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New Puzzles in International Tax Agreements

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Abstract

The G7's "global minimum tax" accord—followed by a new version of the OECD's "Two Pillar Solution" and its endorsement by the G20—is accepted by many as evidence for international tax cooperation. But recent policy discussions offer no answer to a basic question: What can countries cooperate to achieve? This Article shows that the answers provided by proponents of the new international tax agreement are alarmingly *ad hoc*, misleading, and incoherent. Scholarship on corporate taxation has also long failed to identify potentials for international cooperation. The more successful international agreements purport to be, therefore, the more puzzling they become.

I first examine three rationales recently identified for collective action. The first alleges a transformation in the services trade that supposedly undermines premises of traditional international tax design. The second emphasizes the international community's need to appease the United States and prevent the latter from starting trade wars. Both make unusual and untenable factual and normative assumptions. A third rationale seems more familiar—countries should cooperate to end tax competition and multinational companies' tax avoidance—but is at odds with both economic theory and the actual content of the OECD's proposal. Theoretically, ending tax competitions—whether for productive capital or for corporate headquarters—cannot create gains for all countries. And in terms of policy content, the OECD proposal can more plausibly be read as limiting, rather than enhancing, governments' capacities to tax MNCs.

Older and more basic puzzles in theories of international taxation—concerning source-country taxation, residence countries' unilateral relief from double taxation, and bilateral tax treaties—compound these new puzzles. Arguably, these puzzles have led tax scholars to abandon a basic social scientific template for explaining cooperation. Indeed, much of economic scholarship takes international tax institutions as exogenously given. I contrast this state of affairs with economic theories of trade agreements—in particular, with the way the "terms-of-trade" theory rationalizes the GATT/WTO regime. To emulate the success of the "terms-of-trade" theory, I argue, certain assumptions that have long prevailed in discourses about international taxation may need to be jettisoned. Only a more fundamental reconceptualization of the subject matter of international taxation can shed light on the true past and future grounds for international tax cooperation.

Contents

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Introduction

On June 5, 2021, finance ministers of the G7 group of advanced economies emerged from a meeting in London to announce their agreement, in principle, to implement a "global minimum tax."[1] The governments involved instantly proclaimed the agreement to be "seismic," "landmark," and "historic."[2] U.S. Treasury Secretary Janet Yellen declared that it "would end the race-to-the-bottom in corporate taxation, and ensure fairness for the middle class and working people in the U.S. and around the world."[3] Although the agreement was vaguely-worded, the participating governments and the news media rushed to emphasize its significance in opening a new frontier of international cooperation. A narrative is emerging that global cooperation on tax matters is at once difficult to achieve and critical for global welfare—much like global efforts to combat climate change—and the new international tax

[1] *G7 Finance Ministers & Central Bank Governors Communiqué*, US DEP'T OF TREASURY (Jun. 5, 2021), https://home.treasury.gov/news/press-releases/jy0215.
[2] HM Treasury, *G7 Finance Ministers Agree Historic Global Tax Agreement,* G7UK2021 (Jun. 5, 2021), https://www.g7uk.org/g7-finance-ministers-agree-historic-global-tax-agreement/ [hereinafter UK G7 Press Release]; *Transcript of Press Conference by Secretary of the Treasury Janet L. Yellen Following the Close of the G7 Finance Ministers Meetings*, US DEP'T OF TREASURY (Jun. 5, 2021), https://home.treasury.gov/news/press-releases/jy0216.
[3] UK G7 Press Release, *supra*.

agreement represents a breakthrough, not just in policymaking, but also in successful statesmanship against all odds.[4]

This narrative has not only captivated the global public imagination, but has also come to appear overwhelmingly plausible, for two distinct reasons. The first is the very public way in which many countries seem to have indicated their support for a new global tax agreement. The G7 countries clearly positioned themselves as sponsors of such an agreement in June 2021. Then on July 10, finance ministers of the G20 countries met in Venice and backed the G7's proposal,[5] adding the weight of China, Russia, India and other countries to the proposed agreement. The G20's endorsement was in fact a foregone conclusion: in late June of 2021, a forum called the "Inclusive Framework" (IF)—a group of 139 countries that the Organization for Economic Cooperation and Development (OECD) has convened since 2016 to discuss international taxation—met to deliberate about the basic components of a global tax reform plan, which would flesh out the G7's proposal and serve as the basis of the G20's agreement. On July 1, 2021, 130 of these countries endorsed an OECD outline of the plan.[6] Three other countries have added their endorsement since then, leaving only 6 countries to withhold their support as of August 2021.[7] With opponents overwhelmingly outnumbered by supporters, and with both groups in the public spotlight, the momentum for cooperation seems irreversible. The OECD contemplates that "a detailed implementation plan together with remaining issues will be finalized by October 2021."[8] Even if the negotiations become protracted, it seems difficult to imagine the process to entirely unravel.

Second, there appears to be abundant consensus about the inadequacies of the current international tax system, leading to a cornucopia of stories about past stagnation and the accumulating burdens of the status quo. Many, for example, argue that as a result of tax competition—the opposite of cooperation—countries have been forced to lower their corporate income tax (CIT) rates for decades.[9] If this story is accepted, it seems very compelling to view the G7 minimum tax agreement as presenting "a first step to reverse a four-decade decline in the taxes paid by multinational corporations."[10] Others have claimed that the lack of coordination among nations has led to rampant tax avoidance by multinational companies (MNCs).[11] It has become quite popular to portray this as a longstanding global problem requiring concerted international response.[12] Finally, many scholars have long argued that the

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[4] Arthur Cockfield, *Globalization is alive and well and made healthier by the worldwide minimum tax agreement*, TORONTO STAR (Aug. 03, 2021); Richard Partington, *Global tax reform: 130 countries commit to minimum corporate rate*, THE GUARDIAN (Jul. 1, 2021, 19:47 BST).

[5] Christopher Condon, et al., *G-20 Finance Chiefs Back Tax Deal and Vow to Clear Hurdles*, BLOOMBERG (Jul. 10, 2021, 8:08 AM PDT).

[6] OECD, STATEMENT ON A TWO-PILLAR SOLUTION TO ADDRESS THE TAX CHALLENGES ARISING FROM THE DIGITALISATION OF THE ECONOMY – 1 JULY 2021 (2021) hereinafter OECD July 2021 statement].

[7] Kiarra M. Strocko, *Barbados Joins OECD Corporate Tax Reform Plan*, 103 TAX NOTES INT'L 905 (Aug. 16, 2021). The 6 countries are Estonia, Hungary, Ireland, Kenya, Nigeria, and Sri Lanka.

[8] OECD July 2021 statement, *supra* note 6, at 4.

[9] CORPORATE INCOME TAXES UNDER PRESSURE: WHY REFORM IS NEEDED AND HOW IT COULD BE DESIGNED (Ruud A. De Mooij, Alexander D. Klemm & Victoria J. Perry, eds., 2021).

[10] Jeff Stein & Antonia Noori Farzan, *G-7 countries reach agreement on 15 percent minimum global tax rate,* THE WASHINGTON POST (Jun. 5, 2021, 4:36 PM EDT). Part I.B.2 and Part II.A *infra* discuss scholarly disputes about the existence and mechanisms of corporate tax competition.

[11] Ruth Mason, *The Transformation of International Tax*, 114:3 AM. J. INT'L L. 353 (2020); Gabriel Zucman and Gus Wezerek, *This is Tax Evasion, Plain and Simple*, N.Y. TIMES (Jul. 7, 2021).

[12] There are, however, strong disagreements about evidence for these claims among international tax specialists. *See, e.g.,* Mihir A. Desai, Richard Musgrave Lecture: Myths and Mysteries of the Corporate Income Tax (Mar. 24, 2021) (lecture slides available at https://www.cesifo.org/en/node/62081); Dhammika Dharmapala, *Do*

de facto allocation of taxing rights among nations is unfair—a problem that countries clearly are capable of addressing only by cooperating with one another.[13] In light of all these problems, the need for global tax cooperation may seem all too obvious. Consequently, when the UK government claimed that "discussions on the two Pillars"—referring to proposals for reforming international taxation that the OECD advanced as recently as in 2019—have "been ongoing for many years,"[14] few noticed the incongruous chronology.[15]

Contrary to all such appearances, this article sets out a skeptical perspective on the international tax agreement currently under discussion. Specifically, I highlight a fundamental intellectual challenge that both recent policy discussions and a large body of legal and economic scholarship on international taxation have not come even close to meeting—the challenge of answering the simple, but indispensable, question: What are countries cooperating in the international tax sphere to achieve? I will show that the answers offered by the current proponents of the new international tax agreement are alarmingly *ad hoc*, misleading, and incoherent. Moreover, I will highlight how a large body of scholarship on the corporate income tax has failed to yield any coherent story about how countries can meaningfully cooperate. In the end, the Article will argue, a careful observer would not be able to tell whether countries are cooperating in international taxation or instead engaging in a zero-sum game—is global welfare being enhanced by global agreements, or are some countries simply gaining at the expense of others?

To develop this perspective, I first identify three puzzles in recent narratives about why countries should cooperate in corporate taxation, corresponding to three very different rationales that the OECD has identified over time for collective action.[16] A first rationale asserts that global business transactions have become so predominantly remote-based that basic assumptions of the traditional international tax regime, adopted in an era where "brick and mortar" businesses dominated, no longer hold.[17] However, there is little evidence that, globally, the remote provision of services is increasing at the expense of trade through branches and foreign affiliates. Any change of this kind appears to be highly sector- and country-specific. This renders the OECD's claim that any international reform *must* be based on global agreement—and cannot be limited to specific industries—puzzling.[18]

Multinational Firms Use Tax Havens to the Detriment of Other Countries?, *in* GLOBAL GOLIATHS: MULTINATIONAL CORPORATIONS IN THE 21ST CENTURY ECONOMY 437 (C. F. Foley, J. R. Hines, & D. Wessel, eds., 2021); James R. Hines Jr., *How Serious Is the Problem of Base Erosion and Profit Shifting?*, 62:2 CAN. TAX J. 443 (2014). Whether international cooperation is needed to end tax avoidance is discussed in Part I.C.1 *infra*.

