD, *Addressing Base Erosion and Profit Shifting* (Paris: OECD Publishing, 2013).

[72] Yariv Brauner, "What the BEPS?" (2014) 16:2 Fla Tax Rev 55 at 58.

"designed in a way that allows taxpayers to derive benefits from the regime while engaging in operations that are purely tax-driven and involve no substantial activities."[73]

5. The Costs Side of Curbing Tax Competition: Fairness in Sharing the Burden

5.1. The Costs of Curbing Tax Competition

The literature on the ethics of tax competition often focuses on what I am labeling the *rights side* of the problem, that is, on the ethical reasons for curbing tax competition. However, there is no substantial discussion on the *costs side* of addressing tax competition, i.e., on how to share the burden of mitigating tax competition.[74] Any potential solution for tax competition entails important consequences to all countries involved, from states that strategically engage in competitive behaviour to others that participate only defensively, from the poorest to the richest nations in the globe. Any global institutional change aimed at tackling tax competition will result in winners and losers. Since multinationals' choices regarding the location of their economic activities are sensitive to tax differences across

[73] OECD, *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance, Action 5 - 2015 Final Report* (Paris: OECD Publishing, 2015) at 23. See Allison Christians, "BEPS and the New International Tax Order" (2016) 6 Brigham Young UL Rev 1603 at 1631 (pointing out the shift in the OECD's approach from the 1998 initiative to the BEPS project and explaining that the latter focuses on identifying unacceptable country tax practices rather than singling out countries themselves, after criticism over the previous initiative, which appeared to focus on small, non-OECD countries while overlooking the contributions of its own members to the overall phenomenon of harmful tax competition).

[74] A notable exception is Dietsch, *supra* note 2. In a chapter entitled "Life with (or after) tax competition," Dietsch discusses some ethical questions that arise from the implementation of institutional reform that address tax competition, regarding them as matters of transitonal justice.

countries, curbing tax competition might impose significant changes in the global economy, as investments would be determined by other competitive factors, such as natural resources, infrastructure, and regulatory framework.[75]

As problematic as it may be for countries to pursue strategic policies that negatively affect other nations, one may argue that simply putting an end to tax competition would be to correct one injustice—tax competition—with another—creating global institutions that are likely to be biased in favour of the most powerful and rich countries.[76] Indeed, some of the low-tax countries—which would arguably be the biggest losers of institutional reform—are small economies that heavily rely on the current international regime. An example is the small island economies that, characterized by profound economic disadvantages, have specialized in hosting offshore finance centres (OFCs). The literature points out that international organizations have often encouraged these small, resource-poor countries to embrace tax-haven strategies as a means for accelerating development,[77] ignoring the "crowding out" effect of the booming sector that would lead to a situation of

[75] In this respect, it may be argued that even if curbing tax competition could result in greater tax revenues for all economies, some countries might be better off with the domestic benefits of attracting foreign investments through lower tax rates, as they may have more pressing needs than maintaining a social welfare net (Dagan, *supra* note 9 at 133).

[76] Dietsch, *supra* note 2 at 202. See also Michael Littlewood, "Tax Competition: Harmful to Whom?" (2004) 26:1 Mich J Int'l L 411 at 414 ("The extent to which the tax avoidance industry benefits the residents of havens generally (as distinct from merely benefiting those who work in that industry) is debatable, but it seems reasonable to assume that there is generally some benefit").

[77] Philipp Genschel & Laura Seelkopf, "Winners and Losers of Tax Competition" in Peter Dietsch & Thomas Rixen, eds, *Global Tax Governance: What Is Wrong with It and How to Fix It* (Colchester, UK: ECPR Press, 2016) 55 at 69.

overdependence.[78] Institutional reform would cause a relevant impact on these countries, on their financial sectors but also on other sectors of their economy—tourism, agriculture, manufacturing—which were crowded out by the financial industry.[79]

Whether or not it is true that mitigating tax competition might be collectively better for all states in the long run,[80] it is undeniable that it will create costs for some countries while favouring others.[81] Discussing international policies to tackle tax competition should not be limited to the ethics of tax competition in itself but should include a broader ethical examination of how the losses resulting from institutional reform should be distributed

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[78] Mark P Hampton & John Christensen, "Offshore Pariahs? Small Island Economies, Tax Havens, and the Re-Configuration of Global Finance" (2002) 30:9 World Dev 1657 at 1664 ("The assertion ran that wealthy tourists would visit the islands, enjoy the lifestyle, and subsequently establish residence and invest. At the same time bankers and tax accountants would be attracted by the climate and lifestyle and would bring with them their knowledge and experience, adding to the virtuous circle. How could such a favorable situation for a small economy go wrong?").

[79] Dietsch, *supra* note 2 at 211.

[80] While some commentators argue that global tax competition produces unfairness by reducing global tax revenues, others contend that it is rather a desirable process that creates locational efficiency. See David C Elkins, "The Merits of Tax Competition in a Globalized Economy" (2016) 91 Indiana LJ 905; Mitchell B Weiss, "International Tax Competition: An Efficient or Inefficient Phenomenon?" (2001) 16 Akron Tax J 99. See also Julie Roin, "Competition and Evasion: Another Perspective on International Tax Competition" (2001) 89 Georgetown Law J 543 at 570 (arguing that the harms of tax competition commonly associated with the disruption of the redistributive process have been exaggerated in several respects). Moreover, some suggest that tax competition might be beneficial as they produce gains for developing economies (Littlewood, *supra* note 76 at 445–48 ("the shifted investment, although producing less tax revenue than in its original country, might nonetheless produce private benefits for its new host country—in forms such as wages, training, and technology transfer. […] there is no obvious reason to suppose that any undermining of tax equity in developed countries represents a loss greater than the gain made by developing countries.")).

[81] See Christians, *supra* note 4 at 833 (arguing that although all countries may stand to lose from tax competition, all countries may equally stand to lose from curbing tax competition, depending on how "tax competition" is defined and how it is to be regulated).

among countries. Since every change in international policy will positively affect some actors and negatively impact on others, one question needs to be asked: how should the burden of an institutional change be shared? Before addressing this issue, Section 5.2 will analyze how a similar problem is treated in another context. Section 5.3 will then apply a similar rationale to the problem of tax competition.

5.2. The Principle of Common but Differentiated Responsibility (CBDR)

The problem just described resembles the discussion on climate change. That anthropogenic climate change should be mitigated is almost undisputed in the scientific literature.[82] The United Nations Convention on Climate Change,[83] drafted in 1992 at the United Nations Conference on Development and Environment, was signed by 197 parties to date[84] and demonstrates that there is a global consensus on the issue. Similarly, the 2015 Paris Agreement affirms the commitment to a 2 degrees limit target.[85] However, despite acknowledging that emissions reductions are necessary, states recognized that such a solution would result in opportunity costs relating to economic development and growth.[86] In the

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[82] John Cook et al, "Quantifying the Consensus on Anthropogenic Global Warming in the Scientific Literature" (2013) 8 Environ Res Lett 1.

[83] United Nations Framework Convention on Climate Change, A/RES/48/189 (entered into force 21 March 1994).

[84] "Status of Ratification of the Convention," online: UNFCCC <https://unfccc.int/process/the-convention /what-is-the-convention/status-of-ratification-of-the-convention>.

[85] The Paris Agreement, Apr. 22, 2016, T.I.A.S. No. 16-1104 (entered into force 4 November 2016) [hereinafter *Paris Agreement*].

[86] Kok-Chor Tan, *What Is This Thing Called Global Justice?* (Abingdon, Oxfon: Routledge, 2017) at 120.

discussions on how to address climate change, states realized that, for reasons of justice and political feasibility, they would need to think of how to distribute the global responsibility to cap total global greenhouse gas emissions among countries.[87]

At the 2015 Paris Climate Conference, China and India argued for differentiated responsibilities among richer and poorer countries considering their different capabilities.[88] Acknowledging this demand, the Paris Agreement provided that a solution for climate change should "recogniz[e] the specific needs and special circumstances of developing country Parties"[89] and that it should be implemented "to reflect equity and the principle of common but differentiated responsibilities and respective capabilities, in the light of different national circumstances."[90] The agreed principle is now broadly known as the Common but Differentiated Responsibility (CBDR) principle and stands in contrast to the idea that the burden of climate justice should be shared equally by all societies regardless of background conditions.[91]

Political philosophers and commentators have suggested that richer nations should bear more costs than developing countries in addressing climate change based on different moral grounds. For simplicity, I will limit the arguments to the two most common grounds: i)

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[87] Darrel Moellendorf, "Treaty Norms and Climate Change Mitigation" (2009) 23:3 Ethics & Int'l Aff 247 at 251.

[88] "Key Points of the Paris Climate Pact," *New York Times* (12 December 2015), online: <https://www.nytimes.com/interactive/projects/cp/climate/2015-paris-climate-talks/key-points-of-the-final-paris-climate-draft>.

[89] *Paris Agreement*.

[90] *Ibid*.

[91] Tan, *supra* note 86 at 121.

historical responsibility for benefits and damages brought forth by past emissions; ii) ability to pay.[92]

The argument based on historical responsibility comprises two similar but distinct versions.[93] One is the polluter pays principle, which ascribes responsibility to the historical polluter. It builds on the intuitive notion that one should take responsibility for their actions. The polluter pays principle is defended by commentators both on fault and no-fault grounds (strict liability).[94] The second version is called the beneficiary pays principle and identifies the beneficiary of emissions as responsible. It is based on the idea that if the current inhabitants of industrialized countries have benefited from emissions so that their standard of living today is higher than it would otherwise have been, they must pay a cost for that.[95]

The problem with historical responsibility, especially in the case of the polluter pays principle, is in offering a convincing account that past emissions constitute an injustice.[96] It

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[92] See Derek Bell, "Global Climate Justice, Historic Emissions, and Excusable Ignorance" (2011) 94:3 Monist 391 (pointing out that the expression *Common but Differentiated Responsibilities and Respective Capabilities* itself suggests a "hybrid" principle, according to which all states bear a common responsibility for protecting climate-related rights and that how much each state should pay depends on *both* their historical emissions ("differentiated responsibilities") and their ability to pay ("respective capabilities")).

[93] A more detailed classification can be found in Lukas H Meyer & Dominic Roser, "Climate Justice and Historical Emissions" (2010) 13:1 Crit Rev Int Soc Polit Phil 229, where the authors subdivide what I here present as the polluter pays principle in two: the emitter pays principle (based on individual responsibility) and the community pays principle (based on collective responsibility). I here conflate both categories for simplification.

[94] For a detailed analysis, see Darrel Moellendorf, *The Moral Challenge of Dangerous Climate Change* (New York: Cambridge University Press, 2014) at 165–69.

[95] Simon Caney, "Cosmopolitan Justice, Responsibility, and Global Climate Change" (2005) 18 Leiden J Int Law 747 at 757.

[96] Moellendorf, *supra* note 94 at 173.

requires justifying how the wrongs committed by individuals in the past can fall on persons in the present. One possible solution to the problem of intergenerational justice is to adopt a collectivist approach to moral responsibility.[97] Such a solution, however, requires answering some deeper questions about justice and moral agency.[98] The beneficiary pays principle faces similar problems. It requires answering whether present actors should pay if it was only their ancestors who benefited the most. It also involves the issue of identification and measurement. Who are the beneficiaries?[99] How should one measure the benefits?[100]

The other moral ground for differentiated responsibilities is the ability to pay principle, which focuses on the different capabilities of countries to address climate change. It may be

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[97] Caney, *supra* note 95 at 774.

[98] Tan, *supra* note 86 at 126 ("The collectivist turn is a promising solution to the problem of reparations for past international injustice. But its full defense will require some deeper understanding of what makes for a collective *moral agent* and how a collective responsibility can be distributed among individuals of the collective. What are some of the necessary conditions for collective moral agency? Must the collective show some structured deliberative capacity? Must it be a collective whose individuals share national ties or other bonds of solidarity? Or must the individuals of the collective be enjoined via certain common interests? And if there is indeed a collective responsibility, what is the right way of parceling this responsibility out among individuals?").

[99] See, e.g., Henry Shue, "Global Environment and International Inequality" (1999) 75:3 Int'l Aff 531 at 535 (pointing out that "[q]uite a bit of breath and ink has been spent in arguments over how much LDCs have benefited from the technologies and other advances made by the DCs, compared to the benefits enjoyed by the DCs themselves.").

[100] See Tan, *supra* note 86 at 128 ("For instance, is a country benefitting from such activities if it gains economically but loses out in terms of breathable air and clean environment for its citizens? Moreover, how direct must the benefits from emission production be in order to count as a relevant benefit? […] And finally, what difference does it make, if any, if the benefits acquired were not sought out or voluntarily accepted, but simply thrust upon an agent? If the present generation benefits from the actions of their predecessors with- out asking for them – indeed they can't avoid the benefits – can it be fairly held to account?").

argued that the ability to pay principle is so fundamental that it is difficult to justify it by deriving it from considerations that are more fundamental still.[101] One possible moral justification can be found in John Rawls's difference principle, one of the most important principles of justice in modern political philosophy. The difference principle states that the advantages of the better situated are just only if they are part of an institutional setting that improves the expectations of the least advantaged members of society so that existing inequalities must contribute effectively to the benefit of the least advantaged.[102]

The ability to pay principle applied to the problem of climate change reminds us of the costs of the transition to a low-carbon economy. It suggests that, although necessary to mitigate climate change, this transition should not slow human development and the eradication of poverty in the least developed countries.[103] This principle also faces important challenges, especially in applying principles of distributive justice to economic relations across state borders. The idea of principles of global justice at the international level has been

[101] Shue, *supra* note 99 at 537.
[102] See John Rawls, *A Theory of Justice*, rev ed (Cambridge, MA: The Belknap Press, 1999) at 65–70; John Rawls, *Justice as Fairness: A Restatement* (Cambridge, MA: The Belknap Press, 2001) at 61–66.
[103] Moellendorf, *supra* note 94 at 175.

strongly argued by cosmopolitans[104] but has faced equally vigorous opposition from anti-globalists.[105]

5.3. How to Share the Burden of Curbing Tax Competition

Returning to the problem of tax competition, we can see that curbing tax competition involves a similar issue of burden sharing. An ethical analysis of tax competition includes asking who should bear the costs of addressing tax competition and how responsibilities should be assigned among countries. In other words, what normative principles should apply to the burden sharing of mitigating tax competition? Studies in tax competition have often failed to address this issue. Much thought has been directed at finding an *effective* solution

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[104] For early developments of cosmopolitanism, see Charles Beitz, *Political Theory and International Relations* (Princeton: Princeton University Press, 1999); Thomas Pogge, *World Poverty and Human Rights: Cosmopolitan Responsibilities and Reforms*, 2nd ed (Cambridge: Polity Press, 2008).

[105] See, e.g., Thomas Nagel, "The Problem of Global Justice" (2005) 33:2 Phil & Pub Aff 113; Michael Blake, "Distributive Justice, State Coercion, and Autonomy" (2002) 30 Phil & Pub Aff 257; Samuel Freeman, "Distributive Justice and The Law of Peoples" in Rex Martin & David A Reidy, eds, *Rawls's Law of Peoples: A Realistic Utopia?* (Malden, MA: Blackwell, 2006) 243; Andrea Sangiovanni, "Global Justice, Reciprocity, and the State" (2007) 35 Phil & Pub Aff 3.

For an overview of the various positions on this debate, including others not mentioned here, such as the equal per capital emissions approach and the idea of subsistence vs luxury emissions, see Tan, *supra* note 86 at 120–133. See also Philippe Cullet, "Common But Differentiated Responsibilities" in Malgosia Fitzmaurice, David M Ong & Panos Merkouris, eds, *Research Handbook on International Environmental Law* (Cheltenham, UK: Edward Elgar, 2010) 161 at 178 (pointing out that even the binding nature of the principle of CBDR remains disputed, as developed countries are wary of the implications and long-term consequences of recognizing differential treatment as a compulsory principle of international law).

to tackle tax competition, but the matter of *fairness* in how the costs of a solution are distributed internationally has been largely overlooked.[106] Although a comprehensive response to tax competition might be beneficial to most countries—and even if we were to assume that this would bring more fairness to the international tax regime—, a just solution requires an equal concern with fairness in the upshot of institutional reform.[107]

I do not attempt to settle the question here. I rather argue that this is a much-needed discussion, especially considering the increasing efforts of international organizations to achieve cooperation in building a more comprehensive and inclusive framework for international taxation.[108] Building on the insights of philosophers and legal and political

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[106] For important exceptions, see *supra* note 9. See also Avi-Yonah, *supra* note 1 at 1650 (suggesting that between two alternative solutions for tax competition, a solution that favours poorer countries should be preferred as a matter of inter-nation equity).

[107] In this respect, fairness might also help achieve cooperation. Research suggests that even when self-interest favours cooperation, countries might fail to contribute if they feel the distribution of costs is unfair (Scott Barrett, "Making International Cooperation Pay: Financing as a Strategic Incentive" in Inge Kaul & Pedro Conceição, eds, *The New Public Finance: Responding to Global Challenges* (New York: Oxford University Press, 2006) 357 at 366). This means that a fair distribution of the burden can also be seen as an important strategy to establish incentive structures that motivate agreement. See also Benshalom, *supra* note 4 at 79–80 (arguing that if a state has confidence that a long-term agreement is fair, it might be willing to cooperate whether or not its economic position relative to the position of other countries improves); Charles Bram Cadsby & Elizabeth Maynes, "Voluntary Provision of Threshold Public Goods with Continuous Contributions: Experimental Evidence" (1999) 71 J Pub Econ 53 (suggesting that compensation encourages compliance and reduces risks of free-riding behaviour).

[108] An important example is the OECD's Inclusive Framework on BEPS, an initiative launched by the OECD in January 2016 to include the participation "on an equal footing" of non-G20 countries, particularly developing economies, in the implementation of the BEPS project (OECD, *Background Brief: Inclusive Framework on BEPS* (Paris: OECD Publishing, 2017)). Another example is the Platform for Collaboration on Tax, a joint effort launched in April 2016 by the IMF, the OECD, the

scholars developed in the context of climate change, I outline below four principles that could independently or jointly guide the burden sharing of curbing tax competition: the responsible party pays principle, the retrospective beneficiary pays principle, the prospective beneficiary pays principle, and the ability to pay principle.

5.3.1. Responsible Party Pays Principle

One might argue that the costs of curbing tax competition should be shared among the countries that gave cause to it in the first place—let us call this idea the *responsible party pays principle*.[109] It builds on the idea of reparative justice and asks for accountability and responsibility-taking from those who are responsible for harm.[110] At first glance, this may seem to suggest that the existing low-tax countries are responsible for the current international tax scene, and as such, they should bear the costs of curbing tax competition. The institutional history of the existing international tax regime, however, might suggest otherwise.

The present international tax regime was forged when, in the 1920s, the League of Nations commissioned a group of experts to evaluate how to avoid the problem of double

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UN, and the World Bank to increase cooperation between these organizations on designing and implementing international tax standards, providing capacity-building support to developing countries, and ensuring a greater participation of developing countries in international tax policy discussions and institutions (World Bank, *The Platform for Collaboration on Tax: Concept Note* (Washington, DC: World Bank Group, 2016)).

[109] This principle resembles the polluter pays principle discussed in the climate change debate. Here I adapt the term to the problem of tax competition.

[110] Margaret Urban Walker, "Restorative Justice and Reparations" (2006) 37:3 J Soc Phil 377.

taxation in cross-border transactions. The principles then articulated have since been the pillars of international taxation.[111] The decision made then resulted in the existing international tax regime, a web of inconsistent rules exploited by multinationals to avoid taxes.[112] It has been argued that although policymakers at the time did foresee that this tax regime would allow taxpayers to more easily engage in tax avoidance and evasion, they were more concerned that an alternative solution would harm efforts to liberalize trade and investment, the primary objective at the time.[113]

This discussion illustrates the most serious problem with the responsible party pays principle. It requires identifying who is responsible and determining how to measure their degree of responsibility.[114] In this respect, other actors might as well be held accountable for the current state of international tax competition. Commentators note that low-income economies have oftentimes been encouraged by rich countries and by international

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[111] Gabriel Zucman, "Taxing across Borders: Tracking Personal Wealth and Corporate Profits" (2014) 28:4 J Econ Perspect 121 at 123.

[112] *Ibid* at 124.

[113] See, e.g., Thomas Rixen, "From Double Tax Avoidance to Tax Competition: Explaining the Institutional Trajectory of International Tax Governance" (2011) 18:2 Rev Int Polit Econ 197 at 212.

[114] It is interesting to note that in the case of climate change historical polluters often put forward the argument that they were excusably ignorant of the consequences of their actions (Bell, *supra* note 92). This argument cannot be as easily advanced in the case of tax competition, as delegates in the League of Nations were already informed in the 1920s that the international tax regime then decided would generate international tax arbitrage, but they preferred to avoid any potential obstacle to international circulation of capital, seen at the time as "one of the conditions of public prosperity and world economic reconstruction" (Rixen, *supra* note 113 at 212). As Rixen points out, however, what policymakers could not foresee was that the magnitude of cross-border activity and the significance of intangible assets would one day overburden the capacities of tax administrations around the globe (i*bid*).

organizations such as the IMF or the World Bank to pursue policies that include low taxation of capital.[115] Moreover, a broader perspective of the international tax regime might suggest that policy choices made by developed countries in the last few decades have intensified tax competition. The adoption of specific domestic policies of developed countries creates international conditions that favour tax competition over cooperation, which constrains policy alternatives of less developed countries, as multinationals put pressure on them to reduce their taxes.[116] Indeed, some argue that given the need for tax revenues, developing countries would, in general, prefer to refrain from granting tax incentives, but they grant the incentive in response to the existing competition.[117]

The responsible party pays principle also raises an important philosophical problem. A principle based on historical responsibility that implies reparations for past wrongs requires justifying why wrongs committed in the past should be borne by individuals in the present.

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[115] Dietsch, *supra* note 2 at 205. See also Genschel & Seelkopf, *supra* note 77 at 69 (pointing out that international organizonsations such as the United Nations Conference on Trade and Development (UNCTAD) often encourage small, resource-poor countries to embrace tax-haven strategies as a means for accelerating development). It is also important to note that the current tax regimes of many tax havens hardly result from an expression of their will as they are "often holdovers from the colonial era" (Steven A Dean, "Philosopher Kings and International Tax: A New Approach to Tax Havens, Tax Flight, and International Tax Cooperation" (2007) 58 Hastings LJ 911 at 936).

[116] See Christians, *supra* note 55 at 265–66 (mentioning as an example the United States' "deferral" tax regime, which increases the sensitivity of taxpayers to foreign tax rates). The US recent tax reform has substituted the system of worldwide taxation with deferral by a system more akin to territorial taxation. Commentators suggest that the new legislation will exert even more pressure for tax competition (David Kamin et al, "The Games They Will Play: An Update on the Conference Committee Tax Bill" (2017), online: SSRN <https://ssrn.com/abstract=3089423> at 23).

[117] See, e.g., Reuven S Avi-Yonah, "Globalization and Tax Competition: Implications for Developing Countries" (2001) 44:2 Law Quadrangle Notes 60 at 63.

One needs to justify how perpetrators that are no longer alive can be held accountable and how the responsibility can be transferred to present individuals simply because of national or generational association.[118] These issues pose important challenges for a principle based on historical responsibility.[119]

5.3.2. Retrospective Beneficiary Pays Principle

An alternative but related principle might be drawn in the form of the *beneficiary pays principle*. There could be two different versions of this principle, depending on how we look at the issue. A first version—let us call it the r*etrospective beneficiary pays principle*—looks at the gains and losses generated by tax competition and suggests that the past and present beneficiaries of tax competition should bear the costs resulting from curbing it. The larger the benefits one gained from international tax competition, the larger one's share of the costs of mitigating the problem. This version resembles the beneficiary pays principle discussed in the climate change debate. It builds on the idea that where a country has been made better

[118] For a strong case that it should, see David Miller, *National Responsibility and Global Justice* (Oxford: Oxford University Press, 2007) at 135–161.

[119] A somewhat "negative" approach to this idea of responsibility was proposed by Steven Dean (Steven A Dean, "Neither Rules nor Standards" (2013) 87:2 Notre Dame L Rev 537 at 576–82). Focusing on global tax revenues allocation among countries, Dean suggests what he calls the "Benefits and Burdens Principle," according to which global tax revenues should be shared according "not only to the proportion of the world's sales that occur in a particular jurisdiction but also to a measure of the enforcement assistance it provides to other states." (*Ibid* at 578). I consider his benefits and burdens principle a negative approach to the responsible pays principle in the sense that the more a jurisdiction offers in enforcement assistance to reduce tax evasion the less responsible it should be held for the current state of tax competition.

off by a policy that has contributed to the imposition of adverse effects on third parties, then such country has an obligation not to pursue that policy itself and an obligation to address the harmful effects suffered by the third parties.[120]

One could argue that this principle creates positive incentives for wider institutional reform due to its rhetorical value for a shaming strategy against the current beneficiaries of tax competition, which would otherwise be unlikely to cooperate.[121] However, although public shaming by international organizations can be effective in bringing about compliance,[122] we should not ignore that a shaming strategy might result in unprincipled coercion by the most powerful states if there are no clear agreed-upon criteria for defining relevant concepts such as "tax havens" and "unjust tax competition."[123] A recent example is the EU's release of a blacklist of "non-cooperative tax jurisdictions."[124] It has sparked

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[120] Caney, *supra* note 95 at 756.

[121] See, e.g., Dietsch, *supra* note 2 at 192–93 (arguing that net winners of tax competition have a duty to compensate net losers and suggesting that the main reason to argue for these compensatory duties is not actually to see them paid, but rather to deploy them as rhetorical device in the fight against unjust tax competition). It is important to note that Peter Dietsch's proposal of compensatory duties does not build on the idea of benefits, but it rather focuses on the losses generated by tax competition to what he calls the "right holder states." He also does not suggest compensation based on the costs of *curbing* tax competition but rather aims at offsetting the losses caused so far by tax competition itself (Dietsch, *supra* note 2 at 188–218).

[122] JC Sharman, "The Bark Is the Bite: International Organizations and Blacklisting" (2009) 16:4 Rev Int'l Pol Econ 573.

[123] See Christians, *supra* note 57 (analyzing the OECD's 1998 Project on Harmful Tax Practices and arguing that the guiding principles for intervention in domestic tax policy decisions should be explicitly stated and subjected to rigorous analysis and inclusive debate).

[124] The original list and subsequent adjustments are available in European Commission, "Common EU List of Third Country Jurisdictions for Tax Purposes", online: <https://ec.europa.eu/taxation_customs/tax-common-eu-list_en>.

criticism for lack of both transparency and objective criteria as it omits EU member states as well as countries that are commonly viewed as tax havens.[125]

The retrospective beneficiary pays principle faces some relevant challenges. The first question is whether the principle should be limited to current beneficiaries (and current gains from tax competition) or should include historical beneficiaries (and past gains as well). Second, it might be difficult to determine who the beneficiaries are and how to measure the benefits, as such an analysis requires a counterfactual exercise, i.e., it depends on hypothesizing what the world economy would be like had tax competition (which would also need a definition) not taken place.[126] Third, the definition of "benefit" is problematic. Should it consider the gains and losses of tax revenues? Should it include the economic growth resulting from foreign capital attraction? Fourth, if we consider the institutional history of the present international tax scene, as well as the role of rich countries and international organizations in constraining (or influencing) the choices of poorer countries regarding their

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[125] Lena Angvik, "Grey Is the New Black in EU's Tax Haven Blacklist," *TP Week* (6 December 2017), online: <https://www.tpweek.com/articles/grey-is-the-new-black-in-eus-tax-haven-blacklist/aroexjiu>. See also Christians, *supra* note 57 at 101 (observing that the naming and shaming in the OECD's work on harmful tax competition is problematic and represents the determination of taxing rights of sovereign nations by a relatively small and elite group of individuals).

[126] But see Dietsch, *supra* note 2 at 196–201 (suggesting criteria for estimating losses originated from each of the three kinds of tax competition: portfolio capital, paper profit, and foreign direct investments).

One may suggest that an estimation in this case might not be needed, since the implementation of any given solution for tax competition itself would automatically burden the present beneficiaries of tax competition. However, although it is true that the effects of implementation would fall on present beneficiaries, the distribution of the burden would not necessarily be proportionate to how much each country gains or has gained from tax competition, as different alternative solutions for tax competition would produce different economic results.

domestic fiscal policies, it seems ethically troublesome to suggest that the latter alone should bear the costs resulting from the mitigation of tax competition.

