Will the New Global Tax Agreement Benefit the World?

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Will the New Global Tax Agreement Benefit the World?

Wei Cui, July 7, 2021

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The world has been abuzz lately with news of major global agreements within reach to reform international taxation. Countries in the G-7, G-20, and the even more impressive “Inclusive Framework”—a group of 139 countries convened by the Organization for Economic Cooperation and Development (OECD)—appear to be joining hands to end corporate tax competition and multinationals’ tax avoidance. Though many warn that the path to ultimate accord is arduous and depends on details, the declared goals of these efforts command broad public support.

However, we already know enough about the proposed agreement’s contours to question whether it will be good for the world.

Consider first the idea of a global minimum tax. The OECD’s Pillar Two Blueprint makes three recommendations. First, countries where multinationals’ headquarters are located should tax these companies’ foreign income more, if such income is subject to lower-than-minimum tax rates elsewhere. Second, countries are given the right to impose extra tax on payments made to low-tax jurisdictions. Third, countries can negotiate bilaterally to allow one country to raise the tax imposed on payments made to the other country when the latter lowers tax on such payments.

The first recommendation merely modifies existing rules that many countries already adopt on their own to limit profit shifting away from headquarter countries. Countries display varying preferences for the strength of these rules—the same country may even change preferences over time. The U.S., for example, introduced strong versions of such rules as a capital control measure in the 1960s, but loosened them after the collapse of Bretton Woods. Moreover, countries have successfully adopted such rules without coordinating with others—suggesting little gain from coordination.

Sure enough, the OECD only recommends a “common approach” to subjecting low-taxed income to headquarter country taxation: countries are not obliged to enact such rules, but if they do, they should adhere to the OECD’s version. This approach is questionable, because few advanced economies need to consult the OECD’s template to design this type of policy. The main effect of an “OECD model” is likely to prevent countries that first adopt it from subsequently enacting stronger versions: this has been a major legacy of the OECD’s model tax convention, which plays a substantial role in supporting multinationals’ tax avoidance.

The second and third recommendations in the OECD’s minimum tax proposal are similarly optional. It is unclear who will adopt them: although countries may raise taxes on payment to foreigners, they do so for their own revenue objectives, not to force other countries tax such payments more. Moreover, claims that such strategies could establish a global floor to corporate tax rates—even assuming that to be a good thing—are unproven in theory and lack evidence.

What about the idea of picking out the world’s largest multinationals and allocating taxing rights over their “excess profits” among nations? Under this other part of the pending global tax agreement—

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"Pillar One" of the OECD’s proposal—international taxation will be reformed, but likely only for fewer than 100 corporate groups. Instead of allocating profits based on traditional transfer pricing principles, a sales-based apportionment formula will be adopted.

Sales-based apportionment enjoys some intellectual advocates and even experience of actual implementation (e.g. in U.S. states). But until recently, it was considered only a potential technical improvement of existing tax systems in advanced economies, not a key to unlock global cooperative gains. It also speaks only to which countries tax corporate profits, not how much—it does not aim to institute a global minimum tax.

In truth, the promised agreement under Pillar One disguises the withdrawal of two ill-conceived policies. The first is the call by France and its European allies to overhaul international taxation for “the digitalized economy.” Insufficient effort was made to identify what tax problems the digital economy created, or to persuade others that reforming income taxation was a necessary solution. Even worse, France decided to force other countries to pursue its vague vision by enacting what it itself presents as an inferior tax instrument, the digital service tax (DST).

Other countries, including Canada, have found the DST worthy of adoption, without touting it as a tool to force global consensus. But thanks to France, the DST has come to be known as a tax with an expiration date.

This ill-conceived action begot an even worse reaction: the Trump Administration decided to invoke a controversial law—Section 301 of the Trade Act of 1974—to retaliate against DST-imposing countries. The U.S.’ use of Section 301 tariffs likely violates its obligations in the World Trade Organization—thus directly undermining existing global agreements. Ironically, the OECD has relied heavily on the U.S.’ dubious policy to justify its own sponsorship of new international agreements.

Since France could not articulate the superior alternative to the DST, and the Biden administration presumably would not want to continue the Trumpian legacy of violating international agreements, compromises at the OECD allow both to retreat from their untenable positions. Pillar One, with its currently shrunken scope, is the result. Only in the world of international tax can such muddling through be portrayed as triumphs of statesmanship. And only the most powerful countries can present this end to their blunders as good fortune for the rest of the world.