[13] LAURENS VAN APELDOORN & ALLISON CHRISTIANS, TAX COOPERATION IN AN UNJUST WORLD (2021); TSILLY DAGAN, INTERNATIONAL TAX POLICY: BETWEEN COMPETITION AND COOPERATION (2018).

[14] UK G7 Press release, *supra* note 2.

[15] Likewise, the New York Times claimed that Secretary Yellen "secured a landmark international tax agreement…that has eluded the United States for nearly a decade." Alan Rappeport, *Yellen Won a Global Tax Deal. Now Comes the Hard Part.,* N.Y. TIMES (Jun. 6, 2021, 9:47 AM ET). It is unclear what this near-decade-long effort on the part of the U.S. refers to. Whether or not history is being written, it is certainly being re-written.

[16] *See* Part I *infra*.

[17] This rationale, advanced by various governments and commentators, was officialized in OECD, TAX CHALLENGES ARISING FROM DIGITALISATION–INTERIM REPORT 2018: INCLUSIVE FRAMEWORK ON BEPS 23-59 (2018) [hereinafter OECD 2018 Report].

[18] *See* Part I.A *infra* for detailed discussion.

A second rationale, propounded by the OECD since November 2020,[19] is that an international agreement is needed to appease the United States and prevent it from starting trade wars. Even on its face, this is a highly unusual justification for global cooperation. Moreover, the actions that the U.S. threatens to take against other countries are already regulated by the World Trade Organization's (WTO) extensive set of international trade rules. The OECD's call for new global agreements thus seems premised on one country's entitlement to violate existing global trade agreements, and the puzzling view that international cooperation can succeed simply by changing the forum in which it occurs.[20]

The third puzzle arises from a glaring gap between what the G7 claims as already agreed-upon policies (a "global minimum tax") and the actual policies under discussion among the G20 and the IF countries:[21] nowhere in the OECD's "Two Pillar" solution do countries actually commit to adopting a minimum corporate tax rate. Moreover, what is in the OECD's proposal can be more plausibly read as *limiting*, rather than *enhancing*, countries' capacities to tax MNCs. This gap between labeling and substance underscores certain longstanding, unanswered questions: in particular, how cooperating to end tax competitions—whether it is competition for productive capital or for corporate headquarters—creates gains for all countries. No new argument for the existence of such cooperative gain has been advanced in the latest discussions.[22] In sum, all three major justifications recently advanced for a new global tax agreement are unusual on their face and unsatisfactory upon closer examination.

Next, I take a step back and consider whether past scholarship—especially economic research—has identified general rationales for cooperation in international corporate income taxation.[23] The answer, strikingly, is *No*. Economic theory has in fact long struggled to explain basic features of the international tax system: why source countries tax the inflow of foreign capital in the first place, why residence countries grant unilateral relief from double taxation through foreign tax credits or exemptions, and why countries negotiate bilateral tax treaties have all been longstanding puzzles for scholars.[24] Even more importantly, because of these puzzles, tax scholars have foregone a basic and near universal template for explaining actual and proposed cooperation: identifying what countries do in the absence of cooperation, what they can *all* gain from cooperation, and what incentive mechanisms would secure mutually beneficial cooperation. In international tax, what countries do seemingly in the absence of cooperation cannot be easily explained. The objective of cooperation, and indeed even what's best from the global perspective, consequently also become obscure.[25] I will argue that these old puzzles explain why some of the purported objectives of the new international agreement—such as ending corporate tax competition and the use of tax havens—are far more problematic than they might first appear. Moreover, the depth of these puzzles also explains why they are not better known.

Tax specialists may be so accustomed to not having coherent accounts of international cooperation that they forget what it is like to have a coherent one. And those who do not specialize in international tax may find the language of the field too obscure to question its claims about cooperation. To resolve this predicament, I suggest, as a final argument, that tax scholars can benefit

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[19] OECD, TAX CHALLENGES ARISING FROM DIGITALISATION – ECONOMIC IMPACT ASSESSMENT 11 (2020) (hereinafter OECD 2020 Impact Assessment).
[20] *See* Part I.B *infra* for detailed discussion.
[21] See references in infra note 31 for the main documents in the OECD's Two Pillar proposal.
[22] *See* Part I.C *infra* for detailed discussion.
[23] *See* Part II *infra*.
[24] *See* Part II.A, II.B, and II.C *infra* respectively.
[25] *See* Part II.D *infra*.

from a general model for explaining international cooperation that emerges from economic theories of trade agreements.[26] In an influential body of scholarship often referred to as the "terms-of-trade" theory, economists focus on a particular type of harmful externality that emerges from unilateral trade policies to explain the benefits of trade agreements such as the General Agreement on Tariffs and Trade (GATT). In the absence of cooperation, large countries exercise their monopsony power in global markets by raising tariffs on imports, which increase their national incomes at the expense of exporting nations. With cooperation through trade agreements, countries refrain from such beggar-thy-neighbor policies: this neutralizes terms-of-trade manipulations as a source of harmful externalities, while leaving countries free to pursue other domestic policy objectives.

The terms-of-trade theory displays significant explanatory power: it has amassed impressive empirical evidence for how countries behave in the absence of cooperation and how benefits accrued to the parties to GATT; it also gives close attention to features of the GATT architecture that allow countries to negotiate mutually beneficial outcomes and enforce the outcomes of prior bargains.[27] Although it is not the only theory of existing trade agreements, it exemplifies a general social scientific approach to explaining cooperation, which competing theories will need to emulate.[28] By comparison to this approach, in international taxation, the question of what global welfare gain can be achieved through international cooperation is basically unanswered: obviously unsatisfactory "folk theories" about double taxation and tax competition continue to occupy this void.[29]

It is important to clarify at the outset the basic thrust and intended contribution of the skeptical view developed in this Article. Just like domestic policies, all international agreements have their critics. However, critiquing the design of the new international tax agreement proposed by the G7, G20, and the OECD is not the main object of this article. Rather, the skeptical perspective developed here matters for three reasons distinct from any dissatisfaction with these proposals' design. First, increasingly, participants in the international tax discourse engendered by these recent policy developments share neither common normative assumptions nor similar understandings of how international tax rules have worked. This article identifies some of the most substantial divergences in understanding, which proponents of global tax reform often neglect to acknowledge.

Second, I give particular emphasis to how economic theory would rationalize existing international tax institutions and currently proposed reforms. By all accounts, these reforms would generate unprecedented international legal obligations to implement tax policy, with mechanisms of enforcement just beginning to be envisioned.[30] Questions of what is in the unilateral interest of nations to do, and what each nation gains from cooperation, are critical for predicting the levels of enforcement: counting on nations to do things that are in neither their individual nor collective interests seems foolish, and the interpretation of rules is affected by the expectation of enforcement. In that sense, examining international cooperation with the lens of economic theory is a matter of *practical* necessity, not just of intellectual curiosity.

[26] *See* Part III *infra*.
[27] *See* Part III.B *infra*.
[28] See Part III.B *infra*, in particular, about a new theory of offshoring identifying new problems in trade requiring different forms of cooperation.
[29] See Part III.C *infra*.
[30] Mary C. Bennett, *Contemplating a Multilateral Convention to Implement OECD Pillars 1 and 2*, TAX NOTES (Jun. 11, 2021), 1729-1744; Jinyan Li, *The Legal Challenges of Creating a Global Tax Regime with the OECD Pillar One Blueprint*, 75:5 BULL. FOR INT'L TAX'N 2021 (2021).

Third and most importantly, there may be better ways of envisioning international tax cooperation. In fact, theories of trade agreements help identify and even provide a model for the possible components of such a vision. I briefly comment on these components in Part IV, but I will argue that the path towards this new vision is blocked by certain problematic assumptions that have long prevailed in both policy and scholarly discourses on international taxation. These assumptions have been relied on in ever more questionable ways in recent claims about the promises of new international tax cooperation. The price of continuing to accept such assumptions is not just missed political opportunities and squandered global goodwill. By entrenching these assumptions, scholars in the future will need to accept international tax institutions as simply *given*—even more than they already have in the past—and hence struggle even more to guide their practical design. All these are reasons we should be sharply skeptical of claims about international cooperation when its fundamental rationales are so elusive, and why we should challenge casual, rhetorical justifications. Only a more fundamental reconceptualization of the subject matter of international taxation can show us the true past and future grounds for international tax cooperation.

I. Puzzling Rationales for New International Agreements

Explanations of the recent momentum for international tax cooperation commonly refer to the OECD's Base Erosion and Profit Shifting (BEPS) project, launched in 2013, as a predecessor, from which the OECD's current Two Pillar Blueprint evolved.[31] However, narratives about what the OECD and the major participants in the discussions it organized have done—and when—tend to shift, and are frequently revised to support teleological accounts of global agreement.[32] They are thus not best understood as simple factual statements. Instead of studying the "key players" in past and proposed international tax agreements and their various pronouncements, it is useful instead to focus on a single question: if countries are cooperating in the international tax sphere now, what are they cooperating to achieve?

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[31] OECD July 2021 statement, *supra* note 6. The "Two Pillars" refer to a division of proposed topics for coordinated tax reform first set out by the OECD in January 2019 in a short policy note. OECD, ADDRESSING THE TAX CHALLENGES OF THE DIGITALISATION OF THE ECONOMY – POLICY NOTE (2019). That policy note was expanded to a slightly longer "Programme of Work" in May 2019, for discussion among countries participating in the OECD's Inclusive Framework. OECD, PROGRAMME OF WORK TO DEVELOP A CONSENSUS SOLUTION TO THE TAX CHALLENGES ARISING FROM THE DIGITALISATION OF THE ECONOMY (2019) [hereinafter OECD 2019 Programme of Work]. The OECD released draft reports on Pillar One and Pillar Two in late 2019, and final reports in October 2020. *See* OECD, TAX CHALLENGES ARISING FROM DIGITALISATION – REPORT ON PILLAR ONE BLUEPRINT (2020); OECD, TAX CHALLENGES ARISING FROM DIGITALISATION – REPORT ON PILLAR TWO BLUEPRINT (2020) (hereinafter "Pillar One Blueprint" and "Pillar Two Blueprint", respectively).