5.3.3. Prospective Beneficiary Pays Principle

A second version of the beneficiary pays principle would aim at the *prospective beneficiaries* of the mitigation of tax competition. According to this idea, winners from institutional reform should compensate losers for their resulting losses. Compared to the first version of the beneficiary pays principle, this version suggests an almost contrary view. Whereas the retrospective beneficiary pays principle tends to favour countries that currently lose from tax competition, the prospective version of the principle would favour countries that presently benefit from it. The prospective beneficiary pays principle takes tax competition as the status quo and proposes to compensate the prospective losers of institutional reform. It builds on the somewhat intuitive notion that who benefits more from a given policy should also contribute a larger share in bearing its costs. From an ethical perspective, it may be argued that the international community has a moral obligation to smooth the transition for net losers.[127]

An important advantage of this principle seems to be political acceptability. Negotiations for major institutional reform often involve estimations of costs by prospective losers, which will hardly cooperate unless some form of compensation for their losses is

[127] Dietsch, *supra* note 2 at 213.

ensured.[128] To the extent that a comprehensive solution for tax competition requires cooperation from prospective losers (mainly, low-tax countries), compensation based on the prospective beneficiary pays principle might be needed to achieve agreement.[129]

A prospective beneficiary analysis depends on the agreed solution for tax competition. The distribution of gains and losses from institutional reform will vary significantly according to how tax competition is defined and how it will be regulated.[130] Indeed, any potential solution for tax competition would not "reinstate" the global economy to what it "should" be in the absence of tax competition. Institutional reform will rather create a new tax order that will change, not eliminate, the global competition arena. This means that prospective benefits can only be estimated after a specific solution for tax competition is determined. Commentators warn about the risk that an institutional solution for curbing tax

[128] See Genschel & Schwarz, *supra* note 19 at 355 ("The spread of multilateral cooperation is held back by small, low-tax countries either refusing to participate or premising their participation on costly side-payments and/or substantive concessions undermining the effectiveness of the cooperation.").

[129] See Dietsch, *supra* note 2 at 212 (arguing that a targeted compensation of citizens of transitioning tax havens would weaken the feasibility constraints facing the unwinding of tax havens and increase the chances of their cooperation in the transition); Rixen, *supra* note 113 at 201–02 (analyzing tax competition from a game-theoretical perspective and observing that present losers from tax competition would either have to provide side payments to current winners or somehow use their power to force them into compliance). *But see* Dean, *supra* note 115 (criticizing the common assumption that international tax policy is determined by "enlightened philosopher kings devoted to pursuing the national public interest" and that cooperation would only occur where participating nations were to benefit economically from it).

[130] Christians, *supra* note 4 at 833.

competition may favour richer countries.[131] If this were the case, a prospective beneficiary pays principle should at least alleviate the effects of an unjust institutional solution.

5.3.4. Ability to Pay Principle

The three principles discussed so far consider justice from the somewhat narrow perspectives of who gave cause to tax competition (responsible party pays principle), who benefited from it (retrospective beneficiary pays principle), or who would benefit were it to be mitigated (prospective beneficiary pays principle). A recurring weakness of these principles is that they are indifferent to the existing background inequality and varying abilities of countries to bear the burden of institutional reform. Indeed, one might say that the world is not only unequal, but it is unequal in a particular way: most of the inequality is due to inequality among countries, rather than within countries.[132] A broader observation of the global economy might suggest a more comprehensive conception of international justice which considers that some countries have more economic needs than others. It suggests it might be unfair—and even infeasible—to distribute the burden among countries in any way that disregards distinct capabilities to bear them.

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[131] See, e.g., Dagan, *supra* note 9 at 140; Hearson, *supra* note 9; Christians, *supra* note 68.

[132] Branko Milanovic, *Global Inequality: A New Approach for the Age of Globalization* (Cambridge, Mass: The Belknap Press, 2016) at 132. Milanovic points out that inequality among nations is high enough that being born in a rich country matters much more than being born in a rich family and suggests the terms "citizenship premium" for those who are born in a rich country and "citizenship penalty" for those born in poor ones (*ibid* at 128, 131).

The *ability to pay principle* is widely recognized in the tax literature as a measure to determine how to share the burden of taxation among citizens fairly. It builds on the idea that a just tax scheme should distinguish among taxpayers according to their relative income, taking more from those who have more, so as to ensure that each taxpayer bears the same loss of overall welfare.[133] It is relevant to note that the ability to pay principle is discussed in tax scholarship only as a matter of *inter-individual equity* within a nation, i.e., it is a theory that compares inequalities among residents of a given country.[134] Here we consider it as a matter of *inter-nation equity*, applying it as a measure of fairness between countries. Interestingly, the term "ability to pay principle" has been largely used in the philosophical debates on climate change as referring to inter-nation equity rather than to inter-individual equity.[135]

The ability to pay principle applied in the international context suggests that a fair institutional reform that involves distinct gains and losses for different countries should not aggravate the situation of the worse off. This is particularly important as empirical research

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[133] For a philosophical discussion on the justification of the ability to pay principle in the context of domestic tax policy, see Liam Murphy & Thomas Nagel, *The Myth of Ownership: Taxes and Justice* (Oxford: Oxford University Press, 2002) at 20–30.

[134] Even when discussing international taxation, commentators limit the scope of the ability to pay to equity among individuals within a country rather than among countries. See, e.g., J Clifton Fleming Jr, Robert J Peroni & Stephen E Shay, "Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income" (2001) 5:4 Fla Tax Rev 299 (analyzing how different US policies of taxing residents on their worldwide incomes adhere to the ability to pay principle, so understood as fairness among American residents).

[135] See, e.g., Simon Caney, "Climate Change and the Duties of the Advantaged" (2010) 13:1 Crit Rev Int'l Soc Pol Phil 203; Shue, *supra* note 99 at 537–540; Moellendorf, *supra* note 94 at 173–180; Bell, *supra* note 92.

suggests that structural inequalities among countries play a relevant causal role in the production and perpetuation of poverty around the world.[136]

As every state in the world is simultaneously a participant in and a potential victim of the global game of tax competition,[137] winners and losers of tax competition do not compose homogeneous groups. They have different structures and varying levels of development, as would the potential winners and losers of overall institutional reform.[138] Curbing tax competition will not eliminate competition between countries but will rather shift the game to one that relies on other sets of advantages in the search for international competitiveness. How different nations will be adversely affected by such a change will depend on which solution is chosen to address tax competition. The different principles for burden sharing mentioned above (the responsible party pays, the retrospective beneficiary pays, and the prospective beneficiary pays) do not directly consider the different capabilities of countries to meet these costs.

The ability to pay principle requires that a distribution of a burden reduce the advantage of those at the top and prevent existing inequalities from becoming worse through the infliction of an unfair additional disadvantage upon those at the bottom.[139] To ignore these

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[136] See Niheer Dasandi, "International Inequality and World Poverty: A Quantitative Structural Analysis" (2014) 19:2 New Pol Econ 201 (suggesting the need for policymakers to consider the negative effects of international policies and actions on poverty, rather than focusing exclusively on reforms to be undertaken within developing countries).
[137] Christians, *supra* note 21 at 1375.
[138] For an analysis of the determinants of who wins and who loses from tax competition, see Genschel & Seelkopf, *supra* note 77 at 69.
[139] Shue, *supra* note 99 at 540.

inequalities at a time when some countries are still struggling to overcome extreme poverty is to disregard their right to economic development.[140] As some countries suffer from greater structural disadvantages than others, international justice requires that the main institutions of the global economic order be designed to be fair to poor and developing countries.[141]

An important question for applying this principle is how to measure the development level of affected countries. Should it be limited to economic inequality? Should it consider a broader notion of development? The concept of development itself has evolved rapidly in the development literature,[142] and each different conception of the term would suggest a different classification system.[143] Possible measures include per capita income, purchasing power parities (PPP), the Human Development Index (HDI), the Sustainable Development Goals (SDG) index, the Index of Sustainable Economic Welfare, the Happy Planet Index, and the World Happiness Report.[144] International organizations have been using different indicators for this purpose. The World Bank uses the gross national income per capita (GNI/n) as the basis for determining preferential assistance because it considers it to be "the best single indicator of economic capacity and progress."[145] The United Nations Development

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[140] Tan, *supra* note 86 at 123.

[141] Martha C Nussbaum, *Frontiers of Justice: Disability, Nationality, Species Membership* (Cambridge, Mass: The Belknap Press, 2006) at 319.

[142] Ian Goldin, *The Pursuit of Development: Economic Growth, Social Change, and Ideas* (Oxford: Oxford University Press, 2016) at 3.

[143] Lynge Nielsen, "Classifications of Countries Based on Their Level of Development: How It Is Done and How It Could Be Done" (2011) IMF Working Paper, online: <https://www.imf.org/external/pubs/ft/ wp/2011/wp1131.pdf> at 4.

[144] Goldin, *supra* note 142 at 4–17.

[145] Nielsen, *supra* note 143 at 10–11.

Programme uses the HDI as ultimate criteria for assessing the development of a country.[146] The International Monetary Fund employs a framework based on per capita income, market access, and short-term vulnerability, to determine eligibility for concessional financing.[147] The OECD proposes a broader measurement of well-being with its Better Life Index, which includes eleven indicators: community, education, environment, civic engagement, health, housing, income, jobs, life satisfaction, safety and work-life balance.[148]

6. Conclusion

This chapter has argued that a solution for curbing tax competition, as is the case with any institutional reform, brings about costs that should not be excluded from an ethical analysis of tax competition. A normative analysis requires thinking about the moral justifications for mitigating it, but it should equally include an analytical examination of the ethical implications of an institutional solution for tax competition. I have proposed four normative principles that could independently or jointly apply to the burden sharing of curbing tax competition. Two of these principles—the responsible party pays and the retrospective beneficiary pays—look at the past and suggest that countries that gave cause to the problem or have benefited from it should bear the costs of overall institutional reform.

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[146] UNDP, *Human Development Report 2016: Human Development for Everyone* (New York: United Nations Development Programme, 2016).
[147] International Monetary Fund, *Eligibility to Use the Fund's Facilities for Concessional Financing* (Washington, DC: IMF, 2017).
[148] OECD, *How's Life? 2017: Measuring Well-being* (Paris: OECD Publishing, 2017).

The other two principles—the prospective beneficiary pays and the ability to pay—consider the prospective effects of institutional reform in the global economy and the inequities that may arise from it.

Although not definitively advocating which of (or how) these principles should apply to the burden sharing of curbing tax competition—as well as not excluding other possible principles not discussed here—, I believe that the complexity of tax competition and the heterogeneity of the actors involved might require a combination of principles.[149] I would argue that any solution would need to consider the existing background injustices of the international tax system and should thus include the ability to pay principle as one of its elements.[150] A fair framework for tax competition should allow the pursuit of sustainable development in the least developed and developing countries rather than create even more constraints to these economies. On the other hand, a concern with fairness but also with political feasibility might suggest some form of compensation for prospective net losers, as it would otherwise be difficult—and unjust, as we have seen in Sections 5.1 and 5.3.3—to achieve consensus. Therefore, a tentative proposal might be a combination of the prospective beneficiary pays and the ability to pay principles.

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[149] Similarly, Simon Caney proposes a mixed normative principle for the burden sharing of climate change, arguing that, although convenient, a simple formula would fail to address the complexity of the problem (Caney, *supra* note 135 at 222).

[150] See Apeldoorn, *supra* note 9 at 15 (arguing that background justice in the international context requires the creation of redistributive institutions and suggesting that tax revenues from the taxation of multinationals' income should be shared among states in proportion to their GDP or per capita income so as to increase the fiscal self-determination of the poorest countries).

Several questions remain to be answered, such as how to identify and measure past responsibility and how to determine beneficiaries and measure their respective benefits. The question of how the costs of mitigating tax competition should be technically shared also requires further research. I believe this would greatly depend on what solution is to be applied to tackle tax competition. A distribution of the costs might include, for example, financial compensation[151] or unequal restrictions on tax competition (i.e., limiting tax competition according to the chosen criteria, e.g., allowing low-income countries to engage in some forms of tax competition under more moderate restrictions compared to high-income countries).[152]

Interestingly, although there is a rich literature on the philosophical and practical problems of a fair distribution of the burden of mitigating climate change, the discussion of burden sharing in the tax competition literature is nearly non-existent. In this respect, it should be noted that the different normative principles involved in the climate change debate present significant intersections. Those responsible for causing the problem (the polluters, which are the duty bearers according to the polluter pays principle) are oftentimes the ones

[151] An interesting proposal based on financial compensation is advanced by Steven Dean. See Dean, *supra* note 115. He proposes that "tax flight jurisdictions" (countries which commonly suffer from tax evasion and avoidance) negotiate "tax flight treaties" with tax haven jurisdictions, in which the latter agree to exchange information while the former commit to financial compensation by financing the information infrastructure and sharing a portion of the additional tax revenues generated by the tax haven's cooperation. Dean's proposal, however, is not based on normative grounds. He rather suggests it "stand[s] a greater chance [than some alternative proposals] of persuading tax havens to help reduce tax flight." (*Ibid* at 965).

[152] See Dietsch, *supra* note 2 at 202 (suggesting that in the current state of global background injustice, a solution for tax competition could be more permissive with respect to developing countries by tolerating their resorting to tax-competition practices).

which have most benefited from it (the beneficiaries, which are the duty bearers according to the beneficiary pays principle) and are mostly richer industrialized countries (the most able to pay, which are the duty bearers according to the ability to pay principle). In contrast, the intersection of duty bearers in the case of tax competition is significantly narrower. The current beneficiaries of tax competition can hardly be regarded as the most economically capable to bear the costs of institutional reform. Likewise, the causes of the present state of international tax competition cannot be easily assigned to its current beneficiaries. This suggests that, philosophical concerns aside, the implications of how the burden of curbing tax competition is shared should take even more practical relevance.

As international organizations increasingly move towards designing a global framework aimed at reducing tax avoidance and mitigating tax competition, the game of tax competition gradually changes, shifting the distribution of gains and losses among countries. The absence of a serious discussion on how to share the costs of curbing tax competition brings about the risk of a distribution based on power rather than on principle. As commentators have observed, institutional policy decisions tend to reproduce the present imbalance of the global power and a reform of the international tax order is likely to reinforce the existing monopoly of a small number of rich countries over the international tax policy.[153]

[153] Christians, *supra* note 73. See also Dagan, *supra* note 9 at 142–184 (arguing that the shift from competition to negotiated coordination produces unjust inequalities that derive from asymmetries in the relative bargaining power of the negotiating states and suggests that restricting tax competition might produce severe distributive effects on poor countries); Hearson, *supra* note 9 at 5 (pointing out that the track record of global tax governance so far suggests that institutional international decisions

The lack of an explicit discussion on how to share the opportunity costs arising from the implementation of global tax reform might result in countries with less negotiating power bearing most of these costs.

would likely favour more powerful states). See also Martin Hearson, "When Do Developing Countries Negotiate Away Their Corporate Tax Base?" (2018) 30:2 J Int Dev 233 (undertaking a more nuanced analysis of the determinants of tax treaty negotiation outcomes, such as government's revenue base, its reliance on corporate tax, investment asymmetries, and knowledge and negotiation experience). From a broader perspective, see Branko Milanovic, *Worlds Apart: Measuring International and Global Inequalit*y (Princeton: Princeton University Press, 2005) at 149 (arguing that global power is currently held by a relatively small number of very rich people within very rich countries).

It is worth noting that since there is no generally accepted baseline of acceptable tax competition against which to define harmful tax competition, different countries have been defining tax competition based on what shifts the rules in their own favour (Lilian V Faulhaber, "The Trouble with Tax Competition: From Practice to Theory" (2018) 71 Tax L Rev 311).

CHAPTER SIX
Normative Principles for Allocating Taxing Rights

1. Introduction

One of the main functions of international tax law is determining how to allocate rights to tax international income among states. The distribution of taxing rights has been historically justified by what can be generally called origin-based approaches. Origin-based allocation purports that states should be entitled to tax income generated in their territories or arising from the resources they control. A variety of theoretical approaches entails the allocation of taxing rights according to the origin of income, such as the benefits theory, the costs theory, the entitlement theory, the faculty theory, the economic allegiance theory and, more recently, the idea of allocating income according to value creation. These theories ultimately imply that taxing rights must align with the location of the factors contributing to the generation of income.

Recent developments in the international tax scene suggest a re-examination of the normative underpinnings of the current distribution of the international tax base. The global changes arising from the digitalization of the economy have motivated countries to reconsider the present allocation of taxing rights. Furthermore, the challenges to determine where income is created has spurred skepticism about the suitability of origin-based theories to justify the allocation of taxing rights.

This chapter argues that origin-based approaches still hold valid as normative criteria but are significantly limited in scope. Origin-based theories overestimate the feasibility of determining the origin of income and take for granted some of the complexities resulting from economic globalization. A great part of the global production today flows from supply and demand chains that span across multiple sectors and countries. Accurately pinpointing the factors that gave rise to a given income, and their relative contribution, is a difficult if not an impossible task. Moreover, the strong disagreement between countries about which economic factors should be considered relevant for allocating taxing rights has recently led to a greater consideration of distributional consequences. Tax policy discussions on how to allocate taxing rights increasingly rely on impact assessments, suggesting a continued move from origin-based toward distribution-based approaches. The increasing role of distributional implications requires normative criteria that go beyond an origin-based rationale and include distributive justice considerations.

An alternative normative approach, which can be called the differential approach, warrants that the distribution of rights between states should promote global distributive justice. From this perspective, taxing right allocation should aim to address the existing economic inequalities between countries. The chapter's main argument is that the diminished scope of (and the continued departure from) origin-based approaches give rise to a normative claim that the disputed portion of the international tax base should be allocated to the benefit of less affluent countries to help address their development needs.

The remainder of the chapter proceeds as follows. Section 2 explains the normative foundations of origin-based theories, which still predominate in international tax circles, and discusses some of their practical limitations. Section 3 puts forward a two-pronged principle that adopts a differential approach whenever origin-based approaches fail to successfully guide the allocation of taxing rights. Section 4 presents the implications of this alternative normative standard, particularly in proposals that incorporate formulary approaches to the allocation of global business profits.

2. Origin-Based Approaches

2.1. Entitlement Theories and the Principle of Origin

A variety of theories attempt to explain the existing rules for entitling countries to tax a given income. They can be broadly categorized as origin-based theories because they generally align tax entitlement with the location of the factors that have contributed to the generation of income. Perhaps one of the clearest and long-standing explanations for current international allocation of taxing rights is the *economic allegiance theory*. It was notably advanced in the 1920s by the four economists commissioned by the League of Nations to evaluate the international tax rules.[1] Their report is widely considered to have formed the

[1] Bruins, Einaudi, Seligman, and Sir Josiah Stamp, *Report on Double Taxation, submitted to the Financial Committee*, League of Nations, Geneva, 1923, League of Nations Doc EFS 73 [1923 Report].

basis of the current international tax system.[2] The economic allegiance theory submits that income should be allocated among countries according to "the origin of the income or the place where the earnings are created".[3] This came to be known as the *principle of origin*.[4] The underlying rationale is that individuals and corporations benefit from and have economic interests in the states where their income is produced, possessed and disposed of.[5] As far as they benefit from services, infrastructure, and market and labour access from these states, they build a connection that implies a duty to pay taxes.[6]

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[2] See Michael J Graetz, "Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies" (2001) 26:4 Brook J Int'l L 1357 at 1358.

[3] 1923 Report, *supra* note 1 at 24. For an overview, see RSJ Martha, *The Jurisdiction to Tax in International Law* (Deventer: Kluwer Law and Taxation, 1989) at 23-41.

[4] See Eric CCM Kemmeren, *Principle of Origin in Tax Conventions: A Rethinking of Models* (Dongen, The Netherlands: Pijnenburg, 2001).

[5] See 1923 Report, *supra* note 1 at 22–23 (defining *production of wealth* as encompassing "all the stages up to the point when the physical production has reached a complete economic destination and can be acquired as wealth", *possession of wealth* as the "range of functions relating to establishing the title to the wealth and preserving it [which takes place] between the actual fruition of production into wealth and the disposing of it in consumption" and *disposition of wealth* as "the stage when the wealth has reached its final owner, who is entitled to use it in whatever way he chooses. He can consume it or waste it, or re-invest it; but the exercise of his will to do any of these things resides with him and there his ability to pay taxes is apparent"). See also Klaus Vogel, "Worldwide vs. Source Taxation of Income - A Review and Re-evaluation of Arguments (Part I)" (1988) 16:8-9 Intertax 216 at 223-228 (explaining that the origin of income "refers to a state that in some way or other is connected to the production of the income in question, to the state where value is added to a good").

[6] 1923 Report, *supra* note 1 at 18. See also Klaus Vogel, "Worldwide vs. Source Taxation of Income - A Review and Re-Evaluation of Arguments (Part III)" (1988) 16:11 Intertax 393 at 398 (pointing out that a taxpayer integrated in the economic life of a state owes a certain degree of economic allegiance to its government as a compensation for the costs incurred to provide the benefits that contributed to the earning of the income).

Alternative explanatory theories build on a similar normative reasoning. The *benefits theory* requires the allocation of taxing rights according to the benefits derived from each country's provision of public goods and services.[7] It is often justified by the ethical obligation of a taxpayer to pay for the benefits conferred by the government and the notion of an implied contract between the taxpayer and the country imposing the tax.[8] The *costs theory* takes the perspective of the state and aligns tax entitlement with the cost of the services performed by the state rather than the benefits derived from these services.[9] The benefits and the costs theories are considered two variants of the *exchange theory*, which premises on the economic rationale that states and taxpayers exchange services and tax payments.[10] The *entitlement theory* is considered to go beyond the benefits theory for including not only services provided by the government but all factors (such as access to markets and productive resources) that

[7] Richard A Musgrave & Peggy B Musgrave, "Inter-Nation Equity" in Richard M Bird & John G Head, eds, *Modern Fiscal* Issues*: Essays in Honor of Carl S. Shoup* (Toronto and Buffalo: University of Toronto Press, 1972) 63 at 71–72.

[8] Nancy H Kaufman, "Fairness and the Taxation of International Income" (1998) 29 Law Policy Int Bus 145 at 184; Reuven S Avi-Yonah, "All of a Piece Throughout: The Four Ages of U.S. International Taxation" (2005) 25:2 Va Tax Rev 313 at 315. Adopting a similar view, some have argued for a principle of membership, according to which "individuals and companies should be viewed as members in those countries where they benefit from the public services and infrastructure" and therefore "polities should have an effective right to tax individuals and companies as they see fit" (Peter Dietsch & Thomas Rixen, "Tax Competition and Global Background Justice" (2014) 22:2 J Pol Phil 150 at 157–58).

[9] 1923 Report, *supra* note 1 at 18.

[10] Richard Abel Musgrave, "The Voluntary Exchange Theory of Public Economy" (1939) 53:2 QJ Econ 213 at 214–15.

contribute to the creation of income.[11] The *faculty theory*, commonly known as the *ability-to-pay theory*, is also considered a more comprehensive substitute for the benefits theory.[12] According to the faculty theory, in addition to the benefits provided by the government to the acquisition of income, the allocation of taxing rights should consider the costs incurred by the government to allow for the consumption of that income.[13] A more recent attempt to explain the alignment of taxing rights with the place of economic activity is the *value creation theory*. It has been advanced in international tax circles as a basis for aligning taxing rights with the place where economic activities leading to creation of income are performed.[14] The value creation theory is considered to expand the scope of the existing criteria for distributing the international tax base to include the location of consumers and users of goods and services, premised on the idea that they contribute to the creation of income.[15]

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[11] Thomas Rixen, *The Political Economy of International Tax Governance* (Basingstoke: Palgrave Macmillan, 2008) at 59.

[12] See, e.g., 1923 Report, *supra* note 1 at 18; Edwin RA Seligman, "The Theory of Progressive Taxation" (1893) 8:2 Pol Sc Q 220; Kaufman, *supra* note 8 at 184; J Clifton Fleming Jr, Robert J Peroni & Stephen E Shay, "Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income" (2001) 5 Fla Tax Rev 299.

[13] 1923 Report, *supra* note 1 at 18.

[14] OECD, *Addressing the Tax Challenges of the Digital Economy: Action 1 - 2015 Final Report* (Paris: OECD, 2015).

[15] See, e.g., Itai Grinberg, "User Participation in Value Creation" (2018) Brit Tax Rev 407. But see Johannes Becker & Joachim Englisch, "Taxing Where Value Is Created: What's 'User Involvement' Got to Do with It?" (2019) 47:2 Intertax 161. For critical remarks on how the principle of value creation is generally interpreted, see David Quentin, "Corporate Tax Reform and 'Value Creation': Towards Unfettered Diagonal Re-allocation across the Global Inequality Chain" (2017) 7 Acc Econ & L 1; Allison Christians & Laurens van Apeldoorn, "Taxing Income Where Value is Created" (2018) 22:1 Fla Tax Rev 1; Michael P Devereux & John Vella, "Value Creation as the Fundamental Principle

These theories have been used in tax scholarship to explain two main principles for how to allocate tax entitlement. The *source principle* recognizes the entitlement of a state to tax all income arising within its borders. The tax entitlement of the source country derives from the benefits it provides to the economic factors that contribute to the generation of income, such as services, infrastructure, natural resources, educated or low-cost labour, and access to market.[16] The *residence principle* entitles the state where an individual or corporation resides to tax its worldwide income. Residents are held to owe taxes as a return for the rights and privileges they receive as residents, as well as for the benefits accruing to their productive factors prior to foreign investment.[17]

Although there is no clear consensus as to which theory provides the most adequate normative basis for taxing right allocation, what these theories hold in common is that they all rely on some variant of the principle of origin, that is, the notion that the location of the factors that contributed to the creation of income should determine which state is entitled to tax it.

2.2. Normative Basis

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of the International Corporate Tax System" (2018) European Tax Policy Forum Working Paper, online: <ssrn.com/abstract=3275759>.

[16] Peggy B Musgrave, "Combining Fiscal Sovereignty and Coordination: National Taxation in a Globalizing World" in Inge Kaul & Pedro Conceição, eds, *The New Public Finance: Responding to Global Challenges* Oxford: Oxford University Press, 2006) 167 [Musgrave, "Combining"] at 172.

[17] Ibid at 168–69.

Origin-based approaches can be justified by the notion of sovereignty. Sovereignty requires states to respect the independence and autonomy of other states and recognize their territorial integrity.[18] The sovereignty of a state is reflected in its jurisdiction, which comprises the set of legal powers of a state within an international society of states.[19] From an economic perspective, states are thus entitled to the productive factors within their territories.[20]

The source and the residence principles of international tax law are deeply rooted in the two fundamental cornerstones of international law, territoriality and nationality, respectively. Territoriality establishes that a state has jurisdiction over events, persons or things in its territory, including cross-border events that are only partially in its territory and external acts that produce effects within its territory.[21] Nationality establishes a connection based on the relationship between an individual and a sovereign and extends state authority over events taken place beyond national borders. Although conceptually different, nationality

[18] Territorial integrity is generally regarded as a foundational principle of international law given the major role of territorial disputes in enduring interstate rivalries and war (Mark W Zacher, "The Territorial Integrity Norm: International Boundaries and the Use of Force" (2001) 55:2 Int'l Org 215). See also JL Brierly, "Règles générales du droit de la paix" (1936) 58 Recueil des Cours 1 (pointing to the fundamental relationship between jurisdiction and state territory). For a broader discussion, see Cedric Ryngaert, *Jurisdiction in International Law* (Oxford: Oxford University Press, 2008).

[19] Frederick A Mann, "The Doctrine of Jurisdiction in International Law" (1964) 111 Recueil des Cours 1.

[20] Laurens van Apeldoorn, "International Tax Co-operation in an Unjust World: Do States Have an Entitlement to Tax Income Arising in Their Territory?" (2019) 4 British Tax Review 528 at 530.

[21] Alex Mills, "Rethinking Jurisdiction in International Law" (2014) 84:1 Brit YB Int'l L 187 at 194–96.

(in general international law) and residence (in international tax law) derive from the same normative rationale, namely the personal, rather than territorial, connections between a state and an individual as a source of authority.[22]

Sovereignty, thus, generally implies that states should be entitled to the wealth generated in their territories or arising from the resources they control. From this perspective, establishing tax entitlements entails determining the causal relationship between economic factors and the income arising from these factors. According to origin-based approaches, this relationship between the entitlement to a given income and the origin of that income is the fundamental standard for distributing the international tax base.

2.3. Limitations

Two circumstances limit the scope of origin-based approaches as normative criteria for allocating taxing rights. The first problem is that they are difficult to implement in practice. Origin-based approaches need to determine where the income was generated (which generally requires considering every factor without which such income would have not come

[22] See DW Bowett, "Jurisdiction: Changing Patterns of Authority over Activities and Resources" (1982) 53:1 Brit YB Int'l L 1 at 8–9 (noting that the resident's links with a state are as close as those of a national for the purposes of particular areas of regulation, such as taxation, currency and military service obligations). One reason why residence usually substitutes for nationality in tax law is the prevalence in tax law of economic allegiance over political attachments (see 1923 Report, *supra* note 1 at 20). Another reason is that adopting nationality would encourage individuals to abandon their citizenship in exchange for another in a low-tax jurisdiction (see Reuven S Avi-Yonah, "International Tax as International Law" (2004) 57:4 Tax L Rev 483 at 485–86).

to exist)[23] and establish how much each factor has contributed to the creation of such income.[24] Determining these factors in a globalized, multinational scenario is complicated and often infeasible. A great part of the global production today flows from interdependent supply and demand chains that span across multiple sectors and countries. Some of the income generated in global chains derives precisely from reduction in costs associated with sharing of resources across business activities throughout the chain. The contribution of the concurrent factors that lead to cost reduction can hardly be accurately assigned to specific

[23] The origin of income should include any and all antecedents, active or passive, which were factors actually involved in producing the consequence (generation of income). This approach is usually called the "but for" test, or *conditio sine qua non*, and has long been investigated in the legal scholarship on causation in tort law. For an overview, see Richard W Wright, "Causation in Tort Law" (1985) 73:6 Cal L Rev 1735.