[32] For instance, a comprehensive treatment of the OECD's initial BEPS project published in 2016 makes no mention of the Inclusive Framework—and rightly so, because the Inclusive Framework was not convened until 2016, *after* the OECD issued all of its recommendations ("action plans") under the BEPS project. Itai Grinberg, *The New International Tax Diplomacy*, 104 GEO. L.J. 1137 (2016). However, since 2016, narratives about tax cooperation at the OECD usually imply that BEPS was developed within the Inclusive Framework. *See, e.g.* Mason, *supra* note 11. Similarly, a 2020 comprehensive review of the OECD's attempt to broker new agreements after 2018 barely mentions Pillar Two. *See* Mason, *supra* note 11. This was understandable at the time it was published, as the significance of Pillar Two was widely regarded as secondary. Yet as discussed above in the Introduction and further in Part I.C *infra*, Pillar Two and the "global minimum tax" are now regarded as central to the OECD-sponsored agreement.

It turns out that three very different answers to this question have been circulating in the international tax community in the past few years. The differences among them are conspicuous. Moreover, each raises obvious puzzles, to which their proponents suggest little by way of response.

A. "Scale without mass:" mode substitution in the services trade

The first rationale for reforming international taxation that is frequently invoked by national and supra-national governments,[33] the OECD,[34] international organizations such as the International Monetary Fund (IMF),[35] and some scholars[36] is that technological changes allow MNCs to conduct remote business operations and establish substantial "economic presence" in many countries without traditional "physical presence": "brick and mortar" businesses are increasingly being replaced by online transactions. A core phrase that captures this phenomenon, made prominent by the OECD's March 2018 Interim Report on Tax Challenges Arising from Digitalisation, is "scale without mass."[37] Proponents of global reform claim that these changes diminish countries' ability to tax foreign MNCs under the corporate income tax (CIT), because under traditional CIT rules, the presence of a subsidiary, branch or some other form of "permanent establishment" ("PE") is required for a country to tax foreign MNE profit.[38] CIT rules therefore must be revised to better enable countries to tax foreign MNCs doing business "in them" (but remotely).

Given the title of the OECD's current tax project (i.e. to "Address the Tax Challenges Arising from the Digitalisation of the Economy"), this rationale would appear to be critical to current discussions of international tax cooperation. Even so, the implied needs for coordination seem to be only moderate and indirect. Two such needs have been emphasized. First, rules that limit and allocate taxing rights based on PE and related concepts are generally incorporated in bilateral tax treaties. Treaties thus need to be revised to loosen the restrictions such rules impose on new CIT policies.[39] In other words, coordination is needed to preserve the treaty legal order in the face of changing policies. Second, and

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[33] *See e.g.,* HM Treasury, Corporate Tax and the Digital Economy: Position Paper Update (2018), https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/689240/corporate_tax_and_the_digital_economy_update_web.pdf [hereinafter 2018 Corporate Tax Update]; HM Treasury, Digital Services Tax: Consultation (2018), https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/754975/Digital_Services_Tax_-_Consultation_Document_FINAL_PDF.pdf; *see* Eur. Comm'n, *Proposal for a Council Directive Laying Down Rules Relating to the Corporate Taxation of a Significant Digital Presence*, COM (2018) 147 final (Mar. 21, 2018) (hereinafter EU SDP Proposal); *Proposal for a Council Directive on the Common System of a Digital Services Tax on Revenues Resulting from the Provision of Certain Digital Services*, COM (2018) 148 final (Mar. 21, 2018) [hereinafter EU DST Proposal].

[34] OECD, Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report (2015) [hereinafter OECD 2015 Final Report].

[35] IMF, *Corporate Taxation in the Global Economy*, at 15-16, Policy Paper No. 19/007 (Mar. 2019).

[36] Michael P. Devereux et al., Taxing Profit in a Global Economy (2021).

[37] OECD 2018 Report, *supra* note 17, at 51-59.

[38] A brief summary of the logic of "permanent establishment" rules is given in Wei Cui, *The Superiority of the Digital Services Tax over 'Significant Digital Presence' Proposals*, 72:4 Nat'l Tax J 839 (2019).

[39] *See* EU SDP Proposal, *supra* note 33 for a discussion of this point. Moreover, because bilateral tax treaties are said to take time to renegotiate—and some countries may be unwilling to do so—it is argued that multilateral agreements are a more efficient way for countries willing to revise their treaties to do so, simultaneously with many treaty partners, in analogy to the "multilateral instrument" used in the OECD's earlier BEPS project. OECD, Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Sharing (2020).

more vaguely, it is suggested that any policy change that expands a country' ability to tax foreign MNC profit may create the risk of "double taxation." Commentators on international taxation tend to espouse the view that any such "risk"—regardless of its prevalence and magnitude—immediately creates a need for international coordination, even beyond the amendment of bilateral treaties.

Such quick and casual claims about the need for international coordination are common in international taxation, notwithstanding the questionable inferences underlying them.[40] However, even without scrutinizing these inferences, the basic factual premise concerning the changing nature of MNC activities should be examined. Notably, the paradigmatic examples that the OECD and others cite for the "challenges arising from the digital economy" are almost uniformly in the services sector: distribution (e.g. online retail like Amazon and content distribution such as Netflix and Spotify), advertising (Google and Facebook), transportation and lodging (Uber and AirBnB), business services (AWS, Apple), and so on. In the standard terminology of the WTO General Agreement on Trade in Services (GATS), what the international tax community appears to be concerned about is the ascendance of "Mode 1" service trade at the expense of "Mode 3" trade.

GATS categorizes services trade into four modes of supply:

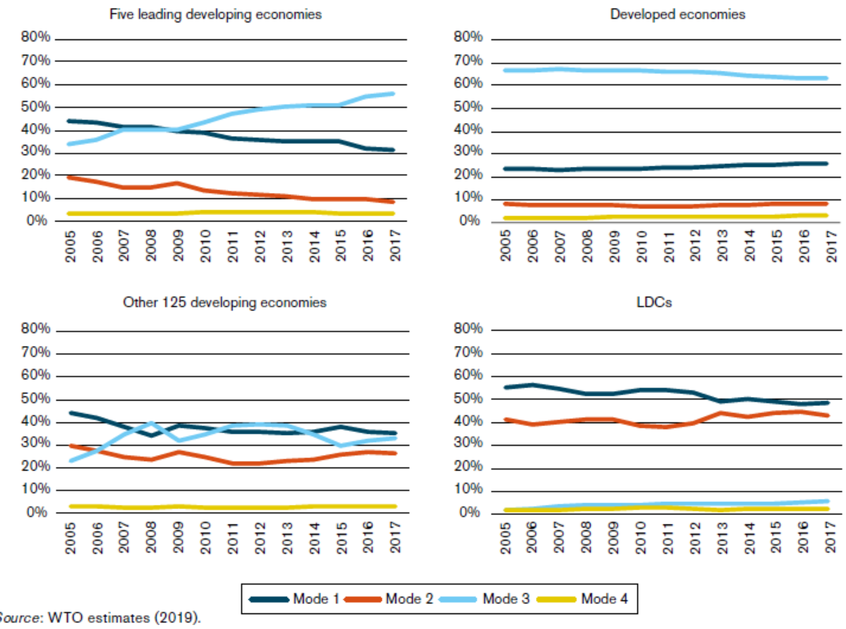
1. Cross-border supply (Mode 1): services supplied from the territory of one country into the territory of another, such as through the internet.
2. Consumption abroad (Mode 2): services provided in the territory of one country to a consumer of another country, such as tourism.
3. Commercial presence (Mode 3): services delivered by a supplier of one country through commercial presence—such as a controlled affiliate or a branch—in the territory of another.
4. Presence of natural persons (Mode 4): a supplier of one country provides services through the presence of natural persons in the territory of another, such as consultants.

The first rationale for coordinated change in international tax, in other words, is based on the premises that traditional CIT rules taxed mainly Mode 3 service trade, and that Mode 3 service trade is being significantly replaced by Mode 1 trade.

However, even though the international tax community has taken this latter premise as a self-evident truth, trade statistics immediately cast doubt on it. According to the WTO 2019 World Trade Report, Mode 3 remains the dominant mode for trading services globally—its value of US$ 7.8 trillion in 2017 represented 58.9% of global services trade—and this pattern has essentially stayed unchanged since 2005. Mode 1 services trade, including through electronic means, totaled US$ 3.7 trillion in 2017 with a 27.7% share. The decline in the share of Mode 3 services trade among developed economies between 2005 and 2017 is quite small (see upper right panel in Figure 1), and the increase of Mode 1 services trade even smaller. In fact, during the same period, for five of the world's leading developing economies in terms of services trade—China, Hong Kong, India, Singapore, and South Korea—there was a rapid rise in the relative importance of Mode 3 trade and a large decline for Mode 1 (see upper left panel in Figure 1).[41] In general, there is tremendous heterogeneity among countries in what and how many services they import and export, and correspondingly, in what modes.

[40] *See* Cui, *supra* note 38, for arguments that coordination conventions—without the need for explicit agreements—are readily available for taxes imposed on location-specific rent.
[41] Growth of the share of Mode 3 services is also observed for France for 2005-2011. Giuseppe Berlingieri et al., *Service offshoring and export experience*, VOX EU CEPR (Jul. 28, 2021).

Figure 1 Share of services by modes of supply[42]



Source: WTO estimates (2019).

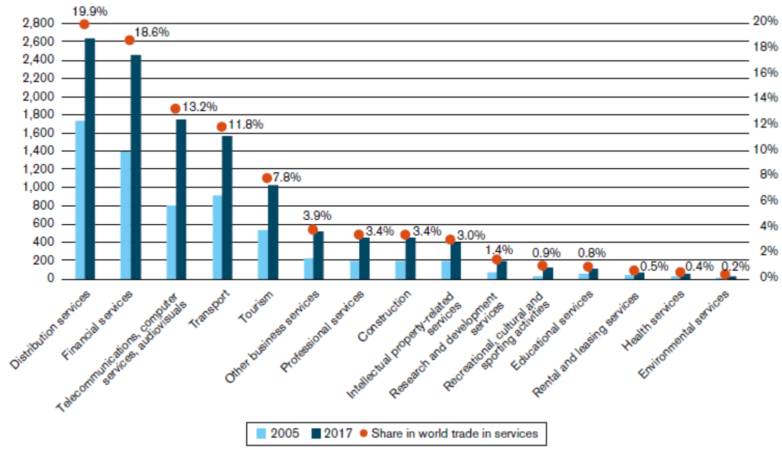
Not only is the extent of Mode-3-to-Mode-1 substitution heterogenous across countries, it is also heterogenous across sectors. This is because Mode 3 trade is dominated by a few sectors (see Figure 2). Distribution services and financial services are the largest traded services globally, accounting for 19.9% and 18.6% of total services trade in 2017. Additionally, 77% of financial services and over 70% of distribution services were traded through foreign affiliates. It appears that the trend of Mode-3-to-Mode-1 substitution is pronounced (and only for some countries) mainly in these sectors.[43] However, the financial services industry is *not* at the center of the current debate about reforming international income taxation; financial firms have been carved out of Pillar One of the OECD proposal and the traditional rules will be preserved for this sector.[44] At the same time, transport and tourism (the 4th and 5th largest categories of services trade) are unlikely to convert to Mode 1, while construction (the 8th largest category) is dominated by Mode 3 supply.

It is also notable that trade in information and communication technology (ICT) services is the third largest sector of global services trade after distribution and financial services, and one of the fastest growing. However, this sector never relied heavily on Mode 3 supply, having always been dominated by Mode 1 (and Mode 4) supply.[45] In other words, although Mode 1 services trade may be

[42] WTO, *World Trade Report 2019: The Future of Services Trade*, at 34 (2019), https://www.wto.org/english/res_e/booksp_e/00_wtr19_e.pdf [hereinafter WTO 2019 Report].
[43] According to the WTO 2019 report, *supra* note 42, the share of financial services exported by EU-controlled affiliates in 2017 was 6 percentage points lower than in 2005, similar to development in the United States. Meanwhile, U.S. financial services exports in Mode 1 almost tripled compared with 2005.
[44] OECD July 2021 statement, *supra* note 6.
[45] Moreover, the EU and India, not the U.S., are the two largest global exporters of computer services and related activities (IT services). WTO 2019 Report, *supra* note 42, at 28.

rapidly growing, it is not the case that such growth comes *at the expense* of traditional Mode 3 trade. Mode 1 and Mode 3 trade can even be complements in some sectors, rather than substitutes.[46]

Figure 2 Leading sectors in global services trade[47]



Source: WTO estimates (2019).
Note: World trade is calculated as the average of world exports and world imports.

Overall, there are very substantial heterogeneities across countries and sectors in the services trade. There is no evidence that significant Mode-3-to-Mode-1 substitution is happening for the majority of countries (or even the majority of advanced economies), or that many countries are losing tax revenue as a result of such substitution. What, then, is the common problem of international taxation to be solved through collective action?

This question is made even more striking if one adopts a purported principle of international tax design that the OECD has occasionally advocated: the same tax rules must apply to different types of international commerce, and no special tax regime should be applied to the "digital economy."[48] Many commentators—and governments including the U.S.—have invoked this principle of "no ring-fencing" to criticize new international tax rules that apply only to particular industries.[49] But without taking an industry-specific perspective, the problem of remote business models replacing "brick and mortar" physical presence would simply disappear.[50]

We thus have a puzzle: what are pronounced to be major "challenges arising from the digitalization of the economy" may have no robust factual basis. It is important to acknowledge that this

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[46] *Id.* at 94.
[47] *Id.* at 25.
[48] OECD COMMITTEE ON FISCAL AFFAIRS, ELECTRONIC COMMERCE: TAXATION FRAMEWORK CONDITIONS 4 (1998); OECD 2015 Final Report, *supra* note 34, at 142; OECD 2019 Programme of Work, *supra* note 31, at 26.
[49] Arthur J. Cockfield, *Tax Wars: How to End the Conflict over Taxing Global Digital Commerce*, 17:2 BERKELEY BUS. L. J. 353 (2020); UNITED STATES TRADE REPRESENTATIVE (OFFICE OF AMBASSADOR ROBERT E. LIGHTHIZER), REPORT ON FRANCE'S DIGITAL SERVICES TAX PREPARED IN THE INVESTIGATION UNDER SECTION 301 OF THE TRADE ACT OF 1974 (2019) (hereinafter USTR Report on French DST)
[50] As some scholars have pointed out, because the efficient design of tax policies relies on discriminating between different types of transactions (e.g. in terms of their responsiveness to tax changes), the principle of "no ring-fencing" goes against efficiency considerations, rather than enhancing efficiency. *See* Michael J. Graetz, *The David R. Tillinghast Lecture: Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 TAX L. REV. 261, 305 (2001).

puzzle characterizes not only inter-governmental discussions organized by the OECD, but also other recent international initiatives. In fact, it is unclear that the OECD would have pursued its current initiative if the European Council (EC) had not put forward two draft "directives" in March 2018 to consider for adoption within the European Union.[51] These two draft directives—one for a set of coordinated digital services taxes (DSTs) within the EU[52] and another for collective amendments of income tax treaties by EU member countries[53]—specifically claimed to provide "interim" and "long-term" solutions to the problem of taxing MNCs operating at "scale without mass." It was these EU initiatives (and a similar proposal made by the UK government[54]) that prompted the OECD to issue its "interim report" on taxation in the digital economy in March 2018. More significantly, it was the EC's failure to secure consensus on its draft directives in November 2018 that resulted in the opportunity for the OECD to describe a new "program of work" in 2019.[55] In any case, this rationale continues to be repeated. Yet it seems spurious and merely rhetorical, and does not identify genuine needs for global cooperation.

B. Tax war and peace?

A second rationale for international tax cooperation that has attained great prominence since 2019 is that an OECD-brokered international tax agreement is needed to avert trade wars that would seriously damage the world economy. In November 2020, the OECD produced an economic impact assessment of its Two Pillar proposal, and asserted that the main case for the proposal rested on the undesirability of an alternative scenario, in which trade wars would reduce global GDP by up to 1% in a "worst-case" scenario.[56] In the words of a prominent OECD official, "any agreement is better than no agreement."[57] By implication, if this were not a matter of war and peace, countries would face no urgent need to cooperate on international tax.

The threatened "trade wars" came about in the following way. As mentioned above, the EC proposed coordinated adoptions of DSTs within the EU in 2018. However, because tax policy decisions at the EC require unanimity, and because a number of EU member states objected to a European DST, the EC proposal was not enacted. Several European countries led by France, as well as Britain, subsequently legislated their own DSTs.[58] These domestically-enacted DSTs came to be known as the "unilateral measures."[59] The U.S. believed that these DSTs were specifically targeted at U.S. tech companies and were discriminatory in nature, and the Office of U.S. Trade Representative (USTR) under the Trump Administration initiated investigations against DST-imposing countries under Section 301 of

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[51] EC DST Proposal and EC SDP Proposal, *supra* note 33.
[52] See Wei Cui, *The Digital Services Tax: A Conceptual Defense*, 73(1) TAX L. REV. 69 (2019).
[53] See Cui, *supra* note 38.
[54] 2018 Corporate Tax Update, *supra* note 33.
[55] Any account by which the OECD's "Two-Pillar Solution" simply evolved or continued from the earlier BEPS project thus critically hides the extent to which the OECD's project was a *reaction* to competing multilateral initiatives.
[56] OECD 2020 Impact Assessment, *supra* note 19, at 11, 183-187.
[57] Stephanie Soong Johnston, *Countries Closer Than Ever to Tax Reform Deal, Saint-Amans Says,* TAX NOTES FED., (Jun. 15, 2021) (citing Pascal Saint-Amans, director of the OECD's Centre for Tax Policy and Administration, Speech at BFM Business regarding progress towards a new international tax reform agreement (Jun. 14, 2021)).
[58] Wei Cui, *The Digital Services Tax on the Verge of Implementation*, 67:4 CAN. TAX J. 1135 (2019).
[59] This loaded label implies that most tax policy measures that apply to MNCs are adopted through bilateral or multilateral agreement, which is clearly false. See Wei Cui, *What Is Unilateralism in International Taxation?*, 114 AJIL UNBOUND 260, 260-64 (2020).

the Trade Act of 1974.[60] The USTR authorized retaliatory tariffs against France in 2020, and against the U.K., Austria, India, Italy, Spain and Turkey[61] under the Biden Administration in 2021. However, the U.S. has voluntarily suspended all of its retaliatory tariffs currently, because the OECD proposes that all countries withdraw their DSTs, once an international tax agreement is reached.[62] If the OECD agreement were to fail and if the U.S. were to proceed with its retaliatory tariffs against DST-imposing countries, trade wars could break out, as these countries are likely to mount retaliatory tariffs against the U.S.[63]

It is important to note that some of the major advocates for international agreements in 2021—including especially the U.S., France, and the U.K.—are would-be belligerents in this story of potential trade wars. Yet they themselves do not claim that averting trade wars is the main reason for international agreement: instead, they appeal to either the rationale based on the changing modes of global commerce discussed above, or the need to end tax competition and corporate tax avoidance (discussed in Part I.C). This discrepancy is highly significant. One might argue that the OECD is more honest about the true nature of the proposed international agreement when it continues to emphasize the averting-trade-war rationale for the agreement, because there would likely be no international agreement if countries do not commit to withdrawing or refraining from imposing DSTs.[64] To put it differently, whatever the appeals of the other policy objectives for international cooperation, the international agreement currently proposed by the OECD, at its core, is an agreement that DSTs should *not* be used to advance these objectives.