[24] Devereux & Vella, *supra* note 15 at 10.

locations.[25] Intangibles pose a similar problem because they lack physical location and benefit the firm as a whole.[26]

[25] See, e.g., Peggy B Musgrave, "Principles for Dividing the State Corporate Tax Base" in Charles E McLure, Jr, ed, *The State Corporation Income Tax: Issues in Worldwide Unitary Combination* (Stanford: Hoover Institution Press, 1984) 228 at 243 ("These firms are interrelated through economies of scale and scope, joint costs, and other factors that render an attempt at separation of activities meaningless."); Reuven S Avi-Yonah & Ilan Benshalom, "Formulary Apportionment – Myths and Prospects: Promoting Better International Tax Policies by Utilizing the Misunderstood and Under-Theorized Formulary Alternative" (2011) 3:3 World Tax Journal 371 at 379 (noting that multinationals flourish by integrating functions in different jurisdictions and reducing costs through synergy that takes advantage of economics of scope and scale, including research and development costs, transactions costs, informational costs, managerial costs, and finance costs); Musgrave, "Combining", *supra* note 16 at 176 (pointing out that with the prevalence of interconnected business operations, economic theory cannot alone can be claimed to correctly assign profits between countries); Michael P Devereux & John Vella, "Are We Heading towards a Corporate Tax System Fit for the 21st Century?" (2014) 35:4 Fiscal Stud 449 (noting that in the context of a multinational the numerous factors that contribute to the creation of income are often spread over a number of countries, making it impossible to pinpoint where the creation of income took place); Michael P Devereux et al, "Residual Profit Allocation by Income" (2019) Oxford University Centre for Business Taxation Working Paper No 19/01, online: <https://ssrn.com/abstract=3358291> at 13 (explaining that the synergies resulting from the combination of different production factors from all parts of a multinational, spread across the world, are not only hard to capture in practice but impossible to allocate to specific corporate units or geographical locations).

[26] See Mitchell A Kane, "Transfer Pricing, Integration and Synergy Intangibles: A Consensus Approach to the Arm's Length Standard" (2014) 6:3 World Tax J 282 at 285 (pointing out that intangibles are impossible to locate spatially and, although often extremely valuable, appear to be immune to accurate valuation); Jerome R Hellerstein, "Federal Income Taxation of Multinationals: Replacement of Separate Accounting with Formulary Apportionment" (1993) 60:10 Tax Notes 1131 at 1141–42 (arguing that given the difficulties to determine a location for intangibles, they might be ignored as a factor for the purposes of allocating taxing rights); Charles E McLure Jr, "U.S. Federal Use of Formula Apportionment to Tax Income from Intangibles" (1997) 14:10 Tax Notes Int'l 859 at 868 (similarly arguing that it would be advisable to disregard intangibles in the determination of taxing rights given the difficulties to establish their geographical location).

Whenever origin-based entitlement theories fail to accurately determine the location and degree of contribution of the factors that give rise to a given income, a decision about how to allocate taxing rights requires an additional moral judgment to be regarded as normatively legitimate. In the absence of clear moral criteria, such a decision will be made by either some form of dispute resolution or political negotiation. If the former is adopted, a purportedly technical solution will eventually conceal a political or moral judgment,[27] since a straightforward answer based on the stated normative standard (namely, an origin-based approach) is, in this case, unavailable. If the latter is adopted, the final decision will be ultimately made on the basis of influence and power. The resulting allocation of taxing rights will eventually favour more powerful countries, compounding to the already severe problem of global inequality.[28] Both solutions are problematic for lacking sound normative basis.[29]

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[27] For a discussion on the relevance of political and moral biases in legal interpretation, see, e.g., Gillian K Hadfield, "Bias in the Evolution of Legal Rules" (1992) 80 Geo LJ 583; Eric A Posner, "Does Political Bias in the Judiciary Matter?: Implications of Judicial Bias Studies for Legal and Constitutional Reform" (2008) 75:2 U Chicago L Rev 853; Jill Anderson, "Misreading like a Lawyer: Cognitive Bias in Statutory Interpretation" (2014) 127:6 Harv L Rev 1521.

[28] Analyzing the different strands of tax competition, Hugh Ault notes that besides the more commonly observed competition for investment, the recent disagreements about how to allocate taxing rights to deal with the challenges posed by the digitalization of the economy has unveiled the concurrent competition for revenues, which despite largely unnoted, goes back to the work of the League of Nations in the 1920s. See Hugh J Ault, "Tax Competition and Tax Cooperation: A Survey and Reassessment" in Jérôme Monsenego & Jan Bjuvberg, eds, *International Taxation in a Changing Landscape: Liber Amicorum in Honour of Bertil Wiman* (Alphen aan den Rijn: Wolters Kluwer, 2019).

[29] This problem is also similar to the concept of causation in tort law. See William M Landes & Richard A Posner, "Causation in Tort Law: An Economic Approach" (1983) 12:1 J Legal Stud 109 at 110 (doubting whether it is possible to use an autonomous concept of cause to decide legal cases

This realization calls for an alternative normative standard when an origin-based approach fails to accurately allocate income among states.

A second limitation of origin-based theories arises from a continued shift away from origin-based considerations toward a distribution-based approach in tax policy discussions. The sharp disagreement between countries about which economic factors should be considered relevant for allocating taxing rights has led to a greater consideration of distributional consequences. Recent discussions about how to adequately allocate taxing rights among states have increasingly relied on economic impact assessments to determine which countries will gain and which will lose as a result of alternative proposals.[30] These

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and arguing that the idea of causation is a result rather than a premise of the analysis of cause). See also Devereux & Vella, *supra* note 15 at 10 (noting that the continued pursuit of origin in complex cases poses additional hurdles for countries without substantial capacity and resources and that the use of arbitrary measures that may proxy for origin brings into question the choice of the normative principle in the first place).

[30] See, e.g., Christoph Spengel et al, "A Common Corporate Tax Base for Europe: An Impact Assessment of the Draft Council Directive on a CC(C)TB" (2012) ZEW Working Paper No 12-039, online: <www.econstor.eu/bitstream/10419/59576/1/718573498.pdf> (assessing the impacts on different EU member states resulting from the adoption of a common corporate tax base); International Monetary Fund, "Spillover in International Corporate Taxation" (2014) IMF Policy Paper, online: <www.imf.org> (discussing how the choice of allocation rules will affect advanced, developing and "conduit" countries); Tommaso Faccio & Valpy Fitzgerald, "Sharing the Corporate Tax Base: Equitable Taxing of Multinationals and the Choice of Formulary Apportionment" (2018) 25:2 Transnat'l Corp 67 (analyzing the various distributional consequences of different formulas under formulary apportionment); Ruud A de Mooij, Li Liu & Dinar Prihardini, "An Assessment of Global Formula Apportionment" (2019) IMF Working Paper No 19/213, online: <imf.org/en/Publications/WP/Issues/2019/10/11/An-Assessment-of-Global-Formula-Apportionment-48718> (assessing the revenue implications for individual countries under alternative formulas under a unitary tax system); Alex Cobham, Tommaso Faccio & Valpy FitzGerald, "Global

discussions suggest that distributional considerations will at least in part replace the role of the traditional origin-based rationale in the final decision on the criteria for allocating taxing rights. This shift requires a normative justification that is not provided by the current economic reasoning behind origin-based theories.

3. The Differential Approach

3.1. The Case for Differentiation

An alternative normative approach for allocating rights between nations can be called differentiation. The differential approach distributes rights so as carry out a universal moral objective, in particular one that aligns with a concern about global justice.[31] A differential

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Inequalities in Taxing Rights: An Early Evaluation of the OECD Tax Reform Proposals" (October 2019), online: <osf.io/preprints/socarxiv/j3p48> (discussing the revenue impacts of tax reform proposals considered by the OECD on lower-income countries); "OECD Presents Analysis Showing Significant Impact of Proposed International Tax Reforms", *OECD* (13 February 2020), online: <www.oecd.org> (reporting the economic implications expected from the reform proposals recently advanced by the OECD over low-, middle-, and high-income countries); Sebastian Beer et al, "Exploring Residual Profit Allocation" (2020) IMF Working Paper No 20/49, online: <imf.org/en/Publications/WP/Issues/2020/02/28/Exploring-Residual-Profit-Allocation-48998> (discussing the tax revenue impacts on investment hubs and lower-income countries resulting from a reallocation of residual profits).

[31] Alexander Cappelen calls this the assignment approach. See Alexander W Cappelen, "The Moral Rationale for International Fiscal Law" (2001) 15:1 Ethics & Int'l Aff 97 at 108 ("A characteristic feature of international fiscal law is that considerations of international income distribution do not have any role in the distribution of tax rights. The assignment approach would challenge this feature of international fiscal law based on what we could call the distributional objection. In its general version this objection points out that benefits arising from special relationships might work to the disadvantage of those who are most in need.").

approach to international tax law would take taxing rights allocation as a significant tool for addressing global inequality and propose a distribution according to countries' characteristics such as per capita income or number of inhabitants. Although the use of differentiation is still relatively unorthodox, it has been embraced in some areas of international law. In international labour law,[32] law of the sea,[33] international trade law,[34] international climate law,[35] and international patent law,[36] the concept of differential treatment has been explicitly used as a way to foster substantive equality among states with varying levels of capacity.

Differential treatment typically comprises non-reciprocal arrangements aimed at promoting substantive equality between countries.[37] The rationale behind differentiation in international law lies in the recognition that formal equal treatment can secure equality only among parties at an identical or similar level of economic and political power, and that

[32] Article 19(3) of the Constitution of the International Labour Organization.
[33] Articles 61 and 62 of the United Nations Convention on the Law of the Sea.
[34] Article XVIII of the Agreement on Tariffs and Trade.
[35] Article 3(1) of the United Nations Framework Convention on Climate Change.
[36] Articles 65(2), 65(4), 66(2), and 67 of the Agreement on Trade-Related Aspects of Intellectual Property Rights.
[37] Differential treatment recognizes the limits of a system based on a fiction of legal equality between states that imposes reciprocity of commitments by all state parties to any treaty. See Daniel Barstow Magraw, "Legal Treatment of Developing Countries: Differential, Contextual, and Absolute Norms" (1990) 1:1 Colo J Int'l Envtl L & Pol'y 69. For a discussion in international taxation about rules that are nominally reciprocal but substantively asymmetrical, see Steven A Dean, "More Cooperation, Less Uniformity: Tax Deharmonization and the Future of the International Tax Regime" (2009) 84 Tul L Rev 125.

differentiated treatment is warranted to correct inequalities among different parties.[38] Differentiation is also seen as a way to foster cooperation and facilitate the effective implementation of international norms.[39]

One prominent example of differential treatment is the principle of common but differentiated responsibilities and respective capabilities, formalized in the United Nations Framework Convention on Climate Change.[40] The principle distinguishes between countries according to their level of responsibility for greenhouse gas emissions and their varying capacities to act in response. It not only guides differentiated obligations under the UN's climate change convention, but also has specific applications in particular areas of activity, such as adaptation, technology transfer, finance and capacity building, and allows for other tailored interpretations by negotiating groups.[41] The principle of common but differentiated responsibilities and respective capabilities allocates greater environmental burdens and costs to more affluent countries than poorer ones. The rationale derives from both distributive

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[38] See Oscar Schachter, "The Evolving Law of International Development" (1976)15 Colum J Transnat'l L 1 (grounding differential treatment on a consideration of need as basis for entitlement); Philippe Cullet, "Differential Treatment in International Law: Towards a New Paradigm of Inter-state Relations" (1999) 10:3 EJIL 549 at 550; Frank J Garcia, *Trade, Inequality, and Justice: Toward a Liberal Theory of Just Trade* (New York: Transnational Publishers, 2003) (taking differentiation as a mechanism to achieve wealth redistribution in the face of substantial inequalities); Eduardo Tempone, "Special and Differential Treatment" in Rüdiger Wolfrum, eds, *Max Planck Encyclopedia of Public International Law* (Oxford: Oxford University Press, 2014).

[39] Cullet, *supra* note 80; Tempone, *supra* note 80.

[40] Article 3(1).

[41] Sébastien Jodoin & Sarah Mason-Case, "What Difference Does CBDR Make? A Socio-Legal Analysis of the Role of Differentiation in the Transnational Legal Process for REDD+" (2016) 5:2 Transnat'l Environ L 255 at 257.

justice and a form of restorative justice. The former holds that distribution of burdens should be made according to countries' ability to pay to avoid delaying poverty eradication in less developed countries.[42] The latter holds that the distribution of burdens should consider countries' historical contribution to climate change as a measure of their responsibility.[43]

3.2. Normative Basis

When it comes to the international tax system, similar normative grounds call for differentiation. From a historical point of view, some of the fundamental problems with the international tax regime affecting the current distribution of taxing rights such as tax competition and tax avoidance significantly result from how the present rules were designed in the 1920s, when the League of Nations commissioned a group of experts to evaluate how to avoid the problem of double taxation in cross-border transactions.[44] The decision made then by today's most powerful economies resulted in the current web of inconsistent rules that are increasingly exploited by multinationals to avoid taxes.[45] Low-income economies

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[42] Darrel Moellendorf, *The Moral Challenge of Dangerous Climate. Change: Values, Poverty, and Policy* (New York: Cambridge University Press, 2014) at 173–77.

[43] Henry Shue, "Global Environment and International Inequality" (1999) 75:3 Int'l Aff 531; Simon Caney, "Climate Change and the Duties of the Advantaged" (2010) 13:1 Crit Rev Int'l Soc & Pol Phil 203.

[44] Graetz, *supra* note 2 at 1358.

[45] Policymakers at the time did foresee that this tax regime would allow taxpayers to more easily engage in tax avoidance and evasion, they were more concerned that an alternative solution would harm efforts to liberalize trade and investment, the primary objective at the time. See Thomas Rixen, "From Double Tax Avoidance to Tax Competition: Explaining the Institutional Trajectory of International Tax Governance" (2011) 18 Rev Int'l Pol Econ 197 at 212.

have oftentimes been encouraged by wealthier countries and by international organizations such as the IMF or the World Bank to pursue policies that include low taxation of capital.[46] Moreover, policy choices made by developed countries in the last few decades have intensified tax competition. The adoption of specific domestic policies of developed countries has created international conditions that favoured tax competition over cooperation, constraining policy alternatives of less developed countries, as multinationals put pressure on them to reduce their taxes.[47]

From a distributive justice standpoint, the international tax regime increasingly constitutes a strong and largely non-voluntary economic association between countries,

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[46] Philipp Genschel & Laura Seelkopf, "Winners and Losers of Tax Competition" in Peter Dietsch & Thomas Rixen, eds, *Global Tax Governance: What Is Wrong with It and How to Fix It* (Colchester: ECPR Press, 2016) 55 at 69 (pointing out that international organizations such as the United Nations Conference on Trade and Development (UNCTAD) often encourage small, resource-poor countries to embrace tax-haven strategies as a means for accelerating development). An important point to make is that the current tax regimes of many tax havens hardly result from an expression of their will as they are "often holdovers from the colonial era." Steven A Dean, "Philosopher Kings and International Tax: A New Approach to Tax Havens, Tax Flight, and International Tax Cooperation" (2007) 58 Hastings LJ 911 at 936.

[47] See Allison Christians, "Global Trends and Constraints on Tax Policy in the Least Developed Countries" (2010) 42 UBC L Rev 239 at 265–66 (pointing to the United States' international tax rules as an example that increases the sensitivity of taxpayers to foreign tax rates); Adam H Rosenzweig, "Why Are There Tax Havens?" (2011) 52 Wm & Mary L Rev 923 (explaining the role of US tax laws in encouraging tax competition and pointing out that an almost exclusive concern about eliminating double taxation has led to increased mobility of capital, which in turn enticed other countries into using tax incentives to attract such capital). See also Reuven Avi-Yonah, "Globalization and Tax Competition: Implications for Developing Countries" (2001) 44 L Quadrangle Notes 60 at 63 (arguing that given the need for tax revenues, developing countries would often prefer not to engage in tax competition, but they are compelled to grant tax incentives in response to the existing competitive scene).

which should raises *special associative duties*—duties owed to parties with whom one stands in a robust relationship or interaction[48]—one of which is the requirement that international institutions do not become sources of privileges to wealthier, more powerful participants.[49] More broadly, the current level of economic integration of nations has made the global economy a substantial presence in the lives of all states, and economic regulation and policy decisions today take place in a global setting that is inescapably interdependent. The fact that rules made by a state (or by supranational rule-making body) are consequential to other states raises the need for some degree of coordination and equity beyond the national level.[50]

3.3. Application

The origin-based and the differential approaches lead to markedly distinct distributional outcomes. The latter aims to reduce international inequalities by allocating greater rights to lower-income states whereas the former tends to maintain or increase the existing inequalities. The question about which of these normative approaches should apply

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[48] These duties are sometimes called *relational* duties. See Andrea Sangiovanni, "On the Relation Between Moral and Distributive Equality" in Gillian Brock, ed, *Cosmopolitanism versus Non-Cosmopolitanism: Critiques, Defenses, Reconceptualizations* (Oxford: Oxford University Press, 2013) 55.

[49] Darrel Moellendorf, "Cosmopolitanism and Compatriot Duties" (2011) 94:4 Monist 535. See also Darrel Moellendorf, "Human Dignity, Associative Duties, and Egalitarian Global Justice" in Gillian Brock, ed, *Cosmopolitanism versus Non-Cosmopolitanism: Critiques, Defenses, Reconceptualizations* (Oxford: Oxford University Press, 2013) 222.

[50] Joshua Cohen & Charles Sabel, "Extra Rempublicam Nulla Justitia?" (2006) 34:2 Phil & Pub Aff 147 at 165.

to taxing right allocation leads to the more fundamental question about whether principles of distributive justice should constrain to the domestic realm or extend to the international domain.[51] Within the spectrum of the various normative accounts of global justice, I take an intermediary position. Some have called this a "third wave" of the debate on global justice.[52]

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[51] This discussion is generally referred to as the problem of global justice. On one end stands *global cosmopolitanism*, which argue that normative requirements of distributive justice should apply at the global level. Cosmopolitan theorists generally share the belief that human beings—and not families, cultures, or nations—are the ultimate units of moral concerns and thereby should be treated equally regardless of nationality or citizenship. On the other end stands *statism*, which typically claims that no duty of egalitarian distributive justice exists outside the state. Statists usually accept that we have universal duties to humanitarian assistance to those in desperate need, but these duties are limited and not grounded on principles of distributive justice. Early works embracing global cosmopolitanism are Charles Beitz, *Political Theory and International Relations* (Princeton: Princeton University Press, 1973) and Thomas W Pogge, *Realizing Rawls* (Ithaca: Cornell University Press, 1989). More recent theories of global cosmopolitanism include Darrel Moellendorf, *Cosmopolitan Justice* (Boulder, CO: Westview Press, 2002); Kok-Chor Tan, *Justice without Borders: Cosmopolitanism, Nationalism and Patriotism* (Cambridge: Cambridge University Press, 2004); Simon Caney, *Justice beyond Borders: A Global Political Theory* (Oxford: Oxford University Press, 2005). One important representative of statism is Thomas Nagel, "The Problem of Global Justice" (2005) 33:2 Phil & Pub Aff 113. Frequently deemed as representatives of a moderate statist view include Michael Blake, "Distributive Justice, State Coercion, and Autonomy" (2001) 30:3 Phil & Pub Aff 257; Samuel Freeman, "The Law of Peoples, Social Cooperation, Human Rights, and Distributive Justice" (2006) 23:1 Soc Phil & Pol'y 29. For a discussion about the statist view applied to international tax policy, see Laurens van Apeldoorn, "A Sceptic's Guide to Justice in International Tax Policy" (2019) 32:2 Can JL & Jur 499.

[52] According to Laura Valentini, this "third wave" provides "a sustained critical discussion of cosmopolitanism and statism, and a fresh perspective helping us to steer a middle course between them" (Laura Valentini, *Justice in a Globalized World A Normative Framework* (Oxford: Oxford University Press, 2011) at 3–4). According to Valentini, two representatives of this position are Gillian Brock, *Global Justice: A Cosmopolitan Account* (Oxford: Oxford University Press, 2009) and David Miller, *National Responsibility and Global Justice* (Oxford: Oxford University Press, 2007). Yet, as she notes, these authors explicitly place themselves respectively in the cosmopolitan and statist traditions.

This middle course position agrees with cosmopolitans that duties of justice exist in regards of global distributions, but stands with statists in that the state has a special place in accounts of justice, so that duties of justice applied internationally differ in content and scope to those applied domestically.[53]

Applied to the problem of allocating taxing rights between states, this middle ground position on global justice entails a normative compromise between an origin-based approach (which is premised on state sovereignty) and a differential approach (which allows for considerations of global justice). The fundamental question is how to reconcile these two normative approaches.

This chapter does not provide a full answer to this question, but it argues that a differential approach should apply at least in cases where an origin-based approach fails to accurately serve as a normative guide for distributing the international tax base. As Section 2.3 demonstrated, in certain cases it is impossible to accurately pinpoint the factors that contributed to the creation of a given income and, more importantly, the degree of contribution of each of these factors. Whenever this difficulty arises, a decision about how to allocate taxing rights will be arbitrary from a moral standpoint unless it is based on some other normative criteria. In these cases, the differential approach seems to be the most compelling alternative normative basis. In the absence of a justifiable normative criterion for

[53] See, e.g., Jon Mandle, *Global Justice* (Cambridge, UK: Polity Press, 2006); Sebatiano Maffettone, "Global Justice: Between Leviathan and Cosmopolis" (2012) 3:4 Global Policy 443; Mathias Risse, *On Global Justice* (Princeton: Princeton University Press, 2012).

allocating taxing rights, priority should be given to a solution that promotes, rather than departs from, distributive justice.

4. Practical Implications

Having established that the differential approach should apply when origin-based approaches fail to serve as a normative guide, the next logical step should be determining when the latter is sufficiently ineffective as to trigger the former. This determination requires settling the degree of inaccuracy we can accept an origin-based approach to have. On one end of the spectrum, one could tolerate an absolute degree of inaccuracy and take the existing proxies for origin of income as acceptable from a normative standpoint. This is the approach implicitly taken, for example, by those who consider that the current allocation of taxing rights is normatively justified. The main problem with taking this stance is that the more complex it is to determine the underlying factors of income generation, the more inaccurate origin-based approaches are in establishing proxies for origin of income. It follows that these proxies become increasingly arbitrary. On the opposite end, one could be as strict as to conclude that any origin-based approach will be arbitrary to some degree as to require its replacement altogether for another normative approach.[54] The main problem with this stance is that it fails to acknowledge the normative validity of origin-based theories and the

[54] This case is made, for example, in Adam Kern, "Illusions of Justice in International Taxation" (2020) 48:2 Phil & Pub Aff 151.

importance of state sovereignty in today's state of affairs. If one is to stand, however, somewhere in the middle of these two extremes, it is difficult to draw a clear-cut line or test for when to shift from an origin-based to a differential approach.

A pragmatic solution is to begin by applying the differential approach in cases where the inaccuracy of origin-based criteria is most evident. One such case is the allocation of corporate profits through formulary apportionment. The following will discuss why a differential should apply in those cases and what it would entail.

4.1. Profit Apportionment in a Global Unitary System

In recent years, many scholars have called for a departure from separate accounting under the arm's-length principle toward a unitary taxation system with formulary apportionment. This shift would change how profits earned by multinational corporations are allocated among jurisdictions. A unitary taxation system under formulary apportionment would allocate multinationals' profits based on a formula that considers the location of economic factors. The shift toward unitary taxation is generally touted as a way to eliminate the complexity of transfer pricing rules and associated administrative and compliance costs, as well as to reduce economic distortions caused by the current system and incentives for tax avoidance practices.[55]

[55] See, e.g., Jinyan Li, "Global Profit Split: An Evolutionary Approach to International Income Allocation" (2002) 50:3 Canadian Tax Journal 823; Walter Hellerstein, "International Income

One important and challenging aspect of adopting a unitary tax scheme, however, is settling on the formula that will determine how profits are allocated among jurisdictions. Proposals for formulary apportionment frequently take an origin-based approach and suggest a multi-factor formula based on a combination of the economic factors that contributed to generation of the profits, such as the place of sales, payroll expenses, and physical assets. Different proposals suggest varying weights to each of these factors.[56] Similarly, jurisdictions that adopt formulary apportionment in intra-state allocation of income use a variety of formulas. The United States and Canada provide prominent examples. These two countries adopt the formulary apportionment model to allocate profits among states and provinces. The experience from these countries point to a considerable arbitrariness from a normative standpoint in how formulas and weights are chosen. Whereas Canadian provinces have adopted a formula that weights equally on payroll and gross receipts,[57] US states have each

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Allocation in the Twenty-first Century: The End of Transfer Pricing? The Case for Formulary Apportionment" (2005) 12:3 Int'l Transfer Pricing J 103; Susan C Morse, "Revisiting Global Formulary Apportionment" (2010) 29:4 Va Tax Rev 593; Reuven S Avi-Yonah, Kimberly A Clausing & Michael C Durst, "Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split" (2009) 9:5 Fla Tax Rev 497.

[56] For a brief analysis of the distributive outcome of different formulas, see Heinz-Klaus Kroppen, Roman Dawid & Richard Schmidtke, "Profit Split, the Future of Transfer Pricing? Arm's Length Principle and Formulary Apportionment Revisited from a Theoretical and a Practical Perspective" in Wolfgang Schön & Kai A Konrad, eds, *Fundamentals of International Transfer Pricing in Law and Economics* (Heidelberg: Springer, 2012) 267 at 273–76.

[57] See Joann Martens Weiner, "Formulary Apportionment and Group Taxation in the European Union: Insights From the United States and Canada" (2005) Directorate-General for Taxation and Customs Union Taxation Paper No 8/2005, online: <ec.europa.eu/taxation_customs/sites/taxation/files/resources/documents/taxation/gen_info/economic_analysis/tax_papers/2004_2073_en_web_final_version.pdf>.

used different formulas that seem to significantly rely on pragmatism. Over time, states have gradually shifted to sales as the main allocating factor, not because of its normative appeal but to reduce the incentives for corporations to move jobs and property out of state.[58]

It is largely accepted that any possible combination will be significantly arbitrary from a normative point of view, given the impossibility of determining the degree to which each factor contributes to the generation of a multinational profits.[59] Yet, the formula ultimately chosen for apportioning profits will have major distributional implications.[60] It is thus

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[58] See Michael Mazerov, "The Single-Sales-Factor Formula: A Boon to Economic Development or a Costly Giveawav?" (2001) 20 State Tax Notes 1775 (noting the weak economic rationale behind the shift toward a single-sales-factor formula); Jack Mintz, "Europe Slowly Lurches to a Common Consolidated Corporate Tax Base: Issues at Stake" in Wolfgang Schön, Ulrich Schreiber & Christoph Spengel, eds, *A Common Consolidated Corporate Tax Base for Europe* (Berlin, Heidelberg: Springer, 2008). For some legal implications of a sales-based formula at the international level, see Charles E McLure Jr & Walter Hellerstein, "Does Sales-Only Apportionment of Corporate Income Violate International Trade Rules?" (2002) 27 Tax Notes Int'l 1315. The shift toward a single-sales factor is also attributed to the difficulty of accurately valuing property. See Morse, *supra* note 55.

[59] See Peggy B Musgrave, "Interjurisdictional Equity in Company Taxation: Principles and Applications to the European Union" in Sijbren Cnossen, ed, *Taxing Capital Income in the European Union: Issues and Options for Reform* (Oxford: Oxford University Press, 2000) 46 ("There does not appear to be any objective, single answer to the question of how company profits should be divided in a multijurisdictional setting"); Tim Edgar, "Corporate Income Tax Coordination as a Response to International Tax Competition and International Tax Arbitrage" (2003) 51:3 Can Tax J 1079 at 1154 ("formulary allocation approaches cannot be justified as realizing some correct allocation defined in any precise normative sense"); Avi-Yonah, Clausing & Durst, *supra* note 55 at 516–17 (acknowledging that any formula can produce arbitrary results in a given industry but arguing that the present separate accounting system is equally or more arbitrary); James R Hines Jr, "Income Misattribution Under Formula Apportionment" (2010) 54 Eur Econ Rev 108 (showing that formulas included in proposals for formulary apportionment are not strongly correlated with determinants of business incomes).

[60] Faccio & Fitzgerald, *supra* note 30.

unsurprising that impact assessment studies, however limited they may be, given data constraints, have grown in importance in tax policy discussions about whether to adopt unitary taxation and how to determine the appropriate formula.[61]

These two factors (the insufficiency of origin-based criteria to apportion profits and the increasing role of distributional implications in the tax policy decision-making) warrant considerations of distributive justice. Given the failure of (and increasing departure from) origin-based approaches to allocate taxing rights, the differential approach takes normative priority. The differential approach requires that the distribution of the international tax base improves rather than worsen global inequality. It requires that one or more international development indicators be included as a contributing factor to the apportionment formula. Including a direct measure of international inequality to the formula is perhaps the only feasible way to achieve a consistent normatively justified approach.[62] This differential

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[61] See, e.g., International Monetary Fund, *supra* note 30; Alex Cobham & Simon Loretz, "International Distribution of the Corporate Tax Base: Implications of Different Apportionment Factors under Unitary Taxation" (2014) International Centre for Tax and Development Working Paper No 27, online: <https://ssrn.com/abstract=2587839>; Faccio & Fitzgerald, *supra* note 30.

[62] Although the most common approach would be to use per capita income as a reference, other indexes may be more appropriate to measure and compare international inequality. See Anthony C Infanti, "Internation Equity and Human Development" in Miranda Stewart & Yariv Brauner, eds, *Tax Law and Development* (Cheltenham, UK: Edward Elgar, 2012) 209 (arguing for expanding the focus of inter-nation equity beyond economic growth to incorporate other non-economic considerations, such as feminist, social or strategic, and proposing the use of other indexes that include non-economic dimensions as criteria for a differential approach, such as the Human Development Index (HDI), the Inequality-adjusted HDI (IHDI), Gender Inequality Index (GII), and the UK Department for International Development (DFID)). See also Kim Brooks, "Global Distributive Justice: The Potential for a Feminist Analysis of International Tax Revenue Allocation" (2009) 21:2 Can J Women & L 267

approach is more suitable for addressing global justice concerns and brings greater transparency regarding normative rationale and distributional outcomes.

4.2. Residual Profit Allocation

Rather than a complete overhaul of the current international tax system, some have argued for an incremental use of formulary apportionment. In this case, formulary apportionment would only apply to the residual portion of multinationals' profits in excess of a standard rate of return, that is, the portion of the profits that exceeds what a third party would expect to earn for performing functions and activities on an outsourcing basis.[63] Its proponents argue that the adoption of formulary apportionment for residual profits would improve the current transfer pricing regime by reducing opportunities for tax avoidance and eliminating relevant compliance and administrative costs.[64]

Compared to proposals for unitary taxation, the idea of a formulary allocation of residual profits seems to present fewer objections by supporters of the current transfer pricing regime, mostly because transfer pricing rules would still apply to routine profits, that is, to the portion of profits that is deemed to correspond to a normal return. Proponents of residual profit approaches often prefer a formula heavily weighted on the location of final sales. The

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(arguing that one of the implications of a feminist analysis of international tax policy is the requirement to allocate greater taxing rights to lower-income countries).

[63] See, e.g., Avi-Yonah, Clausing & Durst, *supra* note 55; Devereux et al, *supra* note 25.

[64] Avi-Yonah & Benshalom, *supra* note 25.

main reasons for a sales-based formula are generally the reduced incentives for businesses to move payroll or assets to low-tax jurisdictions, smaller distorting influence on real economic decisions, and greater likelihood of international coordination.[65]

In a context where the transfer pricing regime is maintained, apportioning residual profits on a formulaic basis seems a promising approach. It also seems correct to argue that an origin-based approach should account for the contribution of sales in the creation of income. The problem, however, is that there is no clear normative basis for allocating *residual* profits to jurisdictions where sales take place. Sales may be a relevant contributing factor for *routine* profits, but it is difficult to make a direct connection between sales contribution and the generation of residual profits.[66] Residual profits, by definition, are not directly attributable to any specific economic factor. Residual profit is the return resulting from the interaction of the constituent parts of a multinational that cannot be assigned to any of its components without a significant degree of arbitrariness.[67] A residual profit approach based on sales seems to effect a political compromise. Instead of integrating sales contribution in the allocation of routine profits, which would be normatively sound, it promotes a corrective measure through the allocation of residual profits. From a political viewpoint, this might loosely appease the demands of sales jurisdictions for greater taxing

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[65] See *supra* note 63.

[66] See Devereux & Vella, *supra* note 15 at 10 (pointing out the difficulties in allocating residual profits according to origin-based approaches).

[67] See Reuven S Avi-Yonah, "The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation" (1995) 15:1 Va Tax Rev 89 at 148–49.

rights (see Section 4.3 below). But from a normative perspective, the proposal is problematic because it benefits sales jurisdictions while disfavouring countries with narrower consumer markets with no clear underlying normative rationale.

The impossibility to adequately allocate residual profits on the basis of origin suggests a stronger case for a differential approach. Although an origin-based approach could be used to determine the states to which residual profits are allocated (nexus), it is unable to provide any guidance for how distribute the residual profits between these states (allocation). A differential approach seems to provide a more appropriate normative basis for allocating residual profits. It would require the assignment of residual profits to the relevant jurisdictions based entirely on a direct measure of international inequality. A differential approach should also provide the same practical advantages of sales-based residual profit allocation regarding susceptibility to tax avoidance and distortion on economic decisions due to the absolute immobility of development indexes to business decisions.

4.3. The OECD's Unified Approach and the "New Taxing Right"

In October 2019, the OECD Secretariat has advanced a proposal for a "unified approach".[68] The unified approach adopts a formulary approach to partially shift the

[68] OECD, *Secretariat Proposal for a "Unified Approach" under Pillar One: Public Consultation Document* (Paris: OECD, 2019) [OECD, *Secretariat Proposal*].

allocation of multinationals' profits to "market jurisdictions".[69] The proposal has come as a response to demands from various countries to update the current allocation of profits generated by digitalized businesses. The phrase "unified approach" indicates the OECD's stated intention to achieve a compromise solution that satisfies all conflicting proposals at the table, namely the European Union's focus on user participation, the US preference for considering marketing intangibles, and the Group of Twenty-Four's proposal for allocating income based on multinationals' significant economic presence.[70] The unified approach allocates only a portion of residual profits to market jurisdictions, thus creating what was labelled as the "new taxing right".[71]

From a normative perspective, the "new taxing right" presents a similar problem to proposals for residual profit allocation discussed in the previous section. Origin-based approaches do not provide a satisfactory normative basis for allocating residual profits. Several aspects of the OECD's proposal demonstrate the lack of a normative rationale. The

[69] According to the OECD, the phrase refers to the jurisdiction where customers or users are located. See OECD, *Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy: Inclusive Framework on BEPS* (Paris: OECD, 2019) at 23.

[70] For a detailed discussion about the political struggles and distributitional implications involving these proposals, see Allison Christians & Tarcisio Diniz Magalhaes, "A New Global Tax Deal for the Digital Age" (2019) 67:4 Can Tax J 1153.

[71] In addition to this formula-based approach (which the OECD calls Amount A), the unified approach includes a fixed baseline return for routine market-facing activities (Amount B) and incremental return attributable to a jurisdiction when Amount B falls short of the market-based routine return assumed under the application of the arm's-length principle (Amount C). For an overview, see Kartikeya Singh, W Joe Murphy & Gregory J Ossi, "The OECD's Unified Approach — An Analysis of the Revised Regime for Taxing Rights and Income Allocation" (2020) 97 Tax Notes Int'l 549.

stated goal of addressing the interests of specific states, namely countries the with large consumer markets, and the stated concern about potential unilateral measures from these countries are evidence that political motivations were more significant than any normative rationale.[72] Two main aspects of how the new approach has been advanced also makes this clear. First, the portion attributable to market jurisdictions is not based on any clear economic criteria but will likely be determined by an agreed-upon fixed percentage.[73] The share of market jurisdictions will thus rely on some form of political agreement rather than on a clear normative stand. And discussions about the appropriate fixed percentage will be, from a normative point of view, a fairly arbitrary exercise. Second, the unconcealed consideration of the distributional consequences of the proposal as a condition for achieving a final agreement shows a move from an *origin-based approach* (which allocates taxing rights based on the relevance of each economic factor to the generation of profits) toward a *distribution-based approach* (which allocates taxing rights based on the actual distributional outcome of the possible alternatives).[74] This shift towards distributional considerations requires a re-

[72] OECD, *Secretariat Proposal*, *supra* note 68 at 4.

[73] Ibid at 15.

[74] The importance of impact assessments of the proposal is emphasized by the OECD and by commentators' analyses. See, e.g., OECD, "Webcast: Update on Economic Analysis and Impact Assessment", online: <oecd.org/tax/beps/webcast-economic-analysis-impact-assessment-february-2020.htm>; OECD, "Tax Challenges Arising from the Digitalisation of the Economy Update on the Economic Analysis & Impact Assessment", online: <oecd.org/tax/beps/presentation-economic-analysis-impact-assessment-webcast-february-2020.pdf>; Allison Christians, "OECD Digital Economy Designers: Share Your Work!" (2020) 97 Tax Notes Int'l 1251 (noting that the information provided in February 2020 by the OECD was only partial—a webcast and a few slides outlining its

evaluation of current normative criteria for allocating profits among states. The move away from an origin-based approach implies that origin-based principles cease to provide normative guidance for allocating taxing rights.

The lack of normative criteria for allocating residual profits makes for a strong case in favour of the differential approach put forth in this chapter. In a context where distributional implications take precedence over other considerations, principles of distributive justice become even more relevant. Although the distributional impacts of the "new taxing right" are still unclear, it will likely disfavour low-income countries with small consumer markets.[75] Conversely, a differential approach requires that a reallocation of taxing rights benefit countries based on their relative development capacities and needs.

5. Conclusion

The current international tax regime is generally guided by origin-based approaches, which distributes taxing rights between states based on the location of the factors that

findings—and the underlying data that led to these results was not made publicly available, raising questions about transparency and inclusivity).

[75] See Christians & Magalhaes, *supra* note 70 at 1173–76 (showing that the shift of profits allocation toward location of consumers will mostly benefit countries with larger consumer market such as EU countries, the U.S., and middle-income countries rather than lower-income ones); Cobham, Faccio & FitzGerald, supra note 30 (concluding that the reallocation of taxing rights deriving from OECD's proposal is likely to reduce revenues for several low-income countries). See also Stephanie Soong Johnston, "Politicians Refocusing on Global Tax Reform Talks, OECD Tax Chief Says" (2020) 98 Tax Notes Int'l 955 at 956 (reporting the acknowledgment by the OECD chief tax executive that least-developed countries may not benefit much from the proposal).

contribute to the creation of income. Although normatively justifiable, origin-based theories fail to provide satisfactory guidance for allocating taxing rights in cases where the factors that gave rise to a given income, or their relative contribution, are unclear.

One example of these cases, which serves as a point of focus for this chapter, involves the allocation of corporate profits through formulary apportionment. Formulary approaches purportedly rely on an origin-based framework, but origin-based criteria have proven to be insufficient to establish the choice of the formula that will ultimately determine how income is assigned between countries. Moreover, recent tax policy discussions have demonstrated a shift from an origin-based approach (which distributes taxing rights based on economic rationale) to a distribution-based one (which gives a greater focus to the distributional outcomes resulting from the adoption of different formulas). The move away from origin-based principles requires a reconsideration of the existing normative criteria for distributing the international tax base.

Whenever origin-based theories fail to accurately allocate taxing rights, the absence of alternative normative criteria leads to a significant degree of arbitrariness. As a consequence, the resulting allocation of rights tends to ultimately favour a few powerful countries. The differential approach put forward in this chapter offers a normative alternative. By applying distributive justice principles, the differential approach also provides adequate guidance in a context where impact assessments and distributional implications assume increasing importance in international tax policy discussions.

CONCLUSION

This thesis's ultimate goal was to analyze the role of international tax policy in improving or worsening global inequality. This goal comprises a positive (descriptive) and a normative component. The *positive* question seeks to understand whether and how the present international tax regime has aggravated global inequality. The *normative* question aims to understand whether processes and rules in the realm of international taxation should play a significant role in addressing global inequality and, if that is the case, what changes are required to promote meaningful positive change.

Chapters 1 to 3 have identified fundamental problems that lead the international tax regime to compound the problem of global poverty and inequality. From a procedural perspective, there are two sets of problems that limit lower-income countries' ability to participate in international tax policy design on an equal footing with more affluent countries. One set of constraints, which I referred to as *institutional legitimacy deficit* (Chapter 1), speaks to the fact that international taxation policies are mostly advanced by international institutions with limited membership that allows only restricted participation of non-members. The other type of problem, which I referred to as *structural legitimacy deficit* (Chapter 2), derives from the existing disparity in power and influence between countries. This includes the imbalance of resources and expertise, but also how network effects and

path dependence constraints prevent developing countries from adopting policies that could be beneficial to them and how sanctions operate in the current international relations, so that more powerful states are able to make credible threats that other states cannot. These structural deficits affect international relations generally, not only in the realm of international taxation, but they produce background imbalances that ultimately determine the result of international tax negotiations.

From a substantive perspective (Chapter 3), the current international tax system presents significant distributive problems. One crucial problem affecting developing countries results from the current tax competition scenario, which affects countries' ability to develop their tax policies and reduce the tax revenues that would be available to countries in the absence of tax competition. Although tax competition impacts many countries generally, it has produced more severe effects on lower-income countries in relative terms due to their higher dependence on corporate income tax revenues as a share of all revenues. Another distributive problem affecting developing countries is that the present allocation of taxing rights among countries significantly benefits wealthier nations. The international tax regime consists of a network of bilateral tax treaties—most based on the OECD Model Tax Convention—that determine how taxing rights are divided between residence (mostly developed) countries and source (mostly developing) countries. Because in the absence of tax treaties, source countries would enjoy primary entitlement to tax income, treaties effectively reallocate taxing rights from developing to developed countries. More

fundamentally, the tax treaty network provides the legal infrastructure for the principles and concepts that shape the international tax regime today, so that the overall structure of international tax law is based on standards, principles, and methods that lead to an inequitable distribution of taxing rights between developing and developed countries.

Chapter 4 argued that although the tax literature has long identified these distributive issues, a broad and in-depth discussion on the normative implications of global justice for addressing these tax policy problems was still lacking. One important reason for this scholarly gap is that the literature tends to conflate legitimacy (discussed in Chapters 1 and 2) with distributive problems (discussed in Chapter 3). Proposals to address the latter (that is, reducing the existing inequities of the international tax regime) frequently focus on improving the former (that is, securing greater participation of developing countries in tax policy decision-making). Whereas improving legitimacy in the international tax regime by strengthening the participation of developing countries in the decision-making process is expected to result in some distributive improvements, this is not a necessary implication, and addressing legitimacy deficits may not suffice to meet the requirements of global justice. Conflating these two normative realms produces what I called the Legitimacy-Justice Fallacy. While distributive justice focuses on how burdens and benefits should be distributed, political justice (or legitimacy) considers who should exercise power and how they should do so. The main problem with an exclusive concern with democratic legitimacy is that it does

not seem able to legitimate every result it generates and thus may fail to produce fair outcomes in the absence of normative parameters focused on distributive justice.

Chapter 4 has also suggested that the OECD seems to rely on the Legitimacy-Justice Fallacy to circumvent discussions on distributive issues when it suggests that the BEPS Inclusive Framework, aimed at addressing legitimacy problems, might resolve the distributive justice problems. The exclusive focus on creating an inclusive process when discussing fairness for developing countries seemingly indicates an attempt to sidestep a more serious discussion on a fair allocation of taxing rights for developing countries. Normative evaluation of the international tax regime requires that both the legitimacy and the distributive justice dimensions be considered and that specific solutions be discussed for each of them. Chapter 4 concludes by calling for normative principles that should apply global justice requirements to international tax policy. Building such a normative framework is the primary goal of the following two chapters of the thesis.

Chapter 5 pointed out that although tax scholars and international organizations, such as the OECD and the EU, have long suggested that tax competition should be mitigated, there is no comprehensive discussion on the costs that would arise from institutional reform designed to curb tax competition. The main problem with proposals to address tax competition is that some countries that currently benefit from it are low-income countries that economically depend on tax incentives to attract foreign investments. Addressing the problem of tax competition without considering the historical reasons that led these countries

to rely on this competitive behaviour and the distributional consequences that would arise from eliminating tax competition is normatively problematic. Overall global reform requires considering normative principles for allocating the costs of curbing tax competition. Chapter 5 outlined four principles that should be considered by potential global tax reform.

Chapter 6 focused on how to allocate tax jurisdictions between countries. It argued that the present international tax rules are typically justified by origin-based theories, which align countries' tax entitlements with the geographical location of the economic factors contributing to the creation of income. Two recent phenomena have rendered origin-based approaches limited in scope. First, the economic integration of multinational corporations and the relevance of intangibles have made it infeasible to precisely pinpoint the factors contributing to the generation of income. Second, the growing disputes between countries about which economic factors should be considered relevant for sharing the international tax base have recently led to increased consideration of distributional consequences, thus moving tax policy discussions away from a clear origin-based rationale toward a consequentialist one. The limitations of origin-based criteria for allocating taxing rights warrant an alternative normative standard. Whenever origin-based theories fail as a normative guide for allocating taxing rights, the absence of alternative normative criteria leads to a significant degree of arbitrariness. As a consequence, the resulting allocation of rights tends to ultimately favour a few powerful countries. The differential approach put forward in Chapter 6 offers a compelling normative alternative. The differential approach requires that the allocation of

tax entitlements be based on distributive justice considerations, particularly when origin-based approaches fail to provide adequate normative support.

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Appendices

APPENDIX A
OECD's Public Consultation Document on Addressing the Tax Challenges of the Digitalisation of the Economy

Base Erosion and Profit Shifting Project

Public Consultation Document

ADDRESSING THE TAX CHALLENGES OF THE DIGITALISATION OF THE ECONOMY

13 February – 6 March 2019

OECD
BETTER POLICIES FOR BETTER LIVES

OECD/G20 Base Erosion and Profit Shifting Project

Addressing the Tax Challenges of the Digitalisation of the Economy

Public Consultation Document

Public Consultation Document

Following a mandate by G20 Finance Ministers in March 2017, the Inclusive Framework on BEPS, working through its Task Force on the Digital Economy (TFDE), delivered an Interim Report in March 2018, *Tax Challenges Arising from Digitalisation – Interim Report 2018*. One of the important conclusions of this report is that members agreed to review the impact of digitalisation on nexus and profit allocation rules and committed to continue working together towards a final report in 2020 aimed at providing a consensus-based long-term solution, with an update in 2019.

Since the delivery of the Interim Report, the Inclusive Framework further intensified its work and several proposals emerged that could form part of a long-term solution to the broader challenges arising from the digitalisation of the economy and the remaining BEPS issues. The work on these proposals is being conducted on a "without prejudice" basis; their examination does not represent a commitment of any member of the Inclusive Framework beyond exploring these proposals. In this context, the Inclusive Framework agreed to hold a public consultation on possible solutions to the tax challenges arising from the digitalisation of the economy on 13 and 14 March 2019 at the OECD Conference Centre in Paris, France. The objective is to provide external stakeholders an opportunity to provide input early in the process and to benefit from that input.

As part of this public consultation, this consultation document describes the proposals discussed by the Inclusive Framework at a high level and seeks comments from the public on a number of policy issues and technical aspects. The comments provided will assist members of the Inclusive Framework in the development of a solution for its final report to the G20 in 2020.

Interested parties are invited to send their comments on this consultation document. Comments should be sent by **6 March 2019** at the latest by e-mail to TFDE@oecd.org in Word format (in order to facilitate their distribution to government officials). They should be addressed to the Tax Policy and Statistics Division, Centre for Tax Policy and Administration.

Please note that all comments on this discussion draft will be made publicly available. Comments submitted in the name of a collective "grouping" or "coalition", or by any person submitting comments on behalf of another person or group of persons, should identify all enterprises or individuals who are members of that collective group, or the person(s) on whose behalf the commentator(s) are acting. Speakers and other participants at the upcoming public consultation in Paris will be selected from among those providing timely written comments on this consultation document. Registration details for the public consultation will be published on the OECD website in March.

The proposals included in this consultation document do not represent the consensus views of the Inclusive Framework, the Committee on Fiscal Affairs (CFA) or their subsidiary bodies. Instead, they intend to provide stakeholders with substantive proposals for analysis and comment.

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1. Introduction

1. The tax challenges arising from the digitalisation of the economy were identified as one of the main areas of focus of the Base Erosion and Profit Shifting (BEPS) Action Plan, leading to the 2015 BEPS Action 1 Report on *Addressing the Tax Challenges of the Digital Economy* (the Action 1 Report).[1] The Action 1 Report recognised that digitalisation and some of the business models that it facilitates present important challenges for international taxation. The report also acknowledged that it would be difficult, if not impossible, to 'ring-fence' the digital economy from the rest of the economy for tax purposes because of the increasingly pervasive nature of digitalisation. It highlighted the ways in which digitalisation had exacerbated BEPS issues, but also noted that the measures proposed under the other BEPS Actions were likely to have a significant impact in this regard. In addition, the Action 1 Report observed that beyond BEPS, digitalisation raised a series of broader direct tax challenges, which it identified as data, nexus and characterisation. These challenges chiefly relate to the question of how taxing rights on income generated from cross-border activities in the digital age should be allocated among countries. While identifying a number of proposals to address these concerns, none were ultimately recommended. After the release of the OECD/G20 BEPS package, countries agreed to renew the mandate of the Task Force on the Digital Economy (TFDE) and continue to monitor developments in respect of digitalisation.

1.1. The Interim Report

2. In March 2017, the G20 Finance Ministers mandated the TFDE, through the Inclusive Framework on BEPS, to deliver an interim report on the implications of digitalisation for taxation by April 2018 and a final report in 2020. The interim report, *Tax Challenges Arising from Digitalisation – Interim Report 2018* (the Interim Report)[2] was agreed by all members of the Inclusive Framework and delivered to the G20 in March 2018. Building on the Action 1 Report, the Interim Report reflects among other things the progress made by the TFDE and the Inclusive Framework since 2015 in considering the two previously identified direct tax issues, namely the exacerbated BEPS issues and the broader tax challenges.

3. On the former issue, related to the impact of digitalisation on BEPS issues, the Interim Report took stock of progress made in the implementation of the BEPS package, and its impact on the various challenges raised by digitalisation. The Interim Report noted that despite the fact that only a small number of BEPS measures were minimum standards and that many of the BEPS measures have only recently been introduced, there was evidence that countries already had gone a long way in achieving a widespread implementation of the various BEPS measures, and that this was already having an impact. In reaction to BEPS Actions 8-10, for example, some multinational enterprises (MNE groups) have realigned their tax arrangements with real economic activity by reconsidering

[1] OECD (2015), *Addressing the Tax Challenges of the Digital Economy*, Action 1 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.

[2] OECD (2018), *Tax Challenges Arising from Digitalisation – Interim Report 2018*, Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.

their transfer pricing positions and by relocating and on-shoring valuable intangible assets. In addition, several highly digitalised MNE groups have also changed their distribution models, which were based on remote sales, to local "buy-sell" distributors in response to the work on BEPS Action 7. In connection with the remaining BEPS challenges, some countries highlighted the risks that even after such a restructuring digitalised MNE groups would be able to use local limited risk distributors to justify only minimal tax in the market jurisdiction, while being able to shift a disproportionately high amount of profit to a small number of affiliates in remote locations provided there is a correlation with a certain level of physical activity (e.g. functions that control risks and functions relating to the development, enhancement, maintenance, protection and exploitation of intangibles (DEMPE)). These countries were concerned that while the BEPS project had significantly contributed to realigning income from intangibles with value creation, notably by putting greater emphasis on real economic activities (e.g. Action 5, Actions 8-10), and by taking a more holistic approach to the review of cross-border transactions (e.g. Action 13), risks remain for highly mobile intangible income-producing factors which can be shifted into low-tax environments based on contractual allocations accompanied by a relatively modest level of decision-making capacity. These risks can arise for highly digitalised MNE groups as well as for MNE groups with more traditional business models.

4. As regards the broader tax challenges relating to the allocation of taxing rights, the Interim Report first provided an in-depth analysis of new and changing business models in the context of digitalisation. This enabled the identification of three characteristics that are frequently observed in certain highly digitalised business models, and the discussion of their implications for the existing profit allocation and nexus rules. *Scale without mass* impacts the distribution of taxing rights over time by reducing the number of jurisdictions where a taxing right can be asserted over a business's profits. A *heavy reliance on intangible assets* strains the rules for allocating income from intangible assets among different parts of an MNE group, creating uncertainties and opportunities for locating income in low or no tax entities. *Data and user participation* poses challenges to the existing nexus and profit allocation rules, especially in situations where the highly digitalised business that exploits the data and user-generated content has little or no taxable presence in the jurisdiction where the users are located. It was noted, however, that countries had different views on the scale and nature of these challenges, and in particular on the question of whether, and to what extent, these challenges should result in changes to the international tax rules. The Interim Report described these countries as falling into three groups, which ranged from countries that considered that there was a need to change existing profit allocation and nexus rules (i.e. first and second group) to countries that considered that no action was needed beyond addressing BEPS issues (i.e. third group).[3]

[3] The first group considered that the reliance on data and user participation may lead to misalignments between the location in which profits are taxed and the location in which value is created. This first group saw the challenge as confined to certain business models, and did not see the case for wide-ranging changes that would alter the principles underpinning the existing tax system. A second group of countries took the view that the ongoing digital transformation of the economy, and more generally trends associated with globalisation, presented challenges to the continued effectiveness of the existing profit allocation and nexus rules. Importantly, for this group of countries, these challenges were not exclusive or specific to highly digitalised business models. Finally, there was a third group of countries which was supportive of the existing the international tax system and did not see the need for any significant reform of the profit allocation and nexus rules. These countries considered that the BEPS package had largely addressed the concerns of

5. In this context, the members of the Inclusive Framework committed to continue working together towards a consensus-based solution with the goal of producing a final report in 2020, with an update to the G20 in 2019. The work would therefore need to focus on the two outstanding issues posed by a rapidly digitalising economy: ongoing work on remaining BEPS challenges as well as a coherent and concurrent review of the nexus and profit allocation rules, including an exploration of the feasibility of different technical solutions that are consistent with the principle of aligning profits with underlying economic activities and value creation.

1.2. The new phase of work

6. Conscious of the G20 time frame and the significance of the issue, the Inclusive Framework and the TFDE further intensified their work since the delivery of the Interim Report. The TFDE met in July 2018, and at that meeting some members made suggestions on how the work could be taken forward to achieve progress towards a consensus-based solution. These proposals were conceived in light of the two interrelated challenges identified in the Action 1 Report and the Interim Report. Some proposals focused on the allocation of taxing rights (the "broader tax challenges") by suggesting modifications to the rules on profit allocation and nexus based on the concept of user contribution or marketing intangibles. Another proposal focused more on unresolved BEPS issues.

7. Following the July meeting, the Inclusive Framework agreed to continue developing these proposals on a "without prejudice" basis, and to consider how the gaps between the different positions identified in the Interim Report could be bridged, taking into consideration the overlaps that exist between the BEPS issues exacerbated by digitalisation and the broader tax challenges. The result of this effort is presented in this consultation document, which sets out a number of proposals which could form part of a long term solution to the broader challenges arising from the digitalisation of the economy and the remaining BEPS issues. The proposals are at the policy design phase and, therefore, their description has been kept at a high level.

8. While the two issues of the ongoing work on remaining BEPS challenges and a concurrent review of the profit allocation and nexus rules are distinct, they intersect and a solution that seeks to address them both could have a mutually reinforcing effect. Therefore both issues should be discussed and explored in parallel.

9. Section 2 of this note describes proposals related to the "broader tax challenges" to the existing profit allocation and nexus rules. It discusses policy proposals that would modify those rules based on the concepts of user participation, marketing intangibles and/or the concept of significant economic presence. It sets out their policy rationale and "mechanics", i.e. the basic design features of a possible set of rules. Section 3 describes proposals related to remaining BEPS concerns and explores two sets of interlocking rules designed to give jurisdictions a remedy in cases where income is subject to no or only very low taxation. These rules would effectively give jurisdictions the right to "tax back" profits that are taxed only at low effective tax rates.

double non-taxation, but acknowledged that it was still too early to fully assess the impact of all the BEPS measures (see Interim Report, par. 388-394).

2. Revised profit allocation and nexus rules

10. This part first sets forth an illustration of the challenges that members have identified with the existing profit allocation and nexus rules. It then discusses three proposals being examined by the Inclusive Framework to address such challenges. These proposals would require fundamental changes to both the profit allocation and nexus rules and expand the taxing rights of user and market jurisdictions. These proposals have important differences, including the justifications put forward for the reallocation of taxing rights, and the businesses for which that change in profit allocation would be relevant.

11. However, these proposals have the same over-arching objective, which is to recognise, from different perspectives, value created by a business's activity or participation in user/market jurisdictions that is not recognised in the current framework for allocating profits. Some of these proposals share important structural commonalities to achieve the aforementioned objective, such as a mechanism based on residual profit allocation for the proposals based on the concepts of "user participation" and "marketing intangibles". Hence, while all the proposals are being explored on their individual merits, the Inclusive Framework is also considering some common design issues and how some of those proposals could be framed in a more aligned manner.

2.1. Illustration of the challenge to the profit allocation and nexus rules

12. The three characteristics identified in the Interim Report – scale without mass, a heavy reliance on intangible assets, and the role of data and user participation – work together to enable highly digitalised businesses to create value by activities closely linked with a jurisdiction without needing to establish a physical presence. For example, some highly digitalised business models may solicit substantial contributions to, and active utilisation of, a web-based platform by a jurisdiction's residents, generating substantial value for a business but, under the current tax rules, that jurisdiction may not have a taxing right over any of that business's income. Some of these business models may facilitate large numbers of transactions between persons within the same country, similarly generating value for the business without creating any taxing right for the user or market jurisdiction – notwithstanding the highly localised impact of the utilisation of the platform. This "remote" participation in the domestic economy enabled by digital means but without a taxable physical presence is often seen as the key issue in the digital tax debate.