Yet the averting-trade-war rationale for international cooperation is highly unusual even on its face. As far as anyone can tell, all of the "trade wars" that the OECD warns about involve a single common belligerent, the U.S. No country is entering into trade wars against any other.[65] This fact is acknowledged and incorporated in an extraordinary way into the OECD's purported simulation of the consequences of the failure of international agreement. In the OECD's simulation of trade wars between a "narrow" group of countries and the U.S.,[66] over 30 countries that either had adopted a DST or reportedly were considering DST adoption as of 2020 are assumed to (i) tax all digital imports from the U.S., (ii) be subjected to either a proportionate retaliatory tariff or a tariff that is 5 times the amounts of DSTs by the U.S., and (iii) enact proportionate counter-tariffs against the U.S for these retaliatory tariffs.

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[60] ANDRES B. SCHWARZENBERG, CONG. RSCH. SERV., R46604, SECTION 301 OF THE TRADE ACT OF 1974: ORIGIN, EVOLUTION, AND USE 34-38 (2020).
[61] *USTR Announces, and Immediately Suspends, Tariffs in Section 301 Digital Services Taxes Investigations*, OFFICE OF THE U.S. TRADE REP.. (Jun. 2, 2021), https://ustr.gov/about-us/policy-offices/press-office/press-releases/2021/june/ustr-announces-and-immediately-suspends-tariffs-section-301-digital-services-taxes-investigations.
[62] OECD July 2021 Statement, *supra* note 6.
[63] See text to *infra* notes 87 for the potential retaliatory measures that the DST-imposing countries may adopt. Some commentators on the DST disputes assert that the adoptions of DSTs are initiations of "tax wars" in themselves. *See, e.g.* Cockfield, *supra* note 48; Ed. Bd., *France Starts a Digital Tax War*, WALL ST. J. OPINION (Jul. 16, 2019, 7:07 PM ET). Such labelling, however, appears highly subjective and selective, as it implies that any tax adopted by one country that other countries do not like amounts to a declaration of "war" that needs to be resolved through international agreements.
[64] The withdrawal of DSTs is a central condition of the OECD's Pillar One proposal. OECD July 2021 Statement, *supra* note 6.
[65] Even the U.S. government itself acknowledges that the DSTs imposed by France and other countries may be applicable to non-U.S. MNCs. USTR Report on French DST, *supra* note 49, at 26-27. No country other than the U.S. claims that these DST-imposing countries have initiated tax or trade wars against them.
[66] OECD 2020 Impact Assessment, *supra* note 19, at 184-186.

In a "worst case" scenario, *all countries in the world* except for China and Hong Kong would adopt DSTs;[67] the U.S. would mount retaliatory tariffs against *all of them* (up to 5 times the value of DSTs); and *all of them* would mount counter-tariffs against the U.S. It is these hyperbolic scenarios of the U.S. waging war against the rest of the world that generate the OECD's dire predictions of the consequences of countries failing to agree on the OECD's proposals.[68]

What the OECD proposes, in other words, is that even if all countries in the world (other than the U.S. and China) are willing to adopt DSTs, DSTs should still be preempted because the U.S. objects to them. This justification for international tax cooperation may seem farfetched—even perverse. But it has gone virtually unchallenged in recent reports and commentaries on international tax cooperation, and is often repeated. Therefore, it is worthwhile to elaborate on at least four reasons why the justification is problematic.

First, the justification is clearly not to be interpreted as claiming that international tax agreements are needed to resolve *actual* trade tensions. If actual trade tensions were at stake, then the justification would fail because it ignores the obvious point that the potential "belligerents" in trade wars should resolve their conflicts themselves, without dragging in the rest of the world. For example, the U.S. under the Trump Administration had also authorized Section 301 retaliatory tariffs against China for the latter's purported violations of its WTO obligations[69]—a trade war that continues under the Biden Administration. Currently, no country or international organization proposes that a new multilateral agreement of any sort should be negotiated to end the U.S.-China trade war. Similarly, the Trump Administration had also authorized Section 301 retaliatory tariffs against the EU in connection with the longstanding *Large Civil Aircraft* dispute.[70] In June 2021, the U.S. and EU agreed to a truce in their reciprocal retaliations in the dispute, again without the involvement of other countries.[71] The amount of tariffs imposed in both the China-U.S. trade war and the reciprocal retaliations in the U.S.-EU *Large Civil Aircraft* dispute are significantly larger in magnitude than the Section 301 tariffs that the USTR has actually planned against DST-imposing countries.[72] A rationale for a global tax agreement based on DST-induced trade tensions therefore emerges only if the U.S. is assumed to be "retaliating" against almost the entire world. In reality, the U.S.'s Section 301 tariffs, adopted in 2020 and 2021 against seven DST-imposing countries, are likely adopted to *deter* other countries from DST adoption. If Section 301 tariffs have to be levied against over 30 countries (the "narrow" group contemplated by the OECD), let alone the "rest of the world," this deterrence strategy would have already utterly failed.

Second, the U.S.'s imposition of Section 301 tariffs against DST-imposing countries likely violates its WTO obligations. In this regard, the Section 301 tariffs against France and other DST-imposing countries resemble the Section 301 tariffs that the U.S. has levied on Chinese imports since 2018 (which

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[67] China and Hong Kong are assumed to neither enact DSTs nor retaliate against them.

[68] OECD 2020 Impact Assessment, *supra* note 19, at 186-187.

[69] SCHWARZENBERG, *supra* note 60, at 28-31; Alan O. Sykes, *The Law and Economics of "Forced" Technology Transfer and Its Implications for Trade and Investment Policy (and the U.S.–China Trade War),* 13:1 J. LEG. ANALYSIS 127 (2021).

[70] SCHWARZENBERG, *supra* note 60 at 31-34.

[71] Robert Goulder, *The Transatlantic Détente Is Simple as A-B-C: Airbus, Boeing, and China,* 102 TAX NOTES INT'L 1877 (2021).

[72] In 2017, $370 billion of U.S.-China trade was affected by the U.S.'s Section 301 tariffs. In 2019, the U.S. imposed tariffs on $7.5 billion of imports from the EU in the *Large Civil Aircraft* dispute. By comparison, The U.S.'s Section 301 tariffs against France in retaliation for the DST covered $1.3 billion of French imports. SCHWARZENBERG, *supra* note 60, at 29, 33, and 35.

have been found to breach WTO law),[73] and differ from the U.S. tariffs against the EU in the *Large Civil Aircraft* dispute (as the latter are authorized by the WTO).[74] Specifically, the USTR does not allege that the DSTs being investigated are in violation of existing international agreements (e.g. WTO rules, regional trade agreements, bilateral tax treaties, etc.). It in effect acknowledges that DSTs are unconstrained by trade agreements.[75] Instead, the USTR's determination is simply that DSTs "[discriminate] against major U.S. digital companies and [are] inconsistent with prevailing international tax policy principles."[76] The USTR's determination under such vague criteria is bound by no rule of law.[77] However, the U.S.'s announced retaliatory tariffs on imported goods from France and other DST-imposing countries are clearly disciplined by the WTO. It is not only the European Union's view that such tariffs would violate U.S. WTO obligations:[78] U.S. legal scholars and U.S. government agencies themselves have questioned the WTO-compatibility of many Section 301 tariffs.[79]

To invoke the U.S. Section 301 tariffs against a large number of countries as the basis of a new international tax agreement therefore assumes the U.S.'s entitlement to violate WTO law. It is not clear how a country willing to breach international obligations towards other countries under an existing (and significant) cooperative regime can commit itself to cooperation in a new regime that is the direct result of such a breach. Moreover, what the OECD effectively claims is that *it* should be the site of international negotiations to prevent disputes that, under existing international law, are expected to be

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[73] In September 2020, a WTO panel found the U.S.'s imposition of Section 301 tariffs against China since 2018 was in violation of WTO rules. Kenneth Rapoza, *What the WTO Ruling Against Trump's China Tariffs Means for a Potential President Biden,* FORBES (Sep. 16, 2020, 10:00 am EDT).

[74] SCHWARZENBERG, *supra* note 60, at 32.

[75] For a detailed analysis of DST compatibility with trade agreements, s*ee* Chris Noonan & Victoria Plekhanova, *Taxation of Digital Services Under Trade Agreements*, 23:4 J. INT'L ECON. L. 1015 (2020).

[76] See, Office of U.S. Trade Rep., *Notice of Determination and Request for Comments Concerning Action Pursuant to Section 301: France's Digital Services Tax*, 84:235 FED. REG. 66956 (Dec. 6, 2019).

[77] U.S. legal scholars have long questioned the lack of constraint on the U.S. government under the "reasonableness" standard under Section 301 of the Trade Act of 1974. See David M. Pedley, *A Definition for "Unreasonable" in Section 301 of the Trade Act of 1974: A Consideration of the United States – Thailand Tobacco Dispute*, 5 EMORY INT'L REV. 285 (1991); Patricia I. Hansen, *Defining Unreasonableness in International Trade: Section 301 of the Trade Act of 1974*, 96 YALE L. J. 1122 (1987).

[78] Jakob Hanke Vela, *EU looks to target Big Tech in trade war with America*, POLITICO (Jul. 20, 2020, 7:34 AM EDT).