13. However, any solution that seeks to address nexus must also address the closely-related issue of profit allocation, or it is bound to fail – with likely increases in uncertainty and controversy without a meaningful increase in income allocation. This can easily be demonstrated by developments already taking place on the ground: in response to the BEPS package (including Action 7), some MNE groups with highly digitalised business models were able to establish local affiliates in market jurisdictions, especially in those jurisdictions constituting the businesses' larger markets. However, the local affiliates are commonly structured to have no ownership interest in intangible assets, not to perform DEMPE functions, and not to assume any risks related to such assets. Accordingly, only a modest return may be allocated to these "limited risk distributors," or LRDs. Thus, without effective changes to profit allocation rules, an MNE group may seek to sidestep the nexus issue by establishing local affiliates that are not entitled to an appropriate share of the group's profit.

14. Finally, if "remote" participation in the absence of a taxable physical presence, or in the absence of one that attracts substantial taxable profits, is considered to be a concern in relation to certain highly digitalised businesses, there is an important question as to whether this concern is not relevant to a broader set of businesses – for example, businesses that, due to digitalisation and changes in the global economy, can build their brand, develop an engaged customer base and create value in the absence of local activities or in the absence of local activities that attract a significant share of taxable profits. In other words, to the extent the current rules are seen as under-allocating income to particular jurisdictions due to the ability of highly digitalised businesses to remotely and non-physically participate in those jurisdictions, horizontal equity, design coherence and a level playing field suggest that consideration should be given to whether that policy concern (and reforms to address that concern) are relevant also to more traditional businesses.

15. Against this background, some members of the Inclusive Framework have made proposals, further discussed below, that focus on value creation in the user/market jurisdiction that is not recognised in the current framework for allocating taxing rights and taxable profits.

2.2. Overview and background

16. The Inclusive Framework is currently examining three proposals for revising the profit allocation and nexus rules in response to these challenges posed by digitalisation. These three proposals, which seek to expand the taxing rights of the user or market jurisdiction, are discussed in further detail below. To date, the discussion has focused primarily on two of these proposals, the user participation proposal and the marketing intangible proposal, where a number of commonalities emerged. A detailed discussion of the concept of significant economic presence is also taking place, but this concept was revisited more recently.

2.2.1. The "user participation" proposal

17. One proposal currently discussed focuses on the value created by certain highly digitalised businesses through developing an active and engaged user base, and soliciting data and content contributions from them.

Policy rationale

18. This proposal is premised on the idea that soliciting the sustained engagement and active participation of users is a critical component of value creation for certain highly digitalised businesses. The activities and participation of these users contribute to the creation of the brand, the generation of valuable data, and the development of a critical mass of users which helps to establish market power.

19. This proposal contemplates that this source of value is most significant, on an absolute basis and relative to more traditional drivers of business value, for the following business models:

a. **Social media platforms:** These platforms are populated by user-generated content, with the volume and quality of that content a key factor in their ability to generate revenue from those users or from paid-for advertising targeted at those users. Social media platforms also benefit from the role users play in building a wider network of platform users, through their role in fostering connections and encouraging others to use the platform. A core business strategy will be to cultivate an active

user base and encourage them to proactively contribute content and spend time on the platform.

b. **Search engines**: In a similar way to a social media platform, much of the content of a search engine is delivered, directly or indirectly, by users of that platform. The intensive monitoring of user data also allows the platform to tailor experiences to individual users, to indirectly improve platform performance for other users, and to earn revenue by selling advertising targeted at users based on their demonstrated interests.

c. **Online marketplaces**: The success of an online marketplace is dependent on the size of the user network on either side of the platform, and the quality and diversity of goods/services those users are offering. A key business strategy will be to build, and encourage users to build, that network. Businesses will also enable and rely on users to play a role in regulating the quality of goods and services provided on the platform, such as by offering public reviews or providing feedback directly to the platform.

20. This value generated by user participation is not captured in user jurisdictions under the existing international tax framework, which focuses on the physical activities of a business itself in determining where profits should be allocated and the extent of the taxing rights of user jurisdictions. This results in businesses being able to generate significant value from a jurisdiction with a significant and engaged user base (user jurisdiction) without the profits they derive from that value being subject to local tax.

21. To better align profit allocation outcomes with value creation, the proposal seeks to revise profit allocation rules to accommodate the value creating activities of an active and engaged user base. In addition, the nexus rules would be revised so that the user jurisdictions would have the right to tax the additional profit allocable to them. However, this change in the rules would be limited to those business models which benefit from this type of user base. For businesses that have more traditional relationships with customers, there would be no change in the profit allocation or nexus rules.

Mechanics

22. The proposal would modify current profit allocation rules to require that, for certain businesses, an amount of profit be allocated to jurisdictions in which those businesses' active and participatory user bases are located, irrespective of whether those businesses have a local physical presence.

23. The proposal acknowledges the difficulties in using traditional transfer pricing methods for determining the amount of profit that should be allocated to a user jurisdiction. For example, it dismisses the idea that the value created by user activities can somehow be determined through the application of the arm's length principle, e.g. through hypothesising the user base as a separate enterprise and asking what return it would receive at arm's length in its dealings with other group entities.

24. It is instead proposed that the profit allocated to a user jurisdiction, in respect of the activities/participation of users, be calculated through a non-routine or residual profit split approach. This approach would, at a basic level, involve:

1. Calculating the residual or non-routine profit of a business, i.e. the profits that remain after routine activities have been allocated an arm's length return;

2. Attributing a proportion of those profits to the value created by the activities of users, which could be determined through quantitative/qualitative information, or through a simple pre-agreed percentage;

3. Allocating those profits between the jurisdictions in which the business has users, based on an agreed allocation metric (e.g. revenues); and

4. Giving those jurisdictions a right to tax that profit, irrespective of whether the business has a taxable presence in their jurisdictions that meets the current nexus threshold.

25. Under this approach, the profit attributed to the routine activities of an MNE group would continue to be determined in accordance with current rules. The only effect of the proposal would be to reallocate a proportion of the non-routine profit of the business, from the entities that are currently realising that profit, to the jurisdictions in which users are located.

26. Significant challenges exist in calculating non-routine profit across an MNE group, and there would be additional difficulties in trying to calculate non-routine profit at the level of an individual business line, e.g. where user participation is considered a material driver of value for one business line within a multi-business line group.

27. To streamline its implementation, the proposal could rely on formulas that would approximate the value of users, and the users of each country, to a business. However, it is acknowledged that this would be a pragmatic approach for allocating profit to a novel driver of value, and one that helps to avoid disputes between countries based on their subjective view of value generated by user participation. The proposal could also be combined with a strong dispute resolution component to minimise additional controversy and double taxation.

28. It is proposed that this approach would be targeted at highly digitalised businesses for which user participation is seen to represent a significant contribution to value creation. That would include, and perhaps be limited to, social media businesses, search engines and online marketplaces. The proposal could also incorporate a range of additional restrictions based on the size of the business to further reduce the administrative burden for tax administrations and taxpayers.

2.2.2. The "marketing intangibles" proposal

29. Another proposal under discussion is based on the concept of marketing intangibles.[4] Like the user participation proposal, it would change the profit allocation and nexus rules. But unlike the user participation proposal, it would not be intended to apply only to a subset of highly digitalised businesses. Instead, it would have a wider scope in an effort to respond to the broader impact of the digitalisation on the economy.

[4] The term "marketing intangibles" as used in this paper has the same meaning as is set forth in the OECD Transfer Pricing Guidelines: "*an intangible . . . that relates to marketing activities, aids in the commercial exploitation of a product or service and/or has an important promotional value for the product concerned. Depending on the context, marketing intangibles may include, for example, trademarks, trade names, customer lists, customer relationships, and proprietary market and customer data that is used or aids in marketing and selling goods or services to customers.*" (*OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017* (OECD TPG), p. 27).

Policy rationale

30. The marketing intangible proposal addresses a situation where an MNE group can essentially "reach into" a jurisdiction, either remotely or through a limited local presence (such as an LRD), to develop a user/customer base and other marketing intangibles. It sees an intrinsic functional link between marketing intangibles and the market jurisdiction.

31. This intrinsic functional link is seen as manifested in two different ways. First, some marketing intangibles, such as brand and trade name, are reflected in the favourable attitudes in the minds of customers and so can be seen to have been created in the market jurisdiction. Second, other marketing intangibles, such as customer data, customer relationships and customer lists are derived from activities targeted at customers and users in the market jurisdiction, supporting the treatment of such intangibles as being created in the market jurisdiction.

32. Taking into account this link between marketing intangibles and the market jurisdiction, the proposal would modify current transfer pricing and treaty rules to require marketing intangibles and risks associated with such intangibles to be allocated to the market jurisdiction. The proposal considers that the market jurisdiction would be entitled to tax some or all of the non-routine income properly associated with such intangibles and their attendant risks, while all other income would be allocated among members of the group based on existing transfer pricing principles.[5] One consequence of this proposal is that market jurisdictions would be given a right to tax highly digitalised businesses – even in the absence of a taxable presence – given the importance of marketing intangibles for such business models.

33. The proposal is intended to be consistent with the principle of allocating profit based on the value creation by firms in that this positive attitude in the minds of customers is created by, and the customer information and data is acquired through, the active intervention of the firm in the market. It is thus different from favourable demand conditions in the market jurisdiction that exist independent of the actions of the firm – such as the existence of a stable population benefitting from a successful economy that provides them with the financial means to be able to buy the relevant product. While these aspects of demand obviously have economic relevance, they are not relevant for the allocation of a firm's profits under the general tax framework, which is based on a determination of how different activities by the firm contribute to its profits.

34. Unlike marketing intangibles, trade intangibles are seen as not similarly possessing an intrinsic functional link with market jurisdictions. A patent used to build an efficient car engine will allow it to achieve the same mileage in one country as it does in another, and does so regardless of who made it or who bought it.

35. The marketing intangible proposal would also help mitigate BEPS concerns. Although BEPS Actions 8-10 achieved significant progress, the shifting of income attributable to marketing intangibles may still be accomplished through the exercise of only a relatively modest degree of decision-making capacity outside the market jurisdiction. Where a local distribution affiliate is needed for business purposes, it may be structured as an LRD and attract only a modest amount of profit. The marketing intangibles that the LRD

[5] The marketing intangible concept could be designed to specially allocate to market jurisdictions only a portion of the non-routine income attributable to marketing intangibles, instead of all of it.

uses in its distribution activities may be owned and controlled remotely, and accordingly all the profits attributable to those intangibles may be shifted out of the market jurisdiction.

36. Importantly also, the proposal maintains that the implications of BEPS Actions 8-10 are different for marketing and trade intangibles. The proposal is premised on the view that MNE groups now have less ability to shift profits attributable to trade intangibles, which generally arise from substantial, observable activities arising in a specific location. In contrast, the proposal contemplates that the situation is significantly more challenging with respect to marketing intangibles, where the link between specific and substantial activities and the return is less readily apparent. Similar considerations also influenced the decision in the context of BEPS Action 5 to permit certain incentive regimes for trade intangibles but not for marketing intangibles.

37. While MNE groups for a long time have had the ability to capture marketing intangible profits outside the market jurisdiction in low tax jurisdictions, recent developments have enhanced their ability to do so which in turn justifies taking a fresh look at this point in time.

38. As discussed and agreed in the Interim Report, digitalisation is transforming the way our economy functions. The impact of digitalisation and the wider changes to business models and value chains, including lower communication and transportation costs, have increased the opportunities for a modern enterprise to reach and interact with customers in a given market either remotely or through a limited physical presence that does not attract substantial taxing rights in the market jurisdiction. For instance, online retailers with no or only a small physical presence in one country may develop a large user and customer base in that country and know more about these users' and customers' shopping preference than a local book shop around the corner. The same is increasingly true for many branded consumer goods companies either because they are directly and digitally engaged with their customers or because they do so via the intermediation of highly digitalised businesses, or both.

39. With consumers increasingly online, consumer-facing businesses need to be online, which in turn reduces the need for a physical presence or changes the nature of the physical presence in a way that reduces the market jurisdiction's taxing rights. Formerly, for a consumer business to invest successfully into a foreign market, develop a broad customer base, and create value would have typically required some physical proximity and a local presence involved in the sales and marketing effort; but this is no longer the case. Sales and marketing can be handled remotely with only shipment and fulfilment – limited risk distribution – still requiring a presence and even that may depend on the nature of the business, including applicable regulatory requirements. The more data on consumers that can be collected, analysed and exploited remotely through the use of digital technology, the easier it is to avoid exercising any of the DEMPE and related risk management functions in the market jurisdiction that under today's rules govern the allocation of income from marketing intangibles.

Application to key fact patterns

40. One way to understand the marketing intangible proposal is to consider its impact on three key fact patterns. The first is where a highly digitalised business derives revenue from sales and marketing activities targeting a particular market jurisdiction in which it does not have a taxable presence. In these situations, the proposal would allocate non-routine profit attributable to the use of marketing intangibles related to the market jurisdiction to that jurisdiction, even in the absence of a taxable presence under existing

rules. In the context of highly-digitalised businesses, such marketing intangibles may include, for example, marketing intangibles generated by the operation of a free search service, free email, free digital storage and the like.[6] The proposal would also change the nexus rules to grant the market jurisdiction the right to tax this marketing intangible profit, even if the entity earning the profit would not have a taxable presence under existing nexus rules. Thus, despite a different conceptual starting point it would get to a result similar to that which would be achieved using the user participation proposal.

41. The second key fact pattern is where the same highly digitalised business has a local presence but operates it as an LRD. The marketing intangible proposal would provide that some or all of the non-routine profit allocable to marketing intangibles associated with the market jurisdiction would be taxable by that market jurisdiction. Further, it would ensure that the nexus rules allow the market jurisdiction to exercise a taxing right over this marketing intangible profit. This proposal would address the issue discussed above and frequently seen in the post-BEPS environment, in which a highly digitalised business establishes an LRD but the resulting profit allocable to the market jurisdiction is considered inappropriately small. Here again, the marketing intangible proposal should achieve a tax outcome broadly similar to that which would be achieved under the user participation proposal.

42. The final key fact pattern is a consumer product business not traditionally thought of as a highly-digitalised business, operating either remotely or through an LRD structure. Consistent with the broadly relevant motivation for the proposal, and to foster equity, coherence, and a level playing field, the proposal contemplates that changes to the profit allocation and nexus rules for situations involving highly digitalised businesses would need to apply equally to similarly-situated structures utilised by traditional consumer businesses. It is in this fact pattern that there remains a gap between the outcomes under the user participation and the marketing intangibles proposals.

Mechanics

43. The proposal would modify current profit allocation and nexus rules to require that the non-routine or residual income of the MNE group attributable to marketing intangibles and their attendant risks be allocated to the market jurisdiction. All other income, such as income attributable to technology-related intangibles generated by research and development and income attributable to routine functions, including routine marketing and distribution functions, would continue to be allocated based on existing profit allocation principles. This is because the latter is perceived to continue to produce results that are consistent with the objective of aligning taxable profits with value creation when applied to such businesses activities.

[6] The definition of marketing intangibles in the OECD TPG includes: "customer lists, customer relationships, and proprietary market and customer data that is used or aids in marketing and selling goods or services to customers." Highly digitalised businesses have revolutionised the availability and depth of usable micro data on customers, potential customers, including their interests and preferences. Such consumer data is typically acquired in exchange for free services, such as free search functions, free emails etc. The marketing intangible proposal would conceptualise the acquisition of such data as an investment in marketing intangibles (i.e. customer lists and the like) which is then monetised either via the sale or other provision of such data to third parties as part of an advertising business model or used to enhance the sales of own goods and services. In addition, these consumer facing digitalised businesses will often have invested in community and wider brand positioning so as to enhance their subjective appreciation by their users.

44. The special allocation of some or all non-routine returns from marketing intangibles, and the related expansion of the market country's taxation rights, would apply regardless of which entity in the MNE group owns legal title to the marketing intangibles, regardless of which entities in the group factually perform or control DEMPE functions related to those intangibles (though as noted above, routine marketing functions would receive a routine return in the location where carried out), regardless of how risks related to the marketing intangibles would be allocated under existing transfer pricing rules, and regardless of how those rules would ordinarily allocate income related to the marketing intangibles and their associated risks. The proposal assumes that in many instances the type of MNE group to which this special allocation rule applies will already have a taxable presence in the market jurisdiction, but accepts that there will be instances where a taxing right would be assigned to the market jurisdiction in cases where no such right exists under the international tax rules as they stand, taking compliance and administrative cost considerations into account.

45. The allocation of non-routine or residual income between marketing intangibles and other income producing factors could be determined through different methods. One approach would be to apply normal transactional transfer pricing principles. Conceptually, the approach would be quite straightforward. First, marketing intangibles would need to be determined and then their contribution to profit would need to be determined under two sets of assumptions: (i) an assumption that the marketing intangibles (and their attendant risks) are allocated under the current rules; and (ii) an assumption that the marketing intangibles (and their attendant risks) are allocated to the market jurisdiction. This calculation could create a marketing intangible adjustment which would be the difference between those two numbers.

46. The income allocation would be dependent entirely on the facts of each case and the economic contribution to profits provided by the marketing intangibles. This would retain the existing rules requiring an identification of the specific marketing intangibles and a calculation of their contribution to profit.

47. Alternatively, the allocation could be done under a revised residual profit split analysis that uses more mechanical approximations. As with any residual profit split this would require a number of steps including the determination of relevant profit, the determination of routine functions and their compensation, the deduction of routine profit from total profit and finally the division of the remaining or "residual" profit. In this regard, there are different ways in which routine profit could be determined for purposes of computing the amount of non-routine income to be subject to the profit split, ranging from a full transfer pricing facts and circumstances analysis to a more mechanical approach (e.g. a mark-up on costs or on tangible assets). Second, and once the amount of routine profit is determined and subtracted from total profit, there are different ways of determining the portion of non-routine or residual profit attributable to marketing intangibles, ranging from, e.g., cost based methods (e.g. costs incurred to develop marketing intangibles versus costs incurred for R&D and trade intangibles) to more formulaic approaches (e.g. using fixed contribution percentages, which may differ by business model).

48. Once the amount of income attributable to marketing intangibles is determined it would be allocated to each market jurisdiction based on an agreed metric, such as sales or revenues. In this context revenue of MNE groups active in the advertising industry, as many digital businesses are, would be sourced not by reference to the residence of the payer but by reference to the customers that are targeted by the advertisement – e.g., in the online platform context, generally the users of the platform.

49. To address concerns that the implementation of the proposal would result in significant controversy and double taxation for business, the proposal should offer taxpayers the possibility of early certainty on the taxation under this approach and come with a strong dispute resolution component.

2.2.3. The "significant economic presence" proposal

50. The Inclusive Framework will also explore a proposal based on the concept of "significant economic presence" described in Section 7.6 of the Action 1 Report ("Developing options to address the broader direct tax challenges of the digital economy"). This proposal is motivated by the view that the digitalisation of the economy and other technological advances have enabled business enterprises to be heavily involved in the economic life of a jurisdiction without a significant physical presence. According to this view, these technological advances have rendered the existing nexus and profit allocation rules ineffective.

51. Under this proposal, a taxable presence in a jurisdiction would arise when a non-resident enterprise has a significant economic presence on the basis of factors that evidence a purposeful and sustained interaction with the jurisdiction via digital technology and other automated means. Revenue generated on a sustained basis is the basic factor, but such revenue would not be sufficient in isolation to establish nexus. Only when combined with other factors would revenue potentially be used to establish nexus in the form of a significant economic presence in the country concerned. In this context, one or more of the following factors may be considered relevant for constituting the kind of purposeful and sustained interaction with a jurisdiction via digital technology and other automated means that would be sufficient to create a significant economic presence: (1) the existence of a user base and the associated data input; (2) the volume of digital content derived from the jurisdiction; (3) billing and collection in local currency or with a local form of payment; (4) the maintenance of a website in a local language; (5) responsibility for the final delivery of goods to customers or the provision by the enterprise of other support services such as after-sales service or repairs and maintenance; or (6) sustained marketing and sales promotion activities, either online or otherwise, to attract customers. As noted in the Action 1 Report, a link would have to be established between the revenue-generating activity of the non-resident enterprise and its significant economic presence. Additional issues to address in respect of revenue as a factor would include the definition of the types of transactions that are to be covered and appropriate thresholds.

52. The proposal contemplates that the allocation of profit to a significant economic presence could be based on a fractional apportionment method, as discussed in Section 7.6.2.2 of the Action 1 Report. A fractional apportionment method would require the performance of three successive steps:

1. the definition of the tax base to be divided,
2. the determination of the allocation keys to divide that tax base, and
3. the weighting of these allocation keys.

53. The tax base could be determined by applying the global profit rate of the MNE group to the revenue (sales) generated in a particular jurisdiction. The tax base would be apportioned by taking into account factors such as sales, assets and employees. In addition, this proposal contemplates that for those businesses for which users meaningfully contribute to the value creation process, users would also be taken into account in apportioning income.

54. Other simplified methods for allocating profit will also be considered, such as the modified deemed profits methods described in section 7.6.2.3 of the Action 1 Report.

55. Equally, in line with the Action 1 Report, the proposal also contemplates the possible imposition of a withholding tax as a collection mechanism and enforcement tool. In this context, consideration could be given to a gross-basis withholding tax at a low rate on payments to an enterprise with a significant economic presence, with the enterprise having the right to file an income tax return and seek a refund if the withheld amount exceeded the enterprise's income tax liability.

2.2.4. Comparing the proposals

Overview

56. The three proposals would require changes to nexus and profit allocation rules. On nexus they all argue for a re-thinking of the traditional nexus concept and, within their different parameters, they go beyond the limitations on taxing rights determined by reference to a physical presence. On profit allocation, the significant economic presence proposal contemplates the use of a fractional apportionment approach with the possibility of using a withholding mechanism for collection while the user contribution and marketing intangible proposals would use a residual profit split approach. All three proposals apply a global approach to determination of profit.

57. While the user contribution and marketing intangible proposals proceed from different conceptual origins and scope they can be conceptualised in a similar way as discussed in further detail below. Furthermore they both use a residual profit split methodology for allocating profit. Accordingly, the remainder of this section focuses on the commonalities and design challenges of these two proposals, while recognising that other commonalities may exist between these proposals and the proposal based on the concept of significant economic presence, including their possible use of a withholding tax as a collection mechanism or enforcement rule, to the extent that this does not result in double taxation.

Commonalities between the user contribution and marketing intangibles proposals

58. The user participation and marketing intangible proposals share important features. Both proposals are based on the principle that business profits should be taxed in the countries in which value is created, and argue that the profit allocation and nexus rules should be amended to better reflect that principle. Both proposals would have the effect of increasing the share of business profit allocated to countries in which users or customers are located, implemented via a changed nexus standard and a residual profit split method, and both proposals would require changes to the existing nexus and profit allocation rules.

59. Despite these commonalities the proposals have different conceptual origins and resulting differences in scope. The user participation proposal emphasizes the value that digital businesses generate from the engagement, interaction and contributions of users, including content, data and powerful network effects. Its premise is that this justifies the reallocation of profits of relevant businesses to countries in which users are located. In contrast, the marketing intangible proposal emphasizes the intrinsic factual link between a market jurisdiction and marketing intangibles related to that jurisdiction, while suggesting that loyalty of an active and engaged user itself could be considered a type of marketing intangible. Its premise is that this intrinsic link justifies the reallocation of profits of

relevant businesses to countries in which customers are located, or rather being awarded taxing rights over some portion of profits attributable to marketing intangibles. The marketing intangible proposal is also intended to help mitigate BEPS concerns, where the income attributable to marketing intangibles may be allocated outside the market jurisdiction through the exercise of only a relatively modest degree of decision-making capacity outside the market jurisdiction.

60. These differences in emphasis inform the different scopes of the two proposals. The user participation proposal could apply only to social media platforms, search engines, and online marketplaces while the marketing intangibles proposal instead potentially could apply to a much broader range of businesses that have significant marketing intangibles.

61. There are questions and challenges that could be raised with both the user participation and marketing intangibles proposals:

- Under the user participation proposal, it could be argued that the value created by the contribution and engagement of users does not constitute value created by the business, and instead constitutes value created by third-parties, that are more akin to suppliers than employees, and are remunerated at arm's length through the provision of a free service. Furthermore, if one accepts the conceptual motivation behind the user participation proposal, there is a question as to whether it has relevance beyond the digital-centric businesses identified above, and whether the narrow scope proposed will prove sustainable over time as digitalisation impacts on more traditional businesses.
- Under the marketing intangibles proposal, the intrinsic link between marketing intangibles and a market jurisdiction could be questioned, particularly where marketing activities are undertaken outside of that jurisdiction and not significantly tailored to local customer habits and preferences. There is also a question as to whether the justification is of equal relevance to companies that sell business-to-business, such as industrial goods and professional services companies, that may have substantial marketing expenditure and valuable trademarks, brands, or goodwill but may not leverage digital technology and customer data in delivering highly targeted/personalised marketing in the same way as consumer-facing businesses.

62. While the proponents would dispute these challenges, in recognition of the larger goal of identifying a potential basis for international consensus, there is reason to explore the possibility of a unifying rationale that addresses the points raised above and bridges the conceptual and scoping differences between the two proposals.

63. Although the proposals have different conceptual origins, a sharpened focus on the proposals' shared foundation in value creation by businesses could facilitate the development of a unified approach. Within the existing value creation framework, the user participation and marketing intangible proposals could be thought to challenge assumptions underlying the existing profit allocation principles about what it means to have an active presence or participation in a jurisdiction and undertake activities there.

64. The existing paradigm generally allocates profits based on the jurisdiction in which physical activities are performed or, in the case of allocating income that represents a return on capital or risk, based on the residence of the entity that legally owns the capital together with the location of the individuals who make relevant decisions regarding the deployment of that capital. Unless an enterprise is physically present in a user or customer's jurisdiction, including through a dependent agent, it generally will not be subject to tax there. In contrast,

the user participation and marketing intangible proposals could be said to embody a different conceptualisation of presence. Both proposals could be said to argue that, even where the physical situs of a business is substantially outside of a market jurisdiction, it is possible for that business to have an active presence or participation in that jurisdiction and generate value through customer/user facing activities that can be said to take place in that jurisdiction.

65. That is, both proposals could be said to take the common position that by failing to acknowledge the reality that businesses can today have an active presence or participation in market countries without a physical presence, or one that would justify a substantial allocation of income to that jurisdiction, the existing international tax rules fail to properly allocate income to the locations in which an enterprise is understood to create value in today's increasingly digitalised world.

66. If the user participation and marketing intangible proposals are viewed from this common perspective – i.e. as re-conceptualisations of assumptions underlying the existing framework about the location at which an enterprise acts – the central question that would need to be resolved to develop a unified approach becomes more readily evident. That central question would be, in what situations can it be said that a business, with a physical situs outside of a market jurisdiction, has an active presence or participation in that jurisdiction and generates value in that jurisdiction through its user or customer related activities?

67. Both proposals share the position that, under a value creation principle, the cross-border sale of goods and services to customers in a jurisdiction should not alone lead a business to have an active presence or participation in that jurisdiction, irrespective of the volume of those sales. Both proposals instead interpret active presence or participation to be a function of a business's active outreach to and interaction with users or customers, including the use of digital technologies to cultivate, interact with and leverage a local customer or user base in a way that creates meaningful value for the enterprise. The question then is whether this is relevant:

- only in situations in which digital-centric businesses engage, interact with and leverage contributions from a participatory user base on a digital platform, as per the user participation proposal;
- in a broader range of situations in which, for example, consumer facing businesses use digital technologies to develop a customer base, collect customer data or deliver highly targeted marketing and personalization of products; or
- in all situations in which businesses have significant marketing intangibles that can be attributed to customers of a jurisdiction, as per the marketing intangibles proposal.

68. In exploring this question, it will be important to consider how digitalisation has impacted different businesses/sectors, and allowed them to participate actively in remote user or customer markets in a way, or to a degree, that was not possible before the rapid technological advances that have taken place in recent decades.

2.3. Potential design considerations

69. Given the commonalities identified above, the marketing intangibles and the user participation proposals raise similar technical issues which justify considering together their key design features. The details of the proposal based on the concept of significant

economic presence were still emerging at the time of drafting this consultation document. Therefore, the policy designs described in this section 2.3 are, for the most part, relevant to the marketing intangible and the user participation proposals.

70. A number of technical options are briefly discussed below, including important policy trade-offs between the search for precision – e.g. through the use of detailed and factual determinations – and the need for certainty and predictability – e.g. through the use of simplified methods. Further technical work on each of these design considerations would be required as the proposals are further developed, including analysing the pros and cons of these proposals, taking into consideration different levels of development and the capacity of tax administrations, the need to ensure a level playing field between small and large jurisdictions, as well as the potential effect of the various options on revenue and taxpayer behaviours.

2.3.1. Scope and potential limitations

71. Despite the different starting points, both proposals contemplate some express scope limitations to align the proposals with the policy objectives outlined above and limit compliance and administration concerns. These limitations could be structured in different ways, but the proposals would need to be limited to businesses in which the contribution of marketing intangibles and/or user participation to the production of income is substantial. This could be determined, for example, through the use of some materiality thresholds (e.g. cost ratios, size of customer and user base, or other metrics) and exclusions (e.g. *de minimis* rules, exemptions of certain industry sectors, exclusion of commodities). Additional limitations, related for instance to the size or profitability of the taxpayer, could also be used to further focus the scope and reduce associated compliance costs, though differentiation also raises issues of fairness.

2.3.2. Business line segmentation

72. Many aspects of the proposals suggest that they could be applied more appropriately at the business line level rather than at the level of the MNE group. A business line approach would however raise significant data availability and administration issues which could increase complexity and uncertainty.

2.3.3. Profit determination

73. The amount of profit (or loss) to be re-allocated would likely not be determined by using existing transactional transfer pricing methods. Instead, a new type of residual profit split method could be mandated, relying on more simplified conventions for determining such profit and approximate results consistent with an application of the arm's length principle. Apart from this special treatment of profit attributable to user participation, marketing intangibles, or some alternative formulation, the existing profit allocation rules would continue to apply.

74. This proposal would involve the following steps:

1. the determination of the total or combined profits to be split;

2. the identification of the residual (i.e. non-routine) portion of this total or combined profits by subtracting the returns allocable to routine functions; and

3. the determination of the portion of the residual profit to be re-allocated.

75. While this proposal would retain many similarities to the existing profit split method, it may apply to a broader aggregate – combined profit of multiple entities – and introduce simplifying conventions that are intended to make the calculations easier. This is because the more the above steps are based on detailed and factual determinations (e.g. conventional transfer pricing analysis), the greater is the risk of disputes and uncertainty in the outcome produced by the proposal. Reducing complexity in the implementation of the various above steps, while at the same time making sure that any approximation is principle-based, will thus be a key policy consideration. The various implications of any simplified method would also need to be assessed as the proposals are further developed, including an examination of their effect on revenue and taxpayer behaviour. In some businesses such as those which are highly digitalised, the separation of non-routine returns attributed to trade intangibles relative to those attributed to user participation or marketing intangibles, with which they are often interconnected, will be important in terms of results and also potentially challenging.

76. Importantly, the application of these methods would not necessarily produce a positive amount of non-routine or residual profit, i.e. where the sum of routine profits is greater than the actual total profit of the MNE group or business line. One possible approach would be to apply the proposals similarly to non-routine losses, in which case the portion of these negative amounts attributable to marketing intangibles or user contribution should also be re-allocated.

2.3.4. Profit allocation

77. The profit (or loss) to be re-allocated to the relevant user or market jurisdictions must be apportioned based on an agreed allocation metric. This metric would need to be a reasonable proxy for the relative value created in each jurisdiction, and be administrable by taxpayers and tax authorities alike.

78. The most straight-forward approach may be to allocate this profit to user or market jurisdictions based on sales or revenues, though other approaches involving users, expenditures in particular jurisdictions, etc., might also be considered. The method used for allocating profit to the relevant user or market jurisdiction should be informed by the method used to determine the relevant amount of non-routine or residual profit. Implementation issues and potential avoidance opportunities will need to be identified and taken into consideration (e.g. manipulation of the location of sales). Adjustments or variations of the metric may also be required in the case of advertising revenue to ensure that profit is allocated to the jurisdiction of the targets of the advertising, as opposed to the jurisdiction of the purchaser of the advertising.

79. In parallel, to the extent that the proposals would not fully supplant the existing profit allocation rules, additional rules will be required to reconcile the outcome of the proposals with the results produced by existing profit allocation rules and prevent double taxation (e.g. constraining the application of the existing rules in certain areas, intra-group adjustments).

2.3.5. Elimination of double taxation

80. Because the new profit allocation proposals envisage a reallocation of the MNE group residual profits to user or market jurisdictions, some changes to existing treaty provisions to address the elimination of double taxation seem necessary. Adjustments to the amount of profits allocated to MNE group members under the proposals should be designed so as to prevent double taxation among associated enterprises.

81. In addition, the new proposals may need to incorporate strong dispute prevention and resolution components to prevent their implementation from resulting in double taxation for businesses.

2.3.6. Nexus and treaty considerations

82. New nexus requirements would be required to implement the profit allocation proposals. The essential task would be to provide user or market jurisdictions with the right to tax the additional income, even if the entity earning that income would have no taxable presence under existing treaty principles. This could conceivably be achieved by amending or supplementing the Article 5 definition of "permanent establishment", allied with changes to the distributive rules in Articles 7 and 9. However, those existing provisions look at transactions between enterprises or parts of an enterprise, whereas the new proposals look at the combined profit of multiple entities within an MNE group. Therefore, an alternative approach might be to introduce the new nexus through a new standalone rule allocating taxing rights over the additional income. In all cases, the proposals recognise the need for a new nexus which would be based on an alternative threshold. There are similarities between this and nexus rules based on a concept of significant economic presence described in section 2.2.3 which should be further explored. Of course countries may also need to amend their domestic laws, such that any new article can become operational and there may be benefits in coordinating the development of any such domestic rules.

2.3.7. Administration

83. The taxation of the reallocated income in the user or market jurisdiction would require the determination of the identity of the taxpayer who bears the tax liability and filing obligations. To the extent that the proposal may result in reallocating income earned by multiple entities in an MNE group (which may be resident in the taxing jurisdiction or in another jurisdiction), further work would be required to identify and assess the different options available to allocate the tax liability, taking into consideration administrative burdens and risks of non-compliance.

84. To address concerns that the implementation of the proposals would result in additional controversy and double taxation for businesses, the proposals would need to incorporate strong dispute prevention and resolution components, and focus on simplicity. For example, early certainty features could range from improved multilateral risk assessment procedures, drawing on the current International Compliance Assurance Programme (ICAP) pilot, to multilateral advance pricing agreement programmes, and joint audit programmes, all following co-ordinated or unified procedures to reduce controversy in the application of the rules and to minimise the risk of double taxation. The objective of any potential dispute prevention and resolution features would be to ensure a consistent application of the proposals across tax administrations in multiple participating jurisdictions.

85. The effective application of the proposals would also require a number of data points to be available to tax administrations (e.g. total profit, business line) which could be derived from tax accounting or financial accounting data. Any additional data needs could potentially be added to an already agreed filing and exchange of information mechanism such as that in place under BEPS Action 13 (country-by-country reporting).

86. To improve compliance, the use of principle-based administrative simplifications and collection mechanisms, which could include new or existing withholding mechanisms

as an enforcement rule supporting the application of the proposals could also be explored, provided this mechanism does not result in double taxation.

2.4. Questions for public comments

87. Commentators' views are requested on the policy, technical and administrability issues raised by each of the three proposals described above. In particular, comments are specifically requested on the following questions:

1. What is your general view on those proposals? In answering this question please consider the objectives, policy rationale, and economic and behavioural implications.
2. To what extent do you think that businesses are able, as a result of the digitalisation of the economy, to have an active presence or participation in that jurisdiction that is not recognised by the current profit allocation and nexus rules? In answering this question, please consider:
    i. To what types of businesses do you think this is applicable, and how might that assessment change over time?
    ii. What are the merits of using a residual profit split method, a fractional apportionment method, or other method to allocate income in respect of such activities?
3. What would be the most important design considerations in developing new profit allocation and nexus rules consistent with the proposals described above, including with respect to scope, thresholds, the treatment of losses, and the factors to be used in connection with profit allocation methods?
4. What could be the best approaches to reduce complexity, ensure early tax certainty and to avoid or resolve multi-jurisdictional disputes?

3. Global anti-base erosion proposal

88. This part of the paper sets out proposals to address the continued risk of profit shifting to entities subject to no or very low taxation through the development of two inter-related rules: an income inclusion rule and a tax on base eroding payments. The rationale and mechanics for these rules are set out below together with a discussion of the key questions for consultation.

3.1. Overview and background

89. While the measures set out in the BEPS package have further aligned taxation with value creation and closed gaps in the international tax architecture that allowed for double non-taxation, certain members of the Inclusive Framework consider that these measures do not yet provide a comprehensive solution to the risks that continue to arise from structures that shift profit to entities subject to no or very low taxation. This risk is particularly acute in connection with profits relating to intangibles, prevalent in the digital economy, but also in a broader context; for instance group entities that are financed with equity capital and generate profits, from intra-group financing or similar activities, that are subject to no or low taxes in the jurisdictions where those entities are established.

90. The global anti-base erosion proposal is made against this background. It is intended to respect the sovereign right of each jurisdiction to set its own tax rates, but reinforces tax sovereignty of all countries to "tax back" profits where other countries have not sufficiently exercised their primary taxing rights. The proposal recognises that in the absence of multilateral action there is a risk of un-coordinated, unilateral action, both to attract more tax base and to protect existing tax base, with adverse consequences for all countries, large and small, developed and developing. It posits that global action is needed to stop a harmful race to the bottom, which otherwise risks shifting taxes to fund public goods onto less mobile bases including labour and consumption, effectively undermining the tax sovereignty of nations and their elected legislators. Unilateral measures taken in response can lead to double taxation and may even result in new forms of protectionism. Developing countries, often with smaller markets, may also lose in such a race and become even more dependent on natural resource taxation to finance their public needs, while multiplying tax free zones and other incentives to attract foreign direct investment. The proposal therefore seeks to advance a multilateral framework to achieve a balanced outcome which makes business location decisions less sensitive to tax considerations, limit compliance and administration costs and avoid double taxation.

91. Recognising, as stated in the Action 1 Report, that it would be difficult, if not impossible, to ring-fence the digital economy from the rest of the economy for tax purposes, the scope of the anti-base erosion proposal is not limited to highly digitalised businesses. However, by focusing on the remaining BEPS challenges, it proposes a systematic solution designed to ensure that all internationally operating businesses pay a minimum level of tax. It does not tolerate that a modest level of substance can result in an allocation of a substantial amount of intangible and risk related returns to group entities that pay no or very little tax. In so doing, it addressees the remaining BEPS challenges linked to the digitalising economy, where the relative importance of intangible assets as profit drivers makes highly digitalised business ideally placed to avail themselves of such planning structures, but it goes even further and addresses these challenges more broadly.

3.2. Mechanics

92. The proposal seeks to address the remaining BEPS challenges through the development of two inter-related rules:

1. an ***income inclusion rule*** that would tax the income of a foreign branch or a controlled entity if that income was subject to a low effective tax rate in the jurisdiction of establishment or residence; and
2. a ***tax on base eroding payments*** that would deny a deduction or treaty relief for certain payments unless that payment was subject to an effective tax rate at or above a minimum rate.

93. These rules would be implemented by way of changes to domestic law and double tax treaties and would incorporate a co-ordination or ordering rule to avoid the risk of economic double taxation that might otherwise arise where more than one jurisdiction sought to apply these rules to the same structure or arrangements.

94. As part of the global anti-base erosion proposal, further consideration could also be given to whether any additional specific rules are required to deal with issues raised by thickly capitalised entities.

95. Some of the broader questions that may need to be addressed as part of this proposal include:

- further work to clarify the kinds of entities, arrangements and behaviours that are within the intended scope of the global anti-base erosion proposal, supported by practical examples;
- analysing the intended operation of the rule in light of anticipated changes in the behaviour of both firms and jurisdictions in response to the proposal;
- further considering the role of substance in the application of the proposal (including the substance criteria developed under BEPS Action 5), particularly in light of its intention to not impact on structuring and location decisions made for economic or business reasons;
- considering safe harbours and thresholds that would reduce complexity in the application of the rule; and
- co-ordinating outcomes and the possibility of incorporating dispute prevention and resolution components in order to reduce controversy in the application of the rules and minimise the risk of double taxation.

3.3. Income inclusion rule

96. The income inclusion rule would operate as a minimum tax by requiring a shareholder in a corporation to bring into account a proportionate share of the income of that corporation if that income was not subject to tax at a minimum rate. The rule would apply to any shareholder with a significant (e.g. 25%) direct or indirect ownership interest in that company and would be applied on a per jurisdiction basis. The amount of income to be included would be calculated under domestic law rules and shareholders would be entitled to claim a credit for any underlying tax paid on the attributed income, with such credits also being calculated on a jurisdiction-by-jurisdiction basis. This rule would supplement rather than replace a jurisdiction's CFC rules.

97. In the case of exempt foreign branches the income inclusion rule would operate by way of switch-over rule that would turn off the benefit of an exemption for income of a branch and replace it with the credit method where that income was subject to a low effective rate of tax in the foreign jurisdiction.

98. The income inclusion rule would build on the Action 3 recommendations and draw on aspects of the US regime for taxing Global Intangible Low-Taxed Income ("GILTI").[7] The rule would be designed in such a way that Member States of the European Union could apply it to both domestic and foreign subsidiaries and Member States could choose to adopt this rule through an EU directive.

99. The income inclusion rule would ensure that the income of the MNE group is subject to tax at a minimum rate thereby reducing the incentive to allocate returns for tax reasons to low taxed entities. The income inclusion rule would have the effect of protecting the tax base of the parent jurisdiction as well as other countries where the group operates by reducing the incentive to put in place intra-group financing, such as thick capitalisation, or other planning structures that strip profit from high to low tax entities within the same group. It is not intended to affect structuring and location decisions made for economic or business reasons.

100. In addition to discussing how the minimum rate itself should be determined and applied, there are a number of further technical issues that would need to be considered in the design of the rule, drawing on the experience from countries with similar rules, including:

- the types of entity covered and definition of the minimum level of ownership or control required in order to apply the income inclusion rule, and in particular the ability of minority shareholders to access the information required in order to determine and calculate their tax liability;
- the mechanism for determining whether a corporation has been subject to tax at the minimum rate (i.e. the design of the effective tax rate test);
- the design of any thresholds or safe harbours to facilitate administration and compliance with the rule;
- the rules for attribution of income to shareholders based on their control or economic ownership including mechanisms to prevent taxpayers structuring around the rules;
- whether the included income should be taxed at the minimum rate or the full domestic rate;
- mechanisms for avoiding double taxation including rules governing the use of foreign tax credits and corresponding adjustments to the scope of any related exemptions; and
- the compatibility of the design of the income inclusion rule with international, and where applicable EU law, obligations.

[7] Public Law No. 115-97, 22 December 2017, Section 14201 (a) introducing sec. 951A in Subpart F of part III of subchapter N of chapter 1 of the Internal Revenue Code of 1986 (US Congress, 2017).

3.4. Tax on base eroding payments

101. The second key element of the proposal is a tax on base eroding payments that complements the income inclusion rule by allowing a source jurisdiction to protect itself from the risk of base eroding payments. More specifically, this element of the proposal would include:

- an *undertaxed payments rule* that would deny a deduction for a payment to a related party if that payment was not subject to tax at a minimum rate; and
- a *subject to tax* rule in tax treaties that would only grant certain treaty benefits if the item of income is sufficiently taxed in the other state.

102. These two measures ensure that the proposal will provide a comprehensive solution to profit shifting risks by ensuring the payer jurisdiction remains protected from base-eroding payments even where that payment is not brought within the charge to taxation in the hands of the underlying owners under the income inclusion rule.

3.4.1. Undertaxed payments rule

103. The undertaxed payments rule would deny a deduction for certain defined categories of payments made to a related party unless those payments were subject to a minimum effective rate of tax. The effective tax rate test would take into account any withholding tax imposed on the payment (including as a result of the denial of treaty benefits under the subject to tax rule described below). The test for whether a payment was to a related party could be based on a 25% common ownership test, similar to that used for the application of the income inclusion rule and in the BEPS Action 2 (hybrids).

104. The rule should apply to a broad range of payments and should cover "conduit" or "imported" arrangements, where the effect of an undertaxed payment is "imported" into the payer jurisdiction through a payment that is otherwise outside the scope of the rule. The benefit of a broad scope is seen in the fact that it avoids design issues that can arise in defining particular categories of payments and would prevent MNE groups from being able to structure transactions that fall outside the scope of these definitions.

105. In addition to considering how the minimum rate should be determined and applied, and the relevance, if any, of any substance in the entity receiving the payment such as substance concepts developed in connection with BEPS Action 5, the key technical issues that would need to be considered in the design of the undertaxed payments rule, drawing on the experience from countries with similar rules, will include:

- the scope of payments covered by the rule and, in particular, the need for a workable scope that addresses the full range of profit shifting risks while minimising the administration and compliance burdens and limiting the potential for economic double taxation or over-taxation;
- the threshold for related party status and, in particular, the degree of common control and the information that parties are likely to need in order to be able to comply with, and to avoid any unintended tax consequences under, the undertaxed payments rule;
- the mechanics of this effective tax rate test including whether it should be applied on an entity by entity or transaction by transaction basis and the development of

robust and workable tests for calculating the effective tax rate on each type of payment;

- the compatibility of the undertaxed payments rule with international obligations; and
- whether the rule should deny deductibility in full or only on a graduated basis reflecting the level of taxation in the jurisdiction of the recipient.

3.4.2. Subject to tax rule

106. To complement the undertaxed payments rule, the anti-base erosion proposal would also include a subject to tax rule that would apply to undertaxed payments that would otherwise be eligible for relief under a double tax treaty. This rule would apply to deny tax treaty benefits provided by the following Articles (using the numbering of the OECD Model Convention):

- ***Article 7 (Business profits).*** In this case the subject to tax rule could allow a contracting state to tax the business profits of a non-resident enterprise regardless of its obligation under Article 7 to only tax profits which are attributable to a permanent establishment, if those profits are not subject to tax at a minimum rate in the residence state.
- ***Article 9 (Associated enterprises).*** The subject to tax rule could make corresponding adjustments in one contracting state dependent on effective taxation by the state making the primary adjustment under Article 9, requiring that state to specify the effective taxation on the adjustment.
- ***Article 10 (Dividends).*** The subject to tax rule could deny treaty benefits in the source state if the residence state does not tax the dividend at a minimum effective rate of tax. Because the rule could defeat the objective of participation exemption regimes to avoid economic double taxation, an alternative rule could include a general carve-out for such regimes or introduce a special effective tax rate test that could take account differences in tax relief systems between the residence and source state.
- ***Article 11 - 13 (Interest, Royalties and Capital Gains).*** The subject to tax rule could deny treaty benefits in the source state if the residence state does not tax the interest, royalties or gains at a minimum effective rate of tax.
- ***Article 21 (Other income).*** Similarly, where Article 21 allocates exclusive taxing rights to the residence state on other income, a subject to tax rule could deny treaty benefits in the source state if the residence state does not tax the income at a minimum effective rate of tax.

107. The subject to tax rule could be limited to payments between related parties, but a broader scope could be explored in Articles 11 to 13. Consideration could be given to thresholds and safe harbours to facilitate administration and compliance with the rule. A delegation of authority to operate the subject to tax rule and mechanisms for resolving disputes could also be considered in order to ensure that the tax on base eroding payments is effective, co-ordinated and limits the risk of double taxation.

108. In addition to technical issues that would need to be considered in the design of the undertaxed payment rule (which equally applies to a subject to tax rule), the following key technical issues would also need to be considered:

- impact on tax exemptions accorded to dividend distributions in order to mitigate double taxation of such dividends that should probably not be affected by a subject to tax rule;
- information that a payee would be required to provide to payers and withholding agents in order to support a treaty benefits; and
- impact on certain categories of taxpayers (e.g. individuals, pension funds, charitable organisations).

3.5. Rule co-ordination

109. Because the various elements of the anti-base erosion proposal are intended to tackle the same structures there is the possibility that these rules will overlap to a certain extent. Given the potential for overlap an ordering rule would be necessary. There are at least two design options for such an ordering rule: a rule that could be applied on a payment by payment basis or a more systemic approach that would switch off the application of one rule if an MNE was based in a jurisdiction that had introduced the other rule. Further technical work would need to explore these overall approaches and then also establish the order in which they would be applied.

3.6. Questions for public comments

110. Commentators views are requested on the policy, technical and administrability issues raised by the proposals described above, including those raised in paragraphs 100 and 105. In particular, comments are specifically requested on the questions set forth below:

1. What is your general view on this proposal? In answering this question please consider the objectives, policy rationales, and economic and behavioural implications of the proposal.
2. What would be the most important design considerations in developing an inclusion rule and a tax on base eroding payments? In your response please comment separately on the undertaxed payments and subject to tax proposals and also cover practical, administrative and compliance issues.
3. What, if any, scope limitations should be considered in connection with the proposal set out above?
4. How would you suggest that the rules should best be co-ordinated?
5. What could be the best approaches to reduce complexity, ensure early tax certainty and to avoid or resolve multi-jurisdictional disputes?

111. In their responses commentators are invited to draw on experiences from the operation and design of existing rules that they consider would be helpful for this discussion.

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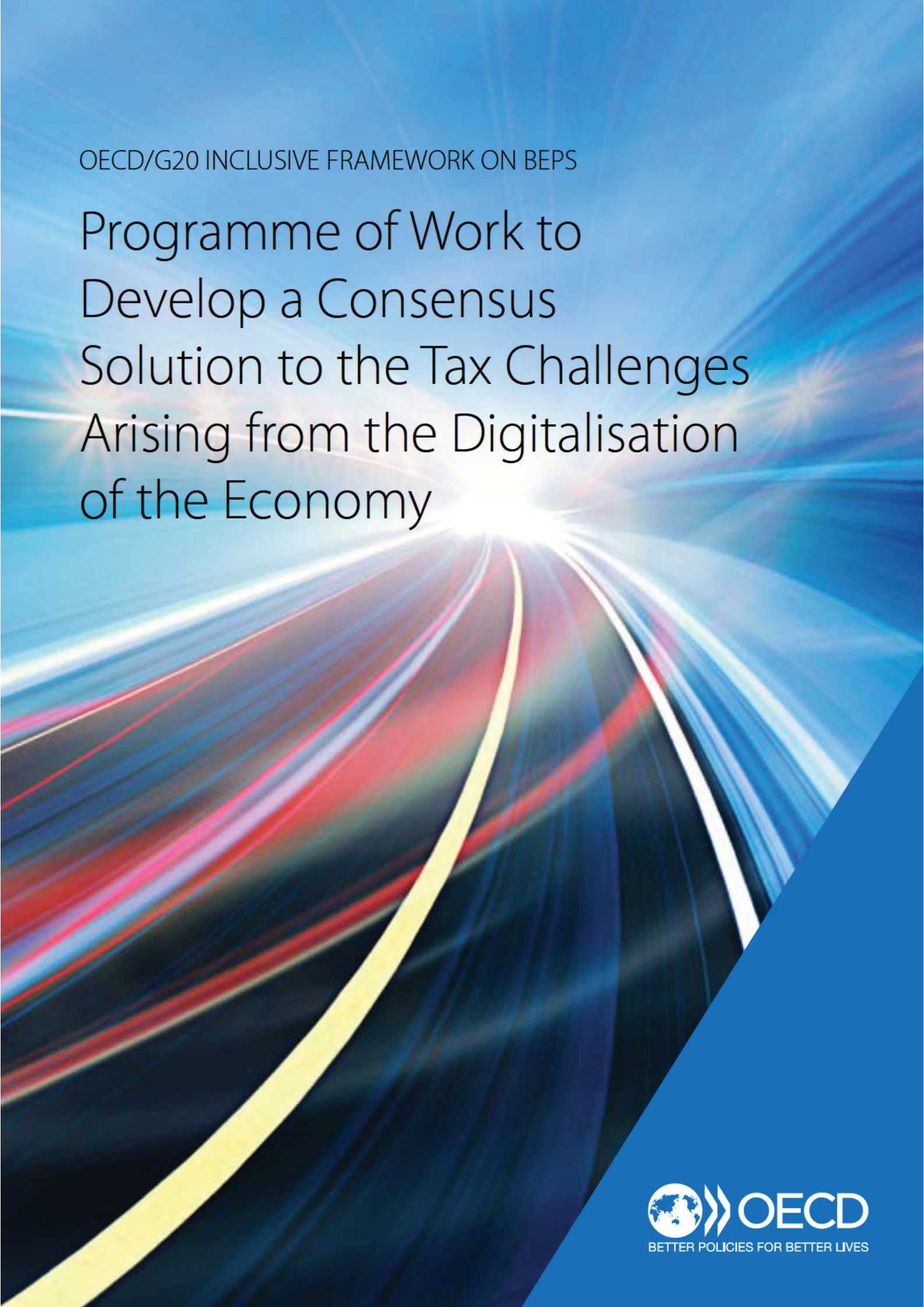
APPENDIX B

OECD's Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy

OECD/G20 INCLUSIVE FRAMEWORK ON BEPS

Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy



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BETTER POLICIES FOR BETTER LIVES

OECD/G20 Base Erosion and Profit Shifting Project

Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy

Inclusive Framework on BEPS

This document, as well as any data and any map included herein, are without prejudice to the status of or sovereignty over any territory, to the delimitation of international frontiers and boundaries and to the name of any territory, city or area.

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Chapter I - Introduction

1. The digital transformation spurs innovation, generates efficiencies, and improves services while boosting more inclusive and sustainable growth and enhancing well-being. At the same time the breadth and speed of this change introduces challenges in many policy areas, including taxation.

2. The tax challenges of the digitalisation of the economy were identified as one of the main areas of focus of the OECD/G20 Base Erosion and Profit Shifting (BEPS) Project, leading to the 2015 BEPS Action 1 Report (the Action 1 Report).[1] The Action 1 Report found that the whole economy was digitalising and, as a result, it would be difficult, if not impossible, to ring-fence the digital economy.

3. For indirect taxes, the Action 1 Report recognised new challenges related to the collection of Value Added Taxes (VAT)/Goods and Services Taxes (GST) on the continuously growing volumes of goods and services that consumers purchase online from foreign suppliers. It recommended implementing the destination principle contained in the 2017 OECD International VAT/GST Guidelines,[2] together with the mechanisms for effective collection of VAT/GST on cross-border supplies of services and intangibles presented in those Guidelines.

4. For direct taxes, the Action 1 Report observed that while digitalisation could exacerbate BEPS issues, it also raises a series of broader tax challenges, which it identified as "nexus, data and characterisation". The latter challenges, however, were acknowledged as going beyond BEPS, and were described as chiefly relating to the question of how taxing rights on income generated from cross-border activities in the digital age should be allocated among jurisdictions. A number of potential options to address these concerns were discussed, but none were ultimately recommended. Instead, the Action 1 Report called for continued work in this area, notably by monitoring developments in respect of digitalisation, with a further report to be delivered by 2020.

5. Notwithstanding the progress made in tackling double non-taxation as part of the BEPS package, and the widespread implementation of the OECD International VAT/GST Guidelines, ongoing concerns around the tax implications of a rapidly digitalising economy led the G20 Finance Ministers, at their meeting in Baden Baden in March 2017, to advance the timeline and request the Inclusive Framework to deliver an interim report by early 2018. In March 2018, the Inclusive Framework, working through its Task Force on the Digital Economy (TFDE), issued *Tax Challenges Arising from Digitalisation – Interim Report 2018* (the Interim Report).[3] The Interim Report provided an in-depth analysis of new and changing business models that enabled the identification of three characteristics frequently observed in certain highly digitalised business models, namely *scale without mass*, *heavy reliance on intangible assets*, and the *importance of data, user participation and their synergies with intangible assets*. The ensuing potential tax challenges were discussed, including remaining BEPS risks and the question of how taxing rights on income generated from cross-border activities in the digital age should be allocated among jurisdictions.

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6. While members of the Inclusive Framework did not converge on the conclusions to be drawn from this analysis, they committed to continue working together to deliver a final report in 2020 aimed at providing a consensus-based long-term solution, with an update in 2019.

7. Conscious of the challenging time frame and the importance of the issues, the Inclusive Framework further intensified its work after the delivery of the Interim Report. Consistent with the analysis included in the Action 1 Report as well as the Interim Report, some members made suggestions on how the work could be taken forward to achieve progress towards a consensus-based solution. Some proposals focused on the allocation of taxing rights by suggesting modifications to the rules on profit allocation and nexus, other proposals focused more on unresolved BEPS issues. In the Policy Note *Addressing the Tax Challenges of the Digitalisation of the Economy*,[4] approved on 23 January 2019, the Inclusive Framework agreed to examine and develop these proposals on a "without prejudice" basis. These proposals were grouped into two pillars which could form the basis for consensus:

- Pillar One focuses on the allocation of taxing rights, and seeks to undertake a coherent and concurrent review of the profit allocation and nexus rules;
- Pillar Two focuses on the remaining BEPS issues and seeks to develop rules that would provide jurisdictions with a right to "tax back" where other jurisdictions have not exercised their primary taxing rights or the payment is otherwise subject to low levels of effective taxation.

8. While the two issues of the ongoing work on remaining BEPS challenges and a concurrent review of the profit allocation and nexus rules are distinct, they intersect and a solution that seeks to address them both could have a mutually reinforcing effect. Therefore the Inclusive Framework agreed that both issues should be discussed and explored in parallel.

9. Since January 2019, and consistent with the Policy Note, the Inclusive Framework has continued to examine the proposals, including by considering how the gaps between the different positions of jurisdictions could be bridged, taking into consideration the overlaps that exist between the BEPS issues exacerbated by digitalisation and the broader tax challenges. As part of this work, a public consultation document was released on 13 February 2019, which sought input from external stakeholders on the specific proposals examined under Pillar One and Pillar Two.[5] The response from stakeholders was robust with more than 200 written submissions running to over 2,000 pages of written comments.[6] Stakeholders had the opportunity to express their views at the public consultation meeting that was held at the OECD Conference Centre in Paris on 13 and 14 March 2019 and that was attended by over 400 representatives from governments, business, civil society and academia.