[79] *See, e.g.* SCHWARZENBERG, *supra* note 60, at 38 ("Should the United States impose retaliatory trade measures [in connection with DSTs], the affected parties could pursue WTO dispute settlement or retaliate by targeting U.S. exports"); Colin Patch, *A Unilateral President vs. A Multilateral Trade Organization: Ethical Implications in the Ongoing Trade War*, 32 GEO. J. LEGAL ETHICS 883 (2019) (arguing that Trump's Section 301 tariffs against China are WTO-incompatible and undermines the international legal order); C. O'Neal Taylor, *The Limits of Economic Power: Section 301 and the World Trade Organization Dispute Settlement System*, 30 VAND. J. TRANAT'L L. 209 (1997).

resolved through the WTO.[80] One is supposed to believe that nations could resolve their disputes simply by switching from one international forum to another.[81]

Third, the OECD's neglect of the fact that U.S. Section 301 tariffs against DST-imposing countries violate WTO law also betrays a lack of understanding that tariffs can and are used not just to wage trade wars, but to enforce international agreements. No supra-national government authority, including the WTO, is able to enforce trade agreements against their signatories: the enforcement must come from other signatories to these agreements.[82] When one signatory is found to violate its WTO obligations, authorized retaliations by others serve to enforce such obligations (or compensate the others for such violations). For example, when the U.S. and EU levied retaliatory tariffs against one another in the *Large Civil Aircraft* dispute, both acted with WTO authorization: the WTO had determined that each side had violated WTO law by adopting certain export subsidy policies. It would be mistaken to describe this as a scenario where "war" broke out, existing international agreements became defunct, and a new agreement needed to be negotiated. Instead, the prior trade agreement was enforced, and if the parties could not come to a resolution, the new status quo, with new WTO-authorized tariffs on both sides, was regarded as a renegotiated outcome.[83]

When the U.S. imposes Section 301 tariffs in violation of its WTO obligations, the other countries are entitled to seek remedy within the WTO framework.[84] Even a WTO ruling against the U.S., however, would have no effect in itself, if the countries injured by U.S. tariffs could not mount counter-tariffs. It is tariffs authorized by the WTO, and other WTO-compliant measures to counter trade policies that violate WTO agreements (such as the U.S. Section 301 tariffs), that enforce such international agreements. In portraying tariffs and counter-tariffs as a matter of war, and in portraying the removal of such tariffs and counter-tariffs as peaceful cooperation—all without distinguishing between tariff measures that violate and those that enforce trade agreements—the OECD lays bare a big gap in its proposal for international tax agreement, namely what would constitute enforcement of the agreements.

To summarize these first three objections: the worst-case scenario for the global economy invoked by the OECD is one where, putting China and Hong Kong aside, every country is at peace with every other except the U.S.; the U.S. is at war with every other country; the U.S. violates its WTO

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[80] Some tax scholars suggest that because *tax matters* are involved, the dispute over the DST should be resolved through the OECD rather than the WTO. Such a claim, however, ignores the fact that the WTO agreements contain only specific carveouts for tax measures. Unless these carveouts apply, there is no ground for claiming that WTO obligations are inapplicable to disputes about tax policies. Indeed, the U.S. went through and lost a lengthy GATT dispute with the EU concerning its income tax policies. See DAVID L. BRUMBAUGH, CONG. RSCH. SERV., RL31660, A HISTORY OF THE EXTRATERRITORIAL INCOME (ETI) AND FOREIGN SALES CORPORATION (FSC) EXPORT TAX-BENEFIT CONTROVERSY (2006).

[81] It is also unclear how the Biden Administration's continued threat of Section 301 tariffs that breach WTO rules can be viewed as multilateralist and cooperative in nature. David Lawder, *U.S. sets and suspends tariffs on six countries over digital taxes,* REUTERS (Jun. 2, 2021, 12:34 PM PDT).

[82] Kyle Bagwell & Robert W. Staiger, *The World Trade Organization, Theory and Practice*, 2 ANN. REV. ECON. 223, 248-249 (2010).

[83] See Alan Sykes, *International Law*, *in* 1 HANDBOOK OF LAW AND ECONOMICS 757, 800-801 (A. Mitchell Polinsky & Steven Shavell eds., 2007).

[84] The intended EU response to U.S. retaliatory tariffs against any EU-member country that imposed the DST was to object to such tariffs at the WTO. Matt Thompson, *EU to Boost Trade Sanctions Given Possible Digital Tax Spat*, LAW360 (Oct. 28, 2020).

obligations in respect of all other WTO signatories; and every other country is enforcing WTO obligations against the U.S. It would seem that this is an unmitigated disaster for the U.S., while the rest of the world continues to cooperate under the WTO. Instead, the OECD presents it as a disaster for the world, and as the end of international cooperation.

In view of the extraordinariness of this proposal, it is useful to consider, fourth and finally, how likely in reality trade wars would erupt around DSTs and remain uncontained without international agreement. The U.S. suffered significant damage from the trade war Trump initiated against China. Though the U.S. is China's largest trading partner, its presumed monopsony power did not prevent most of the burden of the U.S. tariffs from being passed onto U.S. consumers.[85] The U.S. strategy for retaliating against DSTs similarly comprises high-rate tariffs on goods exports to the U.S. Thus, even without considering the possibility of WTO-authorized or WTO-compatible counter-tariffs adopted by other countries, the U.S. would need to be cautious in actually levying the tariffs. Moreover, there are powerful asymmetries between the U.S. and the DST-imposing countries it may retaliate against. For one, the DST, conceived as a tariff on zero-marginal cost digital services, may be adopted by many small countries, some of which may not even have sufficient goods exports to the U.S. for the latter to impose tariffs on.[86] For another, the press reported that in light of the likelihood that WTO dispute resolution mechanisms might remain paralyzed in the near future, the EU was also crafting a set of WTO-compliant policies that would tax or otherwise restrict U.S. exports of a broader range of services and intellectual property licenses to Europe.[87] It is such a set of policies—permitted or simply undisciplined by the WTO—that would constitute the European "belligerents'" responses to the trade wars started by the U.S. For its war threat to be credible, the U.S. needs to have a response to this next stage of escalation.

Overall, the second rationale for international tax cooperation emphasized by the OECD takes the U.S.'s entitlement, willingness and ability to carry out trade wars against a large number of countries for granted. Even though its assumptions are obviously implausible—and even though it betrays a neglect and misunderstanding of major existing institutions of international cooperation under the WTO regime—it is a rationale that commentators on the OECD proposals have largely acquiesced to. Most importantly, this rationale captures an essential component of the proposed international agreement—the withdrawal of DSTs—currently sponsored by the G-7, G-20 and the OECD in 2021. Instead of international cooperation, one country seems to have successfully asserted power over others. That nations "cooperate" this way deserves to be seen as a puzzle.

C. Ending MNC avoidance and tax (and subsidy) competitions?

The case for global tax cooperation has been substantially recast in 2021, first by the Biden Administration, then as a result of the G7/G20 accord on a "global minimum tax." Instead of addressing new policy challenges arising from Mode-1-for-Mode-3 substitution in the services trade, the G7 called

[85] Mary Amiti, Stephen J. Redding & David E. Weinstein, *The Impact of the 2018 Tariffs on Prices and Welfare*, 33:4 J. ECON. PERSP. 187 (2019); Mary Amiti, Stephen J. Redding & David E. Weinstein, *Who's paying for the US tariffs? A longer-term perspective*, 110 A.E.A. PAPERS & PROC. 541 (2020).

[86] For a discussion of the limited retaliation strategies of countries exporting zero-marginal-cost digital services, *see* WOLFRAM RICHTER, THE TAXATION OF DIGITAL SERVICES AS A RENT-EXTRACTING POLICY, DISCUSSION PAPER (2021). To follow the unfortunate war metaphor, the U.S. Section 301 tariffs are akin to aircraft carriers and ballistic missiles, whereas DSTs are analogous to drone strikes.

[87] Vela, *supra* note 78.

for reversing long-term declines in corporate tax rates.[88] And while the OECD still seeks global endorsement of its reform blueprints as a matter of securing "tax peace,"[89] no G7 or G20 country emphasizes this as the most important aspect of an OECD-facilitated agreement. Instead, they claim that the new agreement will end corporate tax competition and MNC tax avoidance. Yet the new rationale circulated in 2021 again rests on many claims brandished as self-evident, but which turn out to be problematic upon even a cursory examination. In fact, instead of enabling countries to tax MNCs more, the OECD's proposals can easily be read as being *in favor of* MNCs.

In particular, "Pillar Two" of the OECD proposal invites countries to cooperate on policies that they can easily and effectively adopt (and have adopted) on their own. The reason for coordinated rather than unilateral adoption, apparently, is to provide MNCs with "certainty" in the application of anti-avoidance rules—which weakens rather than strengthens such rules. Likewise, "Pillar One" of the OECD proposals invites countries to agree on certain methods of taxing MNCs, to be applied only to a small number of corporate groups. The proposal's real linchpin, however, is securing the withdrawal of DSTs—a collective agreement to limit the taxation of MNCs.

This subpart will briefly review these contentious aspects of the OECD proposals. But just as importantly, even abstracting from the OECD's specific approach, there are more fundamental reasons why ending tax competition to attract foreign investment or MNC headquarters *cannot* serve as goals of global cooperation. This makes it less surprising that the OECD proposal *does not* serve such goals.

1. "Agreeing" to a "global minimum tax"

The first thing to know about the OECD's proposed "Two Pillar Solution" (endorsed by the G20 in July 2021) is that nowhere in it are countries required to adopt a minimum CIT rate. There is thus a glaring discrepancy between what politicians and the press claim countries have agreed to and the plain language of the proposed agreement. "Pillar Two" of the OECD proposal contains the main provisions that refer to a minimum tax rate, but they are better described as *anti-avoidance rules*: indeed, the OECD called this part of its proposal the "Global Anti-Base Erosion (GloBE) Proposal" before the "global minimum tax" label began to be used in 2021.