10. This ongoing work, including the public consultation process and inputs received from various stakeholders, has highlighted important areas that need to be discussed among the members of the Inclusive Framework. One area is the effect of the three characteristics noted in the Interim Report, which are more pronounced in certain highly digitalised business models, reinforced by globalisation, and the broader challenges this may pose in relation to existing tax rules, including by exacerbating some BEPS risks.[7] For some commentators and members of the Inclusive Framework the work on the tax challenges of digitalisation has revealed some more fundamental issues of the existing international tax framework, which have remained after the delivery of the BEPS package.

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11. A further issue is the recognition that if the Inclusive Framework does not deliver a comprehensive consensus-based solution within the agreed G20 time frame, there is a risk that more jurisdictions will adopt uncoordinated unilateral tax measures. A growing number of jurisdictions are not content with the taxation outcomes produced by the current international tax system, and have or are seeking to impose various measures or interpretations of the current rules that risk significantly increasing compliance burdens, double taxation and uncertainty. One of the focal points of dissatisfaction relates to how the existing profit allocation and nexus rules take into account the increasing ability of businesses, in certain situations, to participate in the economic life of a jurisdiction without an associated or meaningful physical presence. An unparalleled reliance on intangibles and the rising share of services in cross border trade are among the causes typically identified. This dissatisfaction has created a political imperative to act in a significant number of jurisdictions. Cognisant that predictability and stability are fundamental building blocks of global economic growth, the Inclusive Framework is therefore concerned that a proliferation of uncoordinated and unilateral actions would not only undermine the relevance and sustainability of the international framework for the taxation of cross-border business activities, but will also more broadly adversely impact global investments and growth.

12. This economic and political context is at the foundation of the programme of work for each Pillar outlined in this paper, which has been developed by the Inclusive Framework with a view to reporting progress to the G20 Finance Ministers in June 2019 and delivering a long-term and consensus-based solution in 2020. This timeline is extremely ambitious given the need to revisit fundamental aspects of the international tax system, but is reflective of the political imperative that all members of the Inclusive Framework attach to finding a timely resolution of the issues at stake.

13. A consensus based solution to be agreed among the 129 members of the Inclusive Framework will, in addition to the important technical work that must be carried out, require political engagement and endorsement as the interests at stake for members go beyond technical issues and will have an impact on revenues and the overall balance of taxing rights. For a solution to be delivered in 2020, the outlines of the architecture will need to be agreed by January 2020. This outline will have to include a determination of the nature of, and the interaction between, both Pillars, and will have to reduce the number of options to be pursued under Pillar One. The solution should reflect the right balance between precision and administrability for jurisdictions at different levels of development, underpinned by sound economic principles and conceptual basis. Furthermore, it would be important to ensure a level playing field between all jurisdictions; large or small, developed or developing. The G20 process can provide important momentum in this regard. As indicated in the Policy Note,[8] the rules agreed should not result in taxation where there is no economic profit nor should they result in double taxation.

14. The work programme contained in this paper provides a path to finding such a solution but will require an early political steer informed by an economic analysis and impact assessment of the possible designs of a solution, as described in Chapter IV.

15. Given the interlinked nature of these different elements the Steering Group of the Inclusive Framework will play a key role in advancing this work and developing proposals for the consideration of the Inclusive Framework.

16. To support this process and enable the Steering Group to fulfil its mandate, technical work, including on the economic analysis, at the subsidiary body level will start immediately on all current proposals as needed to support the Steering Group. Once there

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is an agreed architecture proposed by the Steering Group and agreed by the Inclusive Framework, the subsidiary bodies will revert to their more traditional role of working towards the implementation of an agreed policy direction.

17. The programme of work for the future technical work contained in this document needs to be seen in this context. It remains dynamic throughout, recognising that new technical issues may emerge as the work progresses. It has a preparatory focus initially and then turns more definitive once an overall architecture has been agreed. It recognises that there are cross-cutting issues that affect both Pillars requiring close coordination. Finally, it recognises the need for the Steering Group to play a central and ongoing role in managing the work and provide direction as and when needed to achieve a successful outcome.

18. Chapter II of the document focuses on the allocation of taxing rights (Pillar One), and describes the different technical issues that need to be resolved to undertake a coherent and concurrent revision of the profit allocation and nexus rules.

19. Chapter III focuses on remaining BEPS issues (Pillar Two), and describes the work to be undertaken in the development of a global anti-base erosion (GloBE) proposal that would, through changes to domestic law and tax treaties, provide jurisdictions with a right to "tax back" where other jurisdictions have not exercised their primary taxing rights or the payment is otherwise subject to low levels of effective taxation.

20. Chapter IV discusses work to be undertaken in connection with an impact assessment and economic analysis of the proposals.

21. Chapter V explains how the work under both Pillars is organised and articulates the role of the Steering Group in steering, monitoring and co-ordinating the Programme of Work and related outputs in order to ensure that the Inclusive Framework can deliver on its commitment to arrive at a consensus solution and produce a final report by the end of 2020. The schedule of meetings of the Inclusive Framework will be adapted accordingly.

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[5] OECD (2019), Public Consultation Document, *Addressing the Tax Challenges of the Digitalisation of the Economy*, 13 February – 6 March 2019, www.oecd.org/tax/beps/public-consultation-document-addressing-the-tax-challenges-of-the-digitalisation-of-the-economy.pdf.

[6] All written submissions made to the Public Consultation Document are available at: www.oecd.org/tax/beps/public-comments-received-on-the-possible-solutions-to-the-tax-challenges-of-digitalisation.htm.

[7] This matter was recently addressed in a Policy Paper released by the International Monetary Fund (IMF), stressing that the challenges raised by digitalisation are emblematic of wider vulnerabilities in the international tax system that cannot be addressed by small scale reforms but rather ask for a more fundamental reconsideration (International Monetary Fund (2019), *Corporate Taxation in the Global Economy*, Policy Paper No 19/007, Washington D.C., accessible at: https://www.imf.org/en/Publications/Policy-Papers/Issues/2019/03/08/Corporate-Taxation-in-the-Global-Economy-46650.

[8] See footnote 4.

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Chapter II – Revised Nexus and Profit Allocation Rules (Pillar One)

22. Under Pillar One, three proposals have been articulated to develop a consensus-based solution on how taxing rights on income generated from cross-border activities in the digital age should be allocated among countries – namely, the "user participation" proposal,[1] the "marketing intangibles" proposal[2] and the "significant economic presence" proposal.[3]

23. These proposals have important differences, including the objective and scope of the reallocation of taxing rights – hereafter, the "new taxing right". At the same time, they all allocate more taxing rights to the jurisdiction of the customer and/or user – hereafter, the "market jurisdictions"[4] – in situations where value is created by a business activity through (possibly remote) participation in that jurisdiction that is not recognised in the current framework for allocating profits. Further, they have important common policy features, as they all contemplate the existence of a nexus in the absence of physical presence, contemplate using the total profit of a business, contemplate the use of simplifying conventions (including those that diverge from the arm's length principle) to reduce compliance costs and disputes – a feature supported by many commentators at the public consultation, who expressed concerns about approaches that would add complexity to existing tax rules –, and would operate alongside the current profit allocation rules.

24. Hence, although further work will be conducted in parallel to reach a political agreement on the objective and scope of a unified approach, the existing commonalities suggest that there is sufficient scope to establish a programme of work considering together some key design features of a consensus-based solution under Pillar One. The technical issues that need to be resolved under the programme of work may be grouped into three building blocks, namely:

- different approaches to determine the amount of profits subject to the new taxing right and the allocation of those profits among the jurisdictions;
- the design of a new nexus rule that would capture a novel concept of business presence in a market jurisdiction reflecting the transformation of the economy, and not constrained by physical presence requirement; and
- different instruments to ensure full implementation and efficient administration of the new taxing right, including the effective elimination of double taxation and resolution of tax disputes.

25. The programme of work will invite subsidiary bodies to explore these issues and assess their implications, with a view to assisting the Steering Group to reach a unified approach on Pillar One which will facilitate a political agreement.

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1. New profit allocation rules

1.1. Overview

26. The new taxing right requires a method to quantify the amount of profit reallocated to market jurisdictions, and a method to determine how that profit should be allocated among the market jurisdictions entitled to tax under the new taxing right. The different methods suggested so far to determine the profit subject to the new taxing right will be further explored, including the possible use of more simplifications to minimise compliance costs and disputes.

27. Due consideration will be given to concerns about the complexity and uncertainty of the methods articulated so far, and the possible advantages of using other simplified approaches. Additionally, this work will consider the feasibility of business line or regional segmentations, different mechanisms to allocate the profit to the relevant market jurisdictions, the design of various scoping limitations and alternative treatments of losses. It is recognised that, due to the nature and the variety of possible approaches that are to be considered in this work, the scope of the work may need to be adapted as the work progresses.

1.1. New profit allocation rules

The programme of work would explore issues and options in connection with new profit allocation rules. These issues and options are expected to include:

1) The development of conceptually underpinned methods for determining the amount of profit and loss subject to the new taxing right, consistent with the principle of avoiding double taxation;
2) The use of simplification measures where appropriate to limit the burden of the new rules on tax administrations and taxpayers alike; and
3) An assessment of the administrability of the features of any proposal, taking into consideration capacity and resource constraints.

1.2. Modified residual profit split method

28. The MRPS method would allocate to market jurisdictions a portion of an MNE group's non-routine profit that reflects the value created in markets that is not recognised under the existing profit allocation rules. It involves four steps: (i) determine total profit to be split; (ii) remove routine profit, using either current transfer pricing rules or simplified conventions; (iii) determine the portion of the non-routine profit that is within the scope of the new taxing right, using either current transfer pricing rules or simplified conventions; and (iv) allocate such in-scope non-routine profit to the relevant market jurisdictions, using an allocation key.

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29. The programme of work will explore the issues and alternative options associated with each of these steps, including possible simplifications. Further, given that the scope of the new taxing right is not intended to cover all profit, the MRPS method will coexist with the existing transfer pricing rules and rules for coordinating these two sets of rules will be necessary to provide certainty and minimise disputes.

1.2. Modified Residual Profit Split

The programme of work would explore options and issues relating to a modified residual profit split method. These issues and options are expected to include:

1) The development of rules that govern how total profits should be computed for purposes of applying the Modified Residual Profit Split ("MRPS") method.
   a. This requires consideration of the suitability of using accounting rules for the computation of total profits, the relevant measure of profit to be used (such as pre-tax profit etc.), and what adjustments (if any) would be appropriate.
   b. It also requires an evaluation of the relative merits of determining total profits:
      i) on a group-wide basis, including how this approach could be integrated with the existing international tax system to ensure that a group could identify which entity's or entities' profit is subject to the new taxing right exercised by a particular jurisdiction; or
      ii) on an entity or aggregated entity basis, including how the entity or entities in scope could be identified and, where multiple entities are identified, how the combined profits of these entities would be reallocated under the new taxing right.
2) The development of rules to bifurcate total profit into routine and non-routine components. This would require an evaluation of the relative merits of using current transfer pricing rules and simplified approaches. In particular,
   a. The evaluation of using current transfer pricing rules would include consideration of the following:
      i. the impact of future transfer pricing disputes (which can take a number of years to conclude) on routine and non-routine profit computations; and
      ii. the mechanisms that local tax administrations would require to confirm the amount of non-routine profits.
   b. The evaluation of using simplified approaches would include consideration of possible proxies for the determination of non-routine profit.
3) The development of rules to quantify the portion of non-routine profit subject to the new taxing right. This would include an evaluation of the relative merits of using the approaches set forth below.
   a. The adaptation of the current transfer pricing rules, taking into account the issues raised above.

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b. The use of a proxy based on capitalised expenditures. This would include consideration of:

i. how costs relating to the activities and assets in and out of scope of the new taxing right should be identified;

ii. how the "useful lives" of different categories of expenditure and investment should be determined and applied; and

iii. how concerns that cost may not always be an appropriate indicator of value could be addressed.

c. The use of a proxy based on projections of future income.

d. The use of a proxy based on fixed percentages of total non-routine income, including the possibility of using different fixed percentages for different lines of business.

e. Such other proxies as may be developed by the detailed work in this area.

4) The development of rules to allocate the identified profit subject to the new taxing rights among the relevant market jurisdictions. This requires the evaluation of possible allocation keys, such as revenues.

5) The integration of the MRPS method with the existing transfer pricing rules without giving rise to double taxation or double non-taxation.

6) Other technical issues that arise from the exploration of the above topics, recognising that the detailed points discussed above may need to be adapted as the work progresses.

* *A fundamental issue associated with the MRPS method is whether it would be applied to an MNE group as a whole, or whether it would separately take into account different business lines and geographical regions. That topic is addressed below.*

1.3. Fractional apportionment method

30. The fractional apportionment method involves the determination of the amount of profits subject to the new taxing rights without making any distinction between routine and non-routine profit. One possible approach to assessing the profit derived by a non-resident enterprise is to take into account the overall profitability of the relevant group (or business line). This method would involve three steps: (i) determine the profit to be divided, (ii) select an allocation key, and (iii) apply this formula to allocate a fraction of the profit to the market jurisdiction(s).

31. In exploring the development of a fractional apportionment method, the programme of work will explore a number of issues, including:

- Determining options for the starting point of the computation of the relevant profits subject to the fractional apportionment mechanism. Such options may include the profit of the selling entity as determined by the current transfer pricing rules, or by applying a global profit margin to local sales, or by any other measures as may be considered appropriate.

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- Explore different allocation keys that could be taken into account in constructing the formula that would be used to apportion the relevant profit.
- Addressing the interaction between the current profit allocation framework with the fractional apportionment approach, especially if a decision is made to adjust the amount of profit allocated to the market jurisdiction based on the overall profitability of the relevant group or business line.

1.3. Fractional apportionment

The programme of work would explore issues and options relating to a fractional apportionment method. These issues and options are expected to include:

1) The development and evaluation of a method to determine the profits of a non-resident entity or group that would be subject to the fractional apportionment mechanism, including the possibility of taking into account overall profitability.
2) The financial accounting regime and measure upon which the profit determination would be based for this purpose.
3) The factors, including employees, assets, sales, and users, that could be taken into account in constructing the formula that would be used to apportion the relevant profit.
4) The design of rules to coordinate the effect of the fractional apportionment method and the current transfer pricing system, without giving rise to double taxation or double non-taxation. This would include, for example, rules related to how the burden of the new taxing right might be shared with other entities in the MNE group where the profits of a non-resident entity take into account the overall profitability of the group.

1.4. Distribution-based approaches

32. Consistent with the strong demand for simplicity and administrability, the programme of work will also explore other possible simplified methods. This includes consideration of a simplified approach grounded in the twin considerations of the interest in allocating more profit to market jurisdictions and reducing the ongoing controversies associated with the proper pricing of marketing and distribution activities. In contrast to the MRPS method, this approach might address, in addition to non-routine profit, profit arising from routine activities associated with marketing and distribution.

33. One possibility would be to specify a baseline profit in the market jurisdiction for marketing, distribution and user-related activities. Other options might also be considered, for example, the baseline profit could increase based on the MNE group's overall profitability. Through this mechanism, some of the MNE group's non-routine profit would be reallocated to market jurisdictions. The baseline profit could also be modified by additional variables to accommodate, for instance, industry and market differences.

34. The design of such an approach would require consideration of whether it would envisage allocating to market jurisdictions a profit which would be a final allocation – i.e. an allocation which taxpayers or tax authorities would not be able to re-evaluate under the

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current transfer pricing rules. Alternatively, such a simplified approach could be designed to allow the allocation of a higher return under traditional transfer pricing principles to market jurisdictions, such as in those cases where a local distribution company owns and controls all the risks for highly profitable marketing intangibles.

35. In scenarios involving a remote activity, an issue that will need to be explored is whether the amount of profit (including any baseline profit) taxable by that market jurisdiction would be the same as for locally-based marketing and distribution activities, or whether that amount should be reduced in some formulaic manner.

1.4. Distribution-based approaches

The programme of work would explore issues and options related to distribution-based approaches. These issues and options are expected to include:

1) The development of rules providing a baseline amount of profit attributable to marketing, distribution, and user-related activities.
2) The assessment of whether and how a baseline amount could be adjusted based on a group's overall profitability and other relevant factors to effectively allocate a proportion of routine and non-routine profits to market jurisdictions. This could include consideration of how concerns that cost may not always be an appropriate indicator of value could be addressed.
3) The assessment of whether the baseline could function as a minimum or maximum return.
4) The assessment of whether and how any such adjusted profits or returns could be applied where the relevant group has no established tax presence in the market jurisdiction.
5) How the approach could be coordinated with the current transfer pricing system without giving rise to double taxation or double non-taxation.

1.5. Explore the use of business line and regional segmentation

36. The profitability of a MNE group can vary substantially across different business lines and regions. To avoid unintended outcomes and distortions, and ensure a proper balance between simplicity and precision, the programme of work will explore the possibility of determining the profits subject to the new taxing right on a business line and/or regional basis.

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1.5. Business line and regional segmentation

The programme of work would explore issues and options for business line and regional segmentation. These issues and options are expected to include:

1) The design of rules to define and delineate among different business lines for the purposes of applying the approaches described above, and an evaluation of the administrability associated with such rules. As elsewhere, these rules would need to be administrable for taxpayers and tax administrations with different capability and resource constraints. In developing these rules consideration would be given to (i) the information MNE groups already prepare (e.g. for accounting, securities law, or regulatory purposes); (ii) the extent to which this information could be used reliably to segment MNE groups by business line; and (iii) any other required information.

2) The design of rules or principles to allow the regional segmentation of an MNE group's activities for the purposes of applying the approaches described above. These rules or principles could need to consider many of the same issues identified for business line segmentation.

1.6. Design scoping limitations

37. To the extent that the activities and assets within the scope of the new taxing right would not be undertaken or exploited by all businesses, scope limitations may be appropriate. The programme of work will explore different limitations that could operate either by reference to the nature (e.g. through negative exclusions, safe harbours, and/or other screening criteria) or the size (e.g. thresholds based on revenue or other relevant factors) of a given business. In this task, due consideration will be given to the feasibility of business line segmentations and any legal constraint arising from other international obligations. Due consideration will also be given to whether or to what extent any new taxing right would apply to certain items such as commodities and other primary products, and financial instruments.

1.6. Design scope limitations

The programme of work would explore issues and options in connection with design scoping limitations. These issues and options are expected to include:

1) Potential limitations on the scope of the new taxing right. This work would include the development of rules to limit the scope of the new taxing right based on the size of a MNE group or business line. It would also include an evaluation of rules that could focus the scope of the rules on businesses that are of a type to which the rules should apply.

2) Consideration would also be given to whether any scope limitations are legally constrained by other international obligations, e.g. trade regulations.

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1.7. Develop rules on the treatment of losses

38. It is important that the new profit allocation rules have effective application to both profits and losses. The programme of work will explore the different options available for the treatment of losses under the new taxing right.

1.7. Treatment of losses

The programme of work would explore issues and options in connection with the design of rules for the treatment of losses. These issues and options are expected to include:

1) The development of profit allocation rules that apply symmetrically to profits and losses. This should include consideration of the practical consequences of this approach, such as when and how a loss-making MNE group would be required to file a tax return in market jurisdictions.

2) The development of an "earn out" approach to losses, wherein an MNE group would maintain a notional cumulative loss account, and profits would be subject to the new taxing right only once that cumulative loss account had been reduced to zero by subsequent profits.

3) The development of a hybrid system incorporating elements of the symmetric treatment of losses and "earn out" approach could also be considered.

4) The determination of whether all or a defined subset of the losses of an MNE group (such as carry-forward losses, losses in relation to a particular business line, or losses in a particular region/jurisdiction) should be taken into account under the approaches described above.

2. New nexus rules

39. The work programme will explore the development of a concept of remote taxable presence (i.e. a taxable presence without traditional physical presence) and a new set of standards for identifying when such a remote taxable presence exists. The work programme will also consider a new concept of taxable income sourced in (i.e. derived from) a jurisdiction. This taxing right would generally not be constrained by physical presence requirements.

40. Developing a new non-physical presence nexus rule to allow market jurisdictions to tax the measure of profits allocated to them under the new profit allocation rules would require an evaluation of the relative merits of alternative approaches, including:

- amendments to the definition of a "permanent establishment" (PE) in Article 5 of the OECD Model Convention,[5] and potential ensuing changes to Article 7 of the OECD Model Convention;
- development of a standalone rule establishing a new and separate nexus, either through a new taxable presence or a concept of source.

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2.1. New nexus rules rule and other treaty related issues

The programme of work would explore options and issues related to a new nexus rule. These options and issues are expected to include:

1. The development of a new nexus rule that would capture a novel concept of a business presence in a market jurisdiction reflecting the transformation of the economy and not constrained by physical presence requirements, and which would allow market jurisdictions to exercise taxing rights over the measure of profits allocated to them under the new profit allocation rules. This would require an evaluation of the relative merits of alternative approaches, including the making of recommendations on:
    a. Amending Articles 5 and 7 of the OECD Model Convention to deem a PE to exist where an MNE exhibits a remote yet sustained and significant involvement in the economy of a jurisdiction and to accommodate the new profit allocation rules. This would also require a consideration of any impact of such an amendment on other provisions that use the PE concept (Articles 10-13, 15, 21, 22, and 24) and other issues (such as VAT and social security contributions).
    b. Alternatively, introducing a new standalone provision giving market jurisdictions a taxing right over the measure of profits allocated to them under the new profit allocation rules, which would require:
        - identifying and defining a new non-physical taxable presence separate from the PE concept;
        - identifying and defining a new concept of income taxable in the source jurisdiction (i.e. income derived from a particular source in a jurisdiction); and
        - the interaction between the new taxable presence or source income and existing provisions (including especially provisions governing non-discrimination).
2. The evaluation and development of indicators of an MNE group's remote but sustained and significant involvement in the economy of a market jurisdiction. This would require:
    a. a sustained local revenue threshold (both monetary and temporal); and
    b. a range of additional indicators which, in combination with sustained local revenues, would be taken to demonstrate a link beyond mere selling between those revenues and the MNE's interaction with the economy of a jurisdiction.
3. The necessity to change any other treaty provision, such as Article 9, to allow market jurisdictions to exercise taxing rights over the measure of profits allocated to them under the new nexus and profit allocation rules.
4. The considerations to ensure tax certainty, administrability, and effective dispute prevention and resolution.

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3. Implementation of the new taxing right

3.1. Elimination of double taxation

41. The proposals under this Pillar may, depending on the design options eventually chosen, envisage reallocating taxing rights over a proportion of an MNE group's profit (however defined), rather than over the profit from specific transactions or activities undertaken by particular separate entities. It may therefore not be immediately clear which member(s) of an MNE group should be considered to derive the relevant income. This leads to questions about how, in practice, source jurisdictions would exercise the reallocated taxing rights, and how residence jurisdictions would provide relief from double taxation of the relevant income. It is also recognised that the new taxing right may raise new questions relating to the sufficiency of existing double tax relief mechanisms.

42. The work programme will consider those questions and, in particular, explore the effectiveness of the existing treaty (and domestic law) provisions and the need to develop new or enhanced provisions. Consideration would also be given to a multilateral competent authority mutual agreement or framework that would provide additional guidance.

43. The programme of work will also examine the current dispute prevention and resolution procedures in the context of the new nexus and profit allocation rules and, where necessary, make recommendations for changes or enhancements to these procedures, including arbitration procedures, multilateral competent authority agreements, etc.

44. Where appropriate, the work could also consider whether multilaterally co-ordinated risk assessment could be helpful in applying the new nexus and profit allocation rules and make recommendations accordingly. This work could be informed by the ongoing work within the Forum on Tax Administration, including the International Compliance Assurance Programme.

3.1. Elimination of double taxation and dispute resolution

The programme of work would explore options and issues related to the elimination of double taxation and the avoidance and resolution of disputes in relation to the new nexus and profit allocation rules. These options and issues are expected to include:

1) The effectiveness of the existing treaty provisions and the need to develop new or enhanced, treaty provisions for the effective elimination of double taxation in relation to the new nexus and profit allocation rules. This work should examine, in particular:
   a. The extent to which, under the new profit allocation rules, the clear identification of the relevant taxpayer in respect of the income that is reallocated would allow the existing treaty and domestic law mechanisms for eliminating double taxation to continue to operate as intended.
   b. The effectiveness of the existing mechanism for addressing economic double taxation by way of appropriate adjustments under Article 9(2) of the OECD Model Convention and the need for this mechanism to be updated or supplemented in relation to the new profit allocation rules.

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c. The effectiveness of the existing mechanisms for eliminating juridical double taxation by using the exemption or credit method and the need for those mechanisms to be updated or supplemented in relation to the new profit allocation rules.

2) The interaction between the new taxing right and existing taxing rights – in particular those permitting the imposition of withholding taxes on payments (such as royalty payments or payments for services) forming part of the reallocated income. Appropriate recommendations for the development of rules or guidance designed to coordinate the application of these taxing rights in the market jurisdiction would also be explored.

3) The current dispute prevention and resolution procedures, in the context of the new nexus and profit allocation rules. Where necessary, appropriate recommendations for changes or enhancements to these rules would be made. In particular, given that, under some design options, the new approaches will have a more multilateral focus, the work would examine the extent to which these existing procedures need updating because they have focused largely on solving bilateral disputes. This will require, in particular, the evaluation of the need for multilateral approaches to dispute avoidance and resolution.

4) The consideration for multilaterally co-ordinated risk assessment in applying the new nexus and profit allocation rules. This work should be informed by the ongoing work within the Forum on Tax Administration.

3.2. Administration

45. The implementation of any of the approaches would first require identifying the taxpayer who bears the tax liability and the filing obligations. Where the tax liability is assigned to an entity that is not a resident of the taxing jurisdiction, it would be necessary to address the required enforcement and collection arrangements. The work programme will need to examine, and develop recommendations to address, these enforcement and collection issues.

46. One option could be to design simplified registration-based collection mechanisms. A simplified registration-based collection mechanism, together with enhanced exchange of information and cooperation mechanisms may be sufficient for compliance and collection purposes. However, as a complementary measure, a withholding tax mechanism will also be explored in the work programme, where it does not lead to double taxation.

47. The effective application of any of the approaches would likely require a number of data points (e.g. total profit, total profit per business line, sales, users etc.) to be available not only to the tax administrations, but also to the MNE group and the taxpayer itself. In all events, the implementation of any of the approaches would likely result in the need for new data, documentation and reporting obligations. The work programme will develop recommendations for a system to report and disseminate information needed to administer the new taxing right. One option for such a system could be based on the existing framework and technology used for the exchange of country-by-country reports under BEPS Action 13. The data points could be included on a separate report, as the CbC reports are limited to assist with risk assessment.

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48. The work programme will furthermore need to examine the challenges that may arise in determining and reporting the location of sales.

3.2. Administration

The programme of work would explore options and issues in connection with the administration of the new taxing right. These options and issues are expected to include:

1) The development of measures needed for the effective administration of the new taxing right. This work will explore collection mechanisms including a withholding tax, reporting obligations and mechanisms to disseminate that information to the tax authorities.

2) The technical and practical issues that may arise in determining and reporting the location of sales, including:

   a. establishing the final destination of remote sales, sales to a market through third party intermediaries located in a third country, sales in multi-sided business models where the users/consumers are located in different jurisdictions, sales of intermediate goods, and destination of services;

   b. the need for new reporting obligations; and

   c. the need for new and/or revised protocols for the exchange of information between jurisdictions.

3.3. Changing existing tax treaties

49. Any proposal seeking an allocation of taxing rights over a portion of a non-resident enterprise's business profits in the absence of physical presence and computed other than in accordance with the arm's length principle would require changes to existing tax treaties if they are to be successfully implemented. Different approaches could be envisaged to streamline the implementation of these changes and these options would need to be further assessed in the work programme in light of the precise nature of the changes to be made.

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3.3. Modifying Tax Treaties

The programme of work would explore options and issues related to modifying existing tax treaties, with the aim of ensuring that all parties committing to the changes can implement them at substantially the same time. These options and issues are expected to include:

1. Ways to coordinate the effective implementation of the tax treaty changes required to introduce the new nexus and profit allocation rules and address the challenges that arise in relation to the elimination of double taxation and the resolution of associated disputes.
2. The relative merits of implementing these treaty changes by amending or supplementing the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS* (MLI) to further modify existing treaties, or by establishing a new multilateral convention.

References

[1] See paragraphs 17-28 of the Public Consultation Document.

[2] See paragraphs 29-49 of the Public Consultation Document.

[3] See paragraphs 50-54 of the Public Consultation Document.

[4] In the context of the programme of work, the term "market jurisdiction" refers to the jurisdiction where the customers of the business are located or, in the case of businesses that supply services to other businesses, the jurisdiction where those services are used. In the context of many digitalised business models, this definition would cover the jurisdiction where the user is located either because the user acquires goods or services directly from the on-line provider or because the on-line provider provides services to another business (such as advertising) targeting such users.

[5] What matters, of course, is what is in existing bilateral or multilateral tax treaties – whether these are based on the OECD Model Convention or not. But for clarity and convenience this note talks about the OECD Model Convention.