In this proposal, the OECD makes two main recommendations.[90] First, countries with MNC headquarters should subject the companies' foreign income (including income earned by foreign subsidiaries) to an additional tax, if such income is subject to lower-than-minimum tax rates elsewhere. If a country adopts this recommendation—the so-called "Income Inclusion Rule" (IIR)—in respect of headquartered MNCs, then it can be said to have ensured that the foreign income of such MNCs is subject to a *combined* tax rate of no less than the minimum.[91] Second, countries are entitled to impose additional taxes on the payment of income made from them *to* persons in countries that subject such

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[88] Jeff Stein & Antonia Noori Farzan, *G-7 countries reach agreement on 15 percent minimum global tax rate,* THE WASHINGTON POST (Jun. 5, 2021, 4:36 PM EDT).
[89] Nana Ama Sarfo, *The IMF's Big Ideas for the Future of Corporate Taxation,* 102 TAX NOTES INT'L 866 (2021).
[90] A third recommendation is called the "subject to tax rule," which encourages countries to negotiate bilaterally such that one country can raise the tax imposed on payments made to the other country when the latter lowers its tax on such payments. It is thus similar to the "Undertaxed Payment Rule" discussed below, but implemented through tax treaty conventions and on a bilateral, rather than unilateral, basis. Pillar Two Blueprint, *supra* note 31, at 150-151.
[91] Pillar Two Blueprint, *supra* note 31, at __. The IIR minimum tax rate is agreed to be 15% in October 2021.

income to lower-than-minimum tax rates. If a country from which payments are made adopts this recommendation—the so-called "Undertaxed Payment Rule" (UTPR)—then it can be said to be trying to ensure that income arising from itself and accruing to foreigners is subject to a *combined* tax rate of no less than a minimum.[92] However, neither countries adopting the IIR or UTPR nor any other country is asked to consider adopting a stand-alone CIT rate above a minimum rate, for income earned by its own corporations in its own territory. No country, that is, is restricted against adopting low CIT rates to entice MNCs to move their operations to it.

Explaining how such a proposal amounts to a bid to end "tax competition" requires certain elaborate—and ultimately tenuous—narratives, usually omitted for the purposes of media sound bites. Such narratives involve claims about the purported effects of the two types of anti-avoidance rules, discussed further below. However, another basic point to note at the outset is that these rules represent a "common approach": countries are not required to commit to their adoption in any global agreement. Instead, countries are to agree that *if* they were to adopt anti-avoidance rules of a sufficiently similar kind, they must adopt the OECD's version of such rules.[93]

The basic logic of the "Income Inclusion Rule" is thoroughly familiar to tax policymakers and practitioners around the world. Ever since the U.S. adopted comprehensive controlled foreign corporation (CFC) rules in the early 1960s, many countries have enacted similar rules to prevent parent companies or individual shareholders residing in them from avoiding tax, by taxing undistributed income accruing to foreign subsidiaries that might be used by taxpayers to shelter income. The adoption of CFC rules has overwhelmingly taken the form of unilateral legislation, and the international tax community has widely accepted such non-coordination in CFC rule adoption.[94] This is not just because CFC rules are generally believed to be effective even when unilaterally adopted[95] and pose no harmful externalities:[96] CFC rules have also been used to serve policy purposes other than combatting tax avoidance. For example, the U.S.' much admired CFC rules were first enacted in 1962,[97] when the U.S. struggled to deal with a balance of payment crisis and explored all measures to bring capital back to itself.[98] Similarly, the

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[92] Pillar Two Blueprint, *supra* note 31, at __. The UPTR minimum tax rate is agreed to be 9% in October 2021.

[93] Moreover, as a part of the international agreement, countries would agree not to object to others' adoption of such anti-avoidance rules. OECD July 2021 Statement, *supra* note 6.

[94] Some scholars suggest that the U.S. acted as a leader in adopting such practices in the spirit of "constructive unilateralism." *See* Reuven S. Avi-Yonah, *Constructive Unilateralism: U.S. Leadership and International Taxation*, 42:2 Int'l Tax J. 17, 17-24 (2016). Others have called such mutual acceptance of unilateral legislation (of what are believed to be good international tax practices) "coordinated unilateralism." Mason, *supra* note 11.

[95] *See* Dharmapala, *supra* note 12. For a summary of the unilateral introductions of CFC rules, see Johannes Voget, *Relocation of Headquarters and International Taxation*, 95 J PUB. ECON. 1067 (2011).

[96] As discussed further in Part II below, income taxation based on the residence of individual shareholders has long been regarded as the most efficient form of international taxation. *See* Michael Keen & David Wildasin, *Pareto-Efficient International Taxation*, 94 AM. ECON. REV. 259 (2004); Roger H. Gordon & James R. Hines, *International Taxation, in* 4 HANDBOOK OF PUBLIC ECONOMICS 1935 (A.J. Auerbach & M. Feldstein, eds., 2002); Alan J. Auerbach, Michael P. Devereux & Helen Simpson, *Taxing Corporate Income, in* DIMENSIONS OF TAX DESIGN: THE MIRRLEES REVIEW 837 (Stuart Adam et al., eds., 2010); Rachel Griffith, James R. Hines & Peter Birch Sørensen, *International Capital Taxation*, *in* DIMENSIONS OF TAX DESIGN: THE MIRRLEES REVIEW 914 (Stuart Adam et al., eds., 2010).

[97] Also known as the "Subpart F rules," referring to Subpart F of the Internal Revenue Code (IRC).

[98] President John F. Kennedy's Special Message to the Congress on Taxation, April 20th, 1961 (acknowledging that the policy motive for the CFC rules was not only limiting tax avoidance but "to stimulate our economy and our plant modernization, as well as ease our balance of payments deficit.") As the U.S. balance of payment crisis worsened in the 1960s, it even temporarily adopted capital control and an embargo on net direct investment

Trump Administration introduced strengthened measures of U.S. residence-based taxation through the global intangible and low-taxed income (GILTI) regime in 2017, as part of a political agenda purporting to bring jobs back to America.[99] The GILTI represents yet another variant of CFC rules (or what the OECD now calls IIR).[100] In other words, countries may want to design their CFC rules to reflect their changing domestic policy needs (whether or not directly related to taxation). And in the past, governments rarely argued that CFC regimes' effectiveness critically depends on collective adoption.

What, then, is the necessity for global coordination in the adoption of the IIR?[101] As noted above, the OECD actually does *not* expect all countries to commit to IIR adoption, consistent with the presumed feasibility of unilateral adoption. Instead, the OECD's IIR represents a "common approach," rather than being obligatory on participants in the negotiations.[102] Yet the complexity of OECD's Pillar Two blueprint mainly issues from the premise that countries follow a coordination scheme in adopting the IIR. The OECD's main justification for coordinated adoption is that it would create "certainty" for MNCs when many countries adopt anti-avoidance rules.[103] The implication is that there is a high risk that MNCs would be taxed *too much* if IIR (i.e. CFC-like) rules were more widely adopted by countries acting on their own. Consistent with this basic objective, the OECD proposal contains extensive "substance-based carveouts," rules concerning "excluded entities," and priority ordering in the imposition of the IIR,[104] all of which aim to *limit* the IIR's application.

If, however, no or few countries are specifically enabled to adopt IIR (i.e. CFC-like) rules by global coordination, and the main case for coordination is to limit the impact of the adoption of such rules on MNCs, it is clearly misleading to claim that the goal of new global tax cooperation is to *end* MNC tax avoidance. Indeed, in the tax profession, "certainty" is often a code word for narrowly drafted rules that taxpayers can plan around.[105] Extensive legal scholarship has convincingly argued that black-and-white rules regarded as providing "certainty" to taxpayers yield weaker deterrence effects against tax avoiders.[106] If "certainty" is the main benefit of global cooperation in supporting OECD's Pillar Two proposal, one must then conclude that the cooperation is mainly in favor of MNCs, not governments.

The second major component of the OECD's Pillar Two recommendations, the UTPR, differs from the IIR in several respects relevant to the idea of cooperation. First, UTPR-like rules have rarely been adopted before: instead of identifying particular types of transactional structures as prone to being

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outflows to continental Europe. Atish R. Ghosh and Mahvash S. Qureshi, *What's in a Name? That Which We Call Capital Controls* 18-19 (IMF, Working Paper WP/16/25, 2016).

[99] Rebecca M. Kysar, *Critiquing (and Repairing) the New International Tax Regime*, 128 YALE L.J. FORUM 339 (2018).

[100] U.S. tax commentators have argued that any variant of GILTI, even if modified from its current form pursuant to new legislation to be secured by the Biden Administration, will need to be accepted by the OECD as compatible with Pillar Two. [Cite.]

[101] Some scholars have suggested that coordinated adoption of CFC rules is necessary to prevent competition for corporate headquarters. I discuss this in Part I.C.3 *infra*.

[102] OECD July 2021 Statement, *supra* note 6.

[103] Pillar Two Blueprint, *supra* note 31, at __.

[104] Such ordering rules are relevant to tiered corporate structures in which multiple holding companies may be affiliated with different countries, all of which are entitled to impose IIR.

[105] Tax advisors around the world have already extensively analyzed the OECD's Pillar Two proposal, to assure clients of the limited changes it brings, and to analyze the tax planning techniques either precluded or left open. *See, e.g*. KPMG, KMPG REPORT: OECD/G20 INCLUSIVE FRAMEWORK AGREEMENT ON BEPS 2.0 (Jul. 2, 2021).

[106] *See, e.g*, David A. Weisbach, *An Economic Analysis of Anti-Tax-Avoidance Doctrines*, 4:1 AM. L. ECON. REV. 88 (2002).

used for tax avoidance,[107] the UTPR recommends higher taxation, by the country from which payments are made, on payments to any recipient located in a country that taxes the receipt of such payments at a lower-than-minimum tax. Because of the lack of prior precedents,[108] it is difficult to say, with confidence, whether this will be effective in curtailing tax avoidance.

Second, even if the UTPR is potentially effective, the question can be raised as to why countries are better off collectively adopting it rather than unilaterally. Recall that the IIR—or, CFC-like rules—is traditionally regarded as a rule that countries have unilateral incentives to adopt.[109] In contrast, although the UTPR might curtail MNC tax avoidance—MNCs would have less incentive to shift income to low-taxed jurisdictions—it could also increase the tax burden on real investment flows from countries with lower tax rates. The use of UTPR might thus divert foreign investment away from UTPR-adopting to UTPR-free countries. If this diversion effect is strong, the UTPR may not be unilaterally optimal to adopt. This might lead one to argue that if the world's major investment destinations (e.g. the U.S., EU, other OECD countries, and China) all adopt the UTPR, the diversion of investment flow may be less marked. In other words, it may be much less costly for any country to adopt the UTPR if other countries also adopt it.