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Chapter III – Global anti-base erosion proposal (Pillar Two)

50. Under Pillar Two, the Members of the Inclusive Framework have agreed to explore an approach that leaves jurisdictions free to determine their own tax system, including whether they have a corporate income tax and where they set their tax rates[1], but considers the right of other jurisdictions to apply the rules explored further below where income is taxed at an effective rate below a minimum rate. Within this context, and on a without prejudice basis, the members of the Inclusive Framework have agreed a programme of work that contains exploration of an inclusion rule, a switch over rule, an undertaxed payment rule, and a subject to tax rule. They have further agreed to explore, as part of this programme of work, issues related to rule co-ordination, simplification, thresholds, compatibility with international obligations and any other issues that may emerge in the course of the work.

51. Consistent with the Policy Note *Addressing the Tax Challenges of the Digitalising Economy*, approved on 23 January 2019, Members of the Inclusive Framework agree that any rules developed under this Pillar should not result in taxation where there is no economic profit nor should they result in double taxation.

52. This part sets out the global anti-base erosion (GloBE) proposal which seeks to address remaining BEPS risk of profit shifting to entities subject to no or very low taxation It first provides background including the proposed rationale for the proposal and then summarises the mechanics of the proposed rules together with a summary of the issues that will be explored as part of the programme of work.

53. While the measures set out in the BEPS package have further aligned taxation with value creation and closed gaps in the international tax architecture that allowed for double non-taxation, certain members of the Inclusive Framework consider that these measures do not yet provide a comprehensive solution to the risk that continues to arise from structures that shift profit to entities subject to no or very low taxation. These members are of the view that profit shifting is particularly acute in connection with profits relating to intangibles, prevalent in the digital economy, but also in a broader context; for instance group entities that are financed with equity capital and generate profits, from intra-group financing or similar activities, that are subject to no or low taxes in the jurisdictions where those entities are established.[2]

54. The global anti-base erosion proposal is made against this background. It is based on the premise that in the absence of multilateral action, there is a risk of uncoordinated, unilateral action, both to attract more tax base and to protect existing tax base, with adverse consequences for all countries, large and small, developed and developing as well as taxpayers. It posits that global action is needed to stop a harmful race to the bottom, which otherwise risks shifting taxes to fund public goods onto less mobile bases including labour and consumption, effectively undermining the tax sovereignty of nations and their elected legislators. It maintains that developing countries, in particular those with smaller markets,

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may also lose in such a race. Over recent decades, tax incentives have become more widespread in developing countries as they seek to compete to attract and retain foreign direct investment.[3] Some studies have found that, in developing countries, tax incentives may be redundant in attracting investment.[4] Revenue forgone from tax incentives can also reduce opportunities for much-needed public spending on infrastructure, public services or social support, and may hamper developing country efforts to mobilise domestic resources. There is evidence that tax incentives are frequently provided in developing countries in circumstances where governments are confronted with pressures from businesses to grant them.[5] Depending on its ultimate design, the GloBE proposal could effectively shield developing countries from the pressure to offer inefficient incentives and in doing so help them in better mobilising domestic resources by ensuring that they will be able to effectively tax returns on investment made in their countries. The proposal therefore seeks to advance a multilateral framework to achieve a balanced outcome which limits the distortive impact of direct taxes on investment and business location decisions. The proposal is also intended as a backstop to Pillar One for situations where the relevant profit is booked in a tax rate environment below the minimum rate.

55. Recognising, as stated in the Action 1 Report, that it would be difficult, if not impossible, to ring-fence the digital economy from the rest of the economy for tax purposes, the scope of the anti-base erosion proposal is not limited to highly digitalised businesses. By focusing on the remaining BEPS challenges, it proposes a systematic solution designed to ensure that all internationally operating businesses pay a minimum level of tax. In so doing, it helps to address the remaining BEPS challenges linked to the digitalising economy, where the relative importance of intangible assets as profit drivers makes highly digitalised business often ideally placed to avail themselves of profit shifting planning structures.

1. GloBE proposal

56. The proposal seeks to address the remaining BEPS challenges through the development of two inter-related rules:

1) an ***income inclusion rule*** that would tax the income of a foreign branch or a controlled entity if that income was subject to tax at an effective rate that is below a minimum rate; and

2) a ***tax on base eroding payments*** that would operate by way of a denial of a deduction or imposition of source-based taxation (including withholding tax), together with any necessary changes to double tax treaties, for certain payments unless that payment was subject to tax at or above a minimum rate.

57. These rules would be implemented by way of changes to domestic law and double tax treaties and would incorporate a co-ordination or ordering rule to avoid the risk of economic double taxation that might otherwise arise where more than one jurisdiction sought to apply these rules to the same structure or arrangements.

58. The combined rules are intended to affect behaviour of taxpayers and jurisdictions alike which is expected to limit the revenue impact of rule order for jurisdictions. Rather, rule order will need to be determined by reference to principles of good rule design including effectiveness, simplicity and transparency.

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2. Income inclusion rule

59. The income inclusion rule would operate as a minimum tax by requiring a shareholder in a corporation to bring into account a proportionate share of the income of that corporation if that income was not subject to an effective rate of tax above a minimum rate. This rule could supplement a jurisdiction's CFC rules.

60. The income inclusion rule would ensure that the income of the MNE group is subject to tax at a minimum rate thereby reducing the incentive to allocate returns for tax reasons to low taxed entities. The income inclusion rule would have the effect of protecting the tax base of the parent jurisdiction as well as other jurisdictions where the group operates by reducing the incentive to put in place intra-group financing, such as thick capitalisation, or other planning structures that shift profit to those group entities that are taxed at an effective rate of tax below the minimum rate.

2.1. Top up to a minimum rate

61. The work programme would explore an inclusion rule that would impose a minimum tax rate. This approach is consistent with a policy of establishing a floor on tax rates by ensuring that a multinational enterprise (MNE) would be subject to tax on its global income at the minimum rate regardless of where it was headquartered. Consideration could be given to an exception to this principle in the case of income taxed below the minimum rate and benefiting from a harmful preferential regime, which would then be taxed at the higher of the minimum rate or the full domestic rate.

62. In general terms, it is contemplated that this rule would apply where the income is not taxed at least at the minimum level – that is, it would operate as a top up to achieve the minimum rate of tax.[6] A top-up to a minimum rate increases the likelihood of the proposal resulting in a transparent and simple global standard that sets a floor for tax competition and makes it easier to develop consistent and co-ordinated rules. It would further increase the likelihood of achieving a level playing field for both jurisdictions and MNEs and reduces the incentive for inversions and other restructuring transactions designed to take advantage of low effective rates of taxation below the threshold.

63. A minimum tax tied to each country's corporate income tax (CIT) rate would result in a more complex and opaque international framework given the significant variance in CIT rates across Inclusive Framework members. For jurisdictions with high domestic CIT rates, such a design would create a cliff-edge effect for income that was subject to tax at around the minimum tax rate threshold.

2.2. Use of a fixed percentage

64. The work programme would explore an approach using a fixed percentage rather than a percentage of the parent jurisdiction's CIT rate or a range or corridor of CIT rates.

65. While there is precedent in the CFC context for using a percentage of the parent jurisdiction's CIT rate, this approach would give rise to significant variations in the rates used under the inclusion rule, which would result in a rule that is not in line with the intended policy of the GloBE proposal in addressing the risks associated with low-taxation. It would not result in a level playing field and make it difficult to co-ordinate such a rule with the undertaxed payments rule, significantly increasing the risk of double taxation.

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66. Another possible approach would be to use a range or corridor of minimum rates depending on other design elements of the inclusion rule that impact on the effective rate of tax. However, it would be difficult for jurisdictions to quantify the impact of different design features and determine how that translates to an appropriate rate thereby resulting in potentially arbitrary and less transparent outcomes, making it harder for jurisdictions to co-ordinate their rules, thereby increasing compliance and administration costs and leading to a greater risk of double taxation.

67. An approach based on a fixed percentage tax rate is the simplest option from a design perspective. It provides greater transparency and facilitates rule co-ordination, thereby reducing administration and compliance costs. It also helps maintain a level playing field for jurisdictions and taxpayers and reduces the incentives for tax driven inversions and other restructuring transactions.

2.3. Exploration of simplifications

68. The programme of work starts from the proposition that in principle the tax base would be determined by reference to the rules that jurisdictions already use for calculating the income of a foreign subsidiary under their CFC rules, or in the absence of CFC rules, for domestic CIT purposes. Such an approach means, however, that each subsidiary of an MNE would need to recalculate its income in accordance with the tax base calculations in the parent jurisdiction. This may result in significant compliance costs and lead to situations where technical and structural differences between the calculation of the tax base in the parent and subsidiary jurisdiction could result in an otherwise highly taxed subsidiary being treated as having a low effective rate of tax for reasons unrelated to the policy drivers underlying the GloBE proposal.

69. For example, differences between countries in the treatment of carry forward losses and the timing of recognition of income and expenses could impact on the calculation of the effective rate of tax in different jurisdictions. Structural differences in the design of different jurisdictions' tax bases could result in the application of the rule in cases that might not give rise to the policy concerns that are intended to be addressed by the inclusion rule.

70. In order to improve compliance and administrability for both taxpayers and tax administrations and to neutralise the impact of structural differences in the calculation of the tax base, the programme of work will explore simplifications. Simplifications could also serve to make the rules more transparent and help with co-ordination in the operation of the rules.

71. One simplification could be to start with relevant financial accounting rules subject to any agreed adjustments as necessary. The starting point for such an approach could be the financial accounts as prepared under the laws and relevant accounting standards of the jurisdiction of incorporation or establishment, which would be subject to agreed upon adjustments to reflect timing and permanent differences between tax and financial accounting rules. Other simplification measures could also be explored as part of the programme of work.

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2.1. Inclusion Rule

The programme of work would explore options and issues in connection with the design of the income inclusion rule. These options and issues are expected to include:

1) A design that operates as a top up to a minimum rate but with an inclusion at the full rate for income taxed at below the minimum rate and benefitting from a harmful preferential regime;

2) A test for determining when income has been subject to tax at a minimum effective rate whereby:

   a. the tax rate would be based on a fixed percentage;

   b. the tax base would in principle be determined by reference to the rules applicable in the shareholder jurisdiction, but

   c. the design would consider simplifications with a view to reduce compliance costs and avoid unintended outcomes including exploring the possible use of financial accounting rules as a basis for determining net income (with appropriate adjustments including for losses and the timing of recognition of income and expenses).

3) The possible use and effect of carve-outs, including for:

   a. Regimes compliant with the standards of BEPS Action 5 on harmful tax practices, and other substance based carve-outs, noting however such carve-outs would undermine the policy intent and effectiveness of the proposal.

   b. A return on tangible assets.

   c. Controlled corporations with related party transactions below a certain threshold.

4) Different options of blending,[(1)] ranging from blending at the entity level to blending at global group level with a particular focus on blending at the jurisdictional versus global level; and

5) All other relevant design and technical issues, including:

   a. co-ordination with other international tax rules, such as withholding tax rules and other source based taxation rules, transfer pricing rules and adjustments, CFC and other inclusion rules;

   b. co-ordination between inclusion rules where, for instance, in a tiered ownership structure several jurisdictions may apply the rule;

   c. ownership thresholds;

   d. rules for the attribution of income and calculation of tax paid on that income; and

   e. rules for calculating the investor's tax liability.

[(1)] *Blending refers to the ability of taxpayers to mix high-tax and low-tax income to arrive at a blended rate of tax on income that is above the minimum rate.*

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72. There is a need to ensure that the income inclusion rule applies to foreign branches as well as foreign subsidiaries. For example, in the case of profits attributable to exempt foreign branches, or that are derived from exempt foreign immovable property, the income inclusion rule could be achieved through a switch-over rule that would turn off the benefit of an exemption for income of a branch, or income derived from foreign immovable property, otherwise provided by a tax treaty and replace it with the credit method where that income was subject to a low effective rate of tax in the foreign jurisdiction.

2.2. Switch-over rule

The programme of work would explore options and issues in connection with the design of the switch-over rule. These options and issues are expected to include:

1) The design of a switch-over rule for tax treaties that would allow the state of residence to apply the credit method instead of the exemption method where the profits attributable to a permanent establishment (PE) or derived from immovable property (which is not part of a PE) are subject to tax at an effective rate below the minimum rate; and

2) A design that, as much as possible, is simple to implement and to administer.

3. Tax on base eroding payments

73. The second key element of the proposal is a tax on base eroding payments that complements the income inclusion rule by allowing a source jurisdiction to protect itself from the risk of base eroding payments. More specifically, this element of the proposal would explore:

- an *undertaxed payments rule* that would deny a deduction or impose source-based taxation (including withholding tax)[7] for a payment to a related party if that payment was not subject to tax at a minimum rate; and
- a *subject to tax rule* in tax treaties that would only grant certain treaty benefits if the item of income was subject to tax at a minimum rate.

74. The undertaxed payments rule denies a deduction or a proportionate amount of any deduction for certain payments made to a related party unless those payments were subject to a minimum effective rate of tax.

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3.1. Undertaxed payments rule

The programme of work would explore options and issues in connection with the design of the undertaxed payments rule. These options and issues are expected to include:

1) A rule that would achieve a balance between a number of design principles including effectiveness to achieve its stated objectives, design compatibility and co-ordination with other rules, avoidance of double taxation and taxation in excess of economic profit, and minimising compliance and administration costs; and
2) A range of different design options including a consideration of:
   a. the types of related party payments covered by the rule (including measures to address conduit and indirect payments);
   b. the test for determining whether a payment is "undertaxed", which will include dealing with loss situations;
   c. the nature, extent and operation of the adjustment to be made under the rule (including whether it should be on the gross amount of the payment or limited to net income); and
   d. the possible use and effect of carve-outs including those referred to in Box 2.1 above.

75. The proposal also includes a subject to tax rule which could complement the undertaxed payment rule by subjecting a payment to withholding or other taxes at source and denying treaty benefits on certain items of income where the payment is not subject to tax at a minimum rate. This rule contemplates possible modifications to the scope or operations of the following treaty benefits, with priority given to interest and royalties:

a. The limitation on the taxation of business profits of a non-resident, unless those profits are attributable to a permanent establishment. (Article 7 of the OECD Model Convention)
b. The requirement to make a corresponding adjustment where a transfer pricing adjustment is made by the other Contracting State (Article 9 of the OECD Model Convention)
c. The limitation on taxation of dividends in the source state (Article 10 of the OECD Model Convention)
d. The limitations on taxation of interest, royalties and capital gains in the source state (Articles 11-13 of the OECD Model Convention)
e. The allocation of exclusive taxing rights of other income to the state of residence (Article 21 of the OECD Model Convention)

76. There are a number of broad issues to be explored in connection with the subject to tax rule, including the benefits of a withholding tax over a deduction denial approach, the degree of overlap with the undertaxed payments rule, and timing issues also considering the overall principle that any rule should include measures to avoid double taxation.

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77. The proposal also contemplates the exploration of the application of a subject to tax rule to unrelated parties as regards Articles 11 and 12 of the OECD Model Convention. The programme of work would explore risk areas that may justify an extension to unrelated parties or to other treaty benefits beyond interest and royalties. For instance, whether there are certain arrangements, using structured, but otherwise unrelated arrangements that could achieve tax outcomes inconsistent with what is intended by the GloBE proposal.

3.2. Subject to tax rule

The programme of work would explore options and issues in connection with the design of the subject to tax rule. These options and issues are expected to include:

1) Broad issues including:
   a) the need to amend bilateral tax treaties and other cost benefit considerations of a subject to tax rule next to an undertaxed payments rule;
   b) the design of a subject to tax test and the degree of overlap with the test for low taxation under an undertaxed payments rule;
   c) the operation of any withholding tax particularly where the effective rate of tax on the payment may not be known at the time the payment is made and including the need to address issues of possible double taxation;
   d) the identification of risks that would merit the extension of the subject to tax rules to payments between unrelated parties; and
2) Different rule designs, taking into account the specificities of the particular treaty benefit, the learnings from work on the undertaxed payments rule limited to interest and royalties, but also identifying risks that would merit the extension of the scope to other types of payments.

4. Rule co-ordination, simplification, thresholds and compatibility with international obligations

78. Further work will also be required on rule co-ordination, simplification measures, thresholds and carve-outs to ensure the proposal avoids the risk of double taxation, minimises compliance and administration costs and that the rules are targeted and proportionate. This work will address the priority in which the rules would be applied and how they interact with other rules in the broader international framework. In this context it is important to analyse the interaction between this proposal and other BEPS Actions. It will also explore compatibility with international obligations (such as non-discrimination) including, for EU members, the EU fundamental freedoms and how that compatibility could depend on the rule's detailed design.

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4.1. Co-ordination, simplification, thresholds and compatibility with international obligations

The programme of work would explore options and issues in connection with the design of co-ordination, simplification and threshold measures including interaction with BEPS Actions. These options and issues are expected to include:

1. Co-ordination between the undertaxed payments rule, subject to tax rule and income inclusion rule to minimise the risk of double taxation, including simplification measures that could further reduce compliance costs; and
2. Thresholds and carve-outs to restrict the application of the rules under the GLOBE proposal, including:
    a. Thresholds based on the turnover or other indications of the size of the group;
    b. *De minimis* thresholds to exclude transactions or entities with small amounts of profit or related party transactions; and
    c. The appropriateness of carve-outs for specific sectors or industries.
3. Compatibility with international obligations (and, where appropriate, the EU fundamental freedoms).

References

[1] Previous OECD studies, including OECD (2008), *Taxation and Economic Growth*, Working Paper No. 620, have suggested that there may be efficiency benefits in improving the design of the corporate income tax and reducing its relative weight in a country's tax system. However, these studies, which were issued before the BEPS Project was launched, did not consider the proposals currently under discussion under Pillar Two. Current proposals should be designed in a way that preserves the ability of jurisdictions to determine their own tax systems.

[2] Other members are of the view that the rules explored within this pillar may affect the sovereignty of jurisdictions that for a variety of reasons have no or low corporate taxes in particular where they target income arising from substantive activities.

[3] See, for example, IMF, OECD, UN, and World Bank (2015), *Options for Low Income Countries' Effective and Efficient Use of Tax Incentives for Investment*, A Report to the G-20 Development Working Group, pp. 8-9.

[4] Ibid., pp. 11-12.

[5] Ibid., pp. 35-36.

[6] Countries would, of course, remain free to tax a subsidiary's income (or particular categories of income) at a rate higher than the minimum rate as they already do under their CFC rules.

[7] For treaty-related aspects see the subject to tax rule.

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Chapter IV – Economic analysis and impact assessment

79. In agreeing to explore the various proposals under the two Pillars, the Policy Note *Addressing the Tax Challenges of the Digitalising Economy*, approved on 23 January 2019, highlighted the desire of Members of the Inclusive Framework to carry out more in-depth analysis of each proposal and their interlinkages with a particular focus on the importance of assessing the revenue, economic and behavioural implications of the proposals in order to inform the Inclusive Framework in its decision making.

80. Assessing the impact of the proposals will involve an in-depth consideration of how they would be expected to affect the incentives faced by taxpayers and governments, their impact on the levels and distribution of tax revenues and their overall economic effects, including their effects on investment, innovation and growth. The impact assessment will also need to consider how these effects vary across different kinds of MNEs, sectors and economies.

81. The analysis of the economic impacts of the proposals will need to draw upon the existing public finance literature and will also require new empirical research to be undertaken. Such research will need to rely upon the full range of available data sources, including macro-level data (e.g., National Accounts and FDI statistics) and micro-level data (e.g., company financial statements). To the extent that available data permits, the analysis will need to consider the impact of the proposals on particular sectors, industries and business models.

82. The Secretariat has already undertaken some preliminary economic analysis to address these questions. An update of this work was presented to the Inclusive Framework meeting in May 2019. The preliminary analysis has considered available evidence on the size, location, composition and potential allocation of profits under the various Pillar One proposals. Under Pillar Two, proxies for the extent of profits that may be subject to a minimum tax have been considered. The preliminary analysis has also considered the broader incentive effects of the proposals, principally by drawing on the economic literature. So far, the preliminary analysis has drawn on macro-level and micro-level data sources, including National Accounts data, Balance of Payments data, anonymised and aggregated Country-by-Country-Report data and ORBIS.

83. While the economic analysis will be carried out throughout the course of the entire period of the programme of work, the timing of this work will need to be phased in such a way as to deliver members of the Inclusive Framework with the information required to take decisions at key milestones. Building upon the preliminary economic analysis already undertaken, the programme of work will require further Secretariat-led analysis to be provided to members of the Inclusive Framework by the end of 2019. This analysis will be designed to support members of the Inclusive Framework to take decisions in relation to the future direction of the overall programme of work. Continued work will be carried out during 2020, to ensure that the Inclusive Framework can be kept fully informed of the impact of key technical decisions relating to the design of the proposals.

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84. Noting that the various proposals are evolving as discussions continue, the Secretariat will need to carry out a range of economic analyses in order to support the ongoing discussions around design questions associated with the proposals.

85. In carrying out this work, the Secretariat will need to assemble a multidisciplinary team across a number of the OECD's directorates. The Secretariat will carry out its work in consultation with member jurisdictions, bilaterally, and Working Party No.2, other international organisations (e.g., the IMF), the academic community and other stakeholders.

4.2. Economic analysis and impact assessment

The programme of work would require that an economic analysis and impact assessment be carried out. This analysis would explore the following key questions:

1) What are the pros and cons of the proposals with respect to the international tax system?
2) How would the proposals affect the incentives for:
   a. Taxpayers (e.g., profit shifting, investment and location of economic activity)?
   b. Governments (e.g., tax competition)?
3) What is the expected economic incidence / impact of the proposals?
4) What are the expected effects of the proposals on the level and distribution of tax revenues across jurisdictions?
5) What economic impact will the various proposals have for different types of MNEs, sectors and economies (e.g., developing countries; resource-rich countries; R&D intensive economies, etc.)?
6) What data sources and methodologies could jurisdictions use to assess the proposals?
7) What are the expected regulatory costs of the proposals?
8) What would be the impact of the proposals on investment, innovation and growth?

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Chapter V - Organisation of the work to deliver the Programme of Work and next steps

1. Overall approach

86. As described in the Introduction, the work towards a consensus-based solution will proceed along the following separate (but related) tracks:

- first, the Steering Group will continue the process aimed at reaching an agreement on a unified approach to addressing the issues of profit allocation and nexus under Pillar One and agreement on the key design elements of the GloBE proposal under Pillar Two (this work will draw on the expertise of delegates from various working parties);
- second, the subsidiary bodies will provide technical input on certain issues that may arise in the course of developing a consensus-based solution as well as the preparation of final reports that will set out the details of the agreement reached by the Inclusive Framework; and
- third, the Secretariat will provide an economic analysis and impact assessment of the proposals under the two pillars.

87. Although certain parts of the work can be advanced in parallel, there will be many interactions between them. The work to be done under one track will both depend on and drive the progress made under another. For example, the technical work to be undertaken by the various working parties is not only expected to inform and facilitate agreement under Pillars One and Two, but also to evolve and adapt as progress is made on the development of a consensus-based long-term solution.

88. Given the interlinked nature of the work and the challenging time frame for completing it, the Steering Group of the Inclusive Framework will:

- continue its work on the development of a unified approach under Pillar One and the key design elements of the GloBE proposal under Pillar Two so that the outputs from this work can be submitted to the wider Inclusive Framework for agreement; and
- steer, monitor and co-ordinate the work programme and related outputs produced by different subsidiary bodies so as to ensure that a solution can be agreed and delivered in a timely manner.

89. Finally, new technical issues may emerge as the work advances. The programme of work includes the exploration of all relevant issues and options in connection with the Pillars and a subsidiary body should not disregard an option that would address a particular issue on the basis that it has not been raised in the programme of work. To the extent necessary, transition rules would be considered.

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2. Organisation of the work

90. The technical expertise needed to deliver the measures envisaged in the programme of work is largely found within the Inclusive Framework's architecture, namely the Committee on Fiscal Affairs subsidiary bodies:

- Working Party 1, which generally has responsibility for treaty developments and may be called upon to make recommendations under Pillar One regarding the design of a new nexus rule, the effectiveness of the existing, or the need to develop new, provisions for the elimination of double taxation and dispute resolution, ways to effectively implement tax treaty changes, and under Pillar Two regarding switch-over and subject to tax rules;
- Working Party 2, which generally has responsibility for data collection and economic and statistical analysis and will be consulted on the economic analysis and impact assessment of both Pillars;
- Working Party 6, which generally has responsibility for the development of transfer pricing guidance and may be expected to make recommendations regarding the design of a new profit allocation rule under Pillar One;
- Working Party 11, which generally has responsibility for the development of co-ordinated measures to address aggressive tax planning and may be called upon to advance the work on Pillar Two liaising with other working parties as necessary;
- The Task Force on the Digital Economy will continue to play its role in supporting the Steering Group in its coordination role. In particular, it will facilitate any further public consultation in relation to the proposals as required; and
- Other subsidiary bodies such as the FTA MAP Forum which has responsibility for the implementation of BEPS Action 14, as well as other bodies that deal with country-by country related questions including the CBC Reporting Group.

91. The Chairs of the relevant subsidiary bodies, working with the Secretariat, should consider ways to streamline working methods to achieve this goal. In particular, given existing resource constraints, it will not be possible for the Working Parties to meet continuously to accomplish the work on the action items. Therefore, work will also need to be done remotely between the meetings. This work could be co-ordinated through the Bureau of the relevant Working Parties to examine particular issues. Further, Working Parties should evaluate the use of focus groups, ad hoc committees, and other organisational approaches that would facilitate the generation of timely work product.

92. Additionally, the programme of work covers a broad range of issues which involve different expertise and subsidiary bodies, and a critical aspect of this programme will be to ensure an effective coordination of the work. Therefore, the subsidiary bodies would work closely together as they advance their technical work, including working in different joint session formats if necessary.

93. Table 1 assigns responsibilities to different subsidiary bodies for each of the work streams identified in the programme of work. The work will start immediately on all current proposals, as well as on the economic analysis, with initially a focus on supporting the work of the Steering Group. Once there is an agreed architecture proposed by the Steering Group and agreed by the Inclusive Framework, the Working Parties will revert to their more traditional role of working towards the implementation of an agreed policy direction which,

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given the dynamic nature of the work programme, may evolve and also require the involvement of other working parties. A Report on the progress on work is expected in December 2019.

Table 1. Assignment of technical work to subsidiary bodies

	Working Party responsible	Working Party consulted
OVERALL		
1. Support the Steering Group and organise Public Consultation	TFDE	
PILLAR 1		
1. Modified Residual Profit Split	WP6	WP1
2. Fractional apportionment	WP6	WP1
3. Distribution-based approaches	WP6	WP1
4. Business line and regional segmentation	WP6	WP1
5. Design scope limitations	WP1/WP6	
6. Treatment of losses	WP6	WP1
7. New nexus rules	WP1	WP6
8. Elimination of double taxation	WP1/WP6	FTA MAP Forum
9. Dispute resolution	WP1	WP6 FTA MAP Forum
10. Dispute prevention	WP1/FTA MAP Forum	FTA
11. Administration	WP6/WP10	WP1/FTA
12. Modifying Tax Treaties	WP1	WP6/WP11/FTA MAP Forum
PILLAR 2		
1. Inclusion Rule	WP11	WP1
2. Switch-over rule	WP1/WP11	
3. Undertaxed payment rule	WP11	WP1
4. Subject to tax rule	WP1/WP11	
5. Rule co-ordination, simplification and thresholds and compatibility with international obligations	WP11/WP1	FTA
6. Other issues arising in connection with Pillar 2	WP11	
ECONOMIC ANALYSIS		
1. Economic analysis and impact assessment		WP2

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3. Next Steps

94. In accordance with the overall approach described in this Chapter, the Working Parties will meet in June and July and subsequently throughout the remainder of this year to consider relevant technical issues arising in connection with the Programme of Work. These meetings will take place under the leadership and co-ordination of the Steering Group and will focus on those aspects of the Programme of Work that are most pertinent to the development of a unified approach under Pillar One and the key design elements of the GloBE proposal under Pillar Two.

95. The Steering Group will continue to work on the development of a unified approach under Pillar One and the key design elements of the GloBE proposal under Pillar Two so that a recommendation on the core elements of long-term solution can be submitted to the Inclusive Framework for agreement at the beginning of 2020.

96. Throughout 2020 the Inclusive Framework, Steering Group and Working Parties will work on agreeing the policy and technical details of a consensus-based, long-term solution to the challenges of the digitalisation of the economy and will deliver a final report by the end of 2020. Consideration will be given to the holding of public consultations as necessary in order to obtain stakeholder feedback as the various proposals are refined.

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Members of the OECD/G20 Inclusive Framework on BEPS (IF) took a major step forward with the agreement on the *Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy*. This Programme of Work provides detailed instructions to the IF and its technical working groups to deliver a solution to the tax challenges brought by digitalisation. This work focuses on two pillars. The first pillar is about the allocation of taxing rights, and seeks to undertake a coherent and concurrent review of the profit allocation and nexus rules. The second pillar focuses on the remaining BEPS issues and seeks to develop rules that would provide jurisdictions with a right to "tax back" where other jurisdictions have not exercised their primary taxing rights or the payment is otherwise subject to low levels of effective taxation. While exploring these two pillars, the Programme of Work also planned an economic analysis and impact assessment that will be carried out over the next months. This step forward is essential as it shows the willingness of the IF members to agree on a global and sustainable solution by the agreed timeline of 2020.

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