Yet this rationale for cooperation has been neither explicitly offered by the OECD nor elaborated on by any commentator. In fact, as noted before, the OECD does not require any country to commit to the adoption of UTPR—it only recommends a "common approach." If collective action is necessary to enable UTPR adoption, then adoption will depend on whether countries can otherwise form a coalition, outside of the OECD-IF, that commits to collective adoption. Presumably, the OECD itself is not responsible for ensuring the formation of such a coalition. In that case, it is again unclear how Pillar Two generates reduction of MNC tax avoidance as a cooperative outcome.

The direct effect of international cooperation under Pillar Two on MNC tax avoidance is thus likely to be modest at best: it may even increase MNC tax avoidance if anti-avoidance policies that countries may themselves adopt are precluded by the OECD agreement. What effect will Pillar Two have on ending tax rate competition? After all, what grabbed news headlines in 2021 was the possibility that the decline of CIT rates around the world may be reversed, not that countries would adopt more "certain" anti-avoidance rules. How did the *same* OECD proposal, packaged as the "Global Anti-Base Erosion Proposal" before 2021, come to be taken as imposing a "global minimum tax"?

That transformation seems to have resulted from some heroic postulates, made mainly by U.S.-based commentators and not by the OECD itself. It has been suggested that if just a few major capital-exporting countries adopted stringent residence-country anti-avoidance rules (through the OECD's IIR or even stronger domestic rules, such as the U.S. GILTI regime), then much of MNC tax planning using low-tax jurisdictions would cease to pay off. Consequently, countries would lose much of their ability to

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[107] Countries have long adopted a wide range of anti-avoidance rules to limit tax avoidance involving payments to foreign entities, such as rules limiting "earning stripping" (through the payment of interest or royalties to related parties), or rules limiting "treaty shopping" or the use of "conduit" entities. Many of these rules are viewed as effective even when unliterally adopted, which again suggests little gain from collective adoption. See Dharmapala *supra* note 12.

[108] Some have drawn analogies between the UTPR and the Base Erosion and Anti-Avoidance Tax (BEAT), which the U.S. adopted under the Trump Administration. The BEAT imposes a minimum tax on profits earned in the U.S. by foreign investors by denying the effect of deductions of payments made to related parties. However, the BEAT is not based on the tax rate imposed by the payment recipients' country.

[109] Gordon & Hines, *supra* note 96, at __.

attract investment and profit-shifting through low taxes. It is speculated that this would lead some countries to stop pursuing low-tax strategies.[110] Similarly, it has been speculated that given the U.S.' unique attraction as an investment destination, even the U.S. acting alone could neutralize much MNC tax planning by denying deductions for all payments made from the U.S. to low-tax countries.[111] If a small number of other countries form a coalition with the U.S. to enact similar rules—which the international community would accept by endorsing UPTR regimes as legitimate—then many tax planning structures using low-tax jurisdictions may again unwind. It is postulated that this would again lead many low-tax jurisdictions to raise their tax rates. [112]

These narratives have barely been articulated or defended by either the advocates of or commentators on the "global minimum tax." Three comments are sufficient to show why they are problematic. First, they make very strong assumptions—in particular, that the *only reasons* why countries have low CIT rates is that they help such countries attract MNC profit shifting.[113] This is highly implausible in itself. Second, they suggest the following relation between the OECD's Pillar Two proposal and the idea of a minimum CIT rate: even though the IIR and UTPR do not themselves dictate such a minimum tax rate, such a floor to CIT rates might *emerge in reaction* to collective adoptions of the anti-avoidance rules. In other words, a global agreement on anti-avoidance rules, or the adoption of such rules by a small cartel of countries, might incentivize countries to raise their CIT rates even without a general agreement to adopt such a floor. The end of tax competition is not a matter of *ex ante* agreement, but a matter of subsequent strategic interaction.[114] Putting the (im)plausibility of such narratives aside, it is clearly misleading to claim that ending tax competition (below the minimum tax rate) is what countries have agreed to,[115] when commitment to adopting a minimum CIT rate is not even on the agenda.

Third, given that the OECD only recommends a common approach to the adoption of anti-avoidance rules, what actual coalitions will form in the adoption of IIRs and UTPRs are yet to be seen. Claims in the summer of 2021 about what the G7, G20, and the over 130 IF countries have agreed to, therefore, are actually only claims about what some of these countries (or policy advocates in them) would *like* to see all countries agree to. A rhetorical strategy seems to have prevailed in the international sphere whereby simply *saying* that countries have agreed to something (i.e. coordinating to adopt anti-avoidance rules), even when they have not, means that they *will* agree to that thing.

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[110] Richard Rubin, *Global Tax Deal Holdouts Face Squeeze Under Biden Administration Plan*, WALL ST. J, (Jun. 16, 2021, 11:30 AM ET) (quoting Janet Yellen as claiming that the IIR will squeeze low tax country hold-outs); Jake Johnson, *G7 countries reach agreement to set "global minimum" tax rate for multinational corporations*, SALON (Jun. 7, 2021, 5:00 AM EDT) (quoting Gabriel Zucman for a similar claim).

[111] This is the characterization given of the SHIELD ("stopping harmful inversions and ending low-tax developments") regime that the Biden Administration proposed through its Made in America Tax Plan.

[112] *See, e.g*. The New York Times Editorial Board, *Make Tax-Dodging Companies Pay for Biden's Infrastructure Plan*, N.Y. TIMES (Apr. 17, 2021).

[113] As a result of the "substance-based carveouts" in the OECD proposal, MNCs that have real productive activities in low-tax jurisdictions will not be affected by the IIR and UTPR.

[114] Since there is no *ex ante* agreement that all countries should adopt CIT rates no lower than a minimum, neither the IIR nor the UTPR can be said to be enforcing such an agreement.

[115] The OECD has claimed that tax competition above the agreed minimum tax rate (possibly of 15%) would still be permitted: this implies that tax competition below that rate is precluded—but no element of the OECD Two Pillar solution dictates such preclusion.

2. Ending a race to the top

If the connection between the OECD's Pillar Two proposal and the goal of ending tax competition and MNC tax avoidance is tenuous, the connection between the OECD's Pillar One proposal to this goal is strained beyond recognition.[116] Pillar One purportedly provides new types of taxing rights over MNC profits to countries that, due to constraints imposed by bilateral tax treaties, previously would not have been allowed to tax such profits.[117] In particular, Pillar One envisions that countries may tax certain types of profits of certain MNCs as long as the MNCs generate sales revenue from them (rather than requiring subsidiaries and PEs). This purported thrust of Pillar One raises two sets of questions. First, why do countries need to be "granted" such taxing rights through a global agreement? If it is only rules in existing bilateral tax treaties that stand in the way of the claim and exercise of such rights, why can countries not just renegotiate tax treaties among themselves? Moreover, overrides of existing tax treaties occur with some frequency in international taxation; countries that want to break the constraints of existing agreements do not generally seek global permission for doing so. What is exceptional about the change proposed by Pillar One? Second, how does Pillar One contribute to the goal of ending tax competition and MNC tax avoidance?

One answer to the first set of questions is that some countries may not be able individually to renegotiate bilateral tax treaties. This is especially the case when the contracting states on the other side are unwilling and wield bargaining power. A multilateral agreement among many nations may allow some countries to band together and negotiate for terms that would not otherwise be obtainable. This logic is sound, but it in turn raises the following question: why would those countries that resist the renegotiation of existing bilateral tax treaties (e.g. those who prefer the status quo of tying taxing rights to MNCs' subsidiaries or PEs) want to join a multilateral agreement to renegotiate the same treaties? The question is especially acute because multilateral bargaining has little precedence in international taxation.[118] Therefore, if bilateral tax treaties cannot be renegotiated because of the unwillingness of some powerful countries, those powerful countries must be given clear incentives for joining a multilateral agreement.

In the case of the OECD's Pillar One, it is no secret that, before 2021, the powerful country most resistant to joining such multilateral tax agreements was the U.S. Even in 2020, the U.S. did not believe that creating international taxing rights based on sales was in its interest,[119] and it especially resisted proposals to apply such new methods to particular sectors ("ringfencing") where its MNCs were dominant players.[120] The main "inducement" offered by countries advocating for a new multilateral tax

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[116] Yet, the rigid language of international tax so easily lends itself to mechanical repetition without understanding that the disconnect has gone largely unnoticed by journalists.

[117] This proposal for creating new rights for taxing foreign MNCs without physical presence is largely justified on the ground of Mode-1-for-Mode-3 service trade substitution, discussed in Part I.A.

[118] Mason, *supra* note 11 acknowledges that the OECD historically has not been an institution for reaching collective agreements on taxation. Mason contends that the OECD's first BEPS project "transformed" international taxation by making the OECD into such an institution. This contention remains controversial. See Yariv Brauner, *Serenity Now! The (Not So) Inclusive Framework and the Multilateral Instrument*, SSRN (Jul. 1, 2021); Shu-yi Oei, *World Tax Policy in the World Tax Polity? An Event History Analysis of OECD/G20 BEPS Inclusive Framework Membership*, 47 YALE J. INT'L L. (forthcoming 2021-2022). Cui, *supra* note 59.

[119] Letter from Steve Mnuchin, U.S. Secretary of the Treasury, to Finance Ministers of France, Italy, Spain, and the U.K. (Jun. 12, 2020).

[120] See text accompanying *supra* notes 48-50 for the OECD's position against ringfencing—a position heavily influenced by the U.S.' position.

agreement (France and some of its EU allies) was the threat of DSTs, which are not constrained by tax treaties. This "inducement" was not sufficient for the U.S., given that the Trump Administration believed that the U.S. could deter DSTs simply with Section 301 retaliatory tariffs. But in the version of Pillar One that the OECD announced in July 2021, the scope of new taxing rights based on sales was narrowed to fewer than 100 MNCs.[121] This allowed Secretary Yellen to inform the U.S. Congress that Pillar One would not result in losses of U.S. revenue to foreign governments.[122] A multilateral tax agreement would then become attractive to the U.S., as long as it still leads to a ban on DST adoption.[123]

If this is how global tax agreement comes together, it would of course be quite ironic: even if the OECD proposal was to enable some countries with weak bilateral bargaining power to obtain some more favorable terms through multilateral agreements, it would also enable one country with strong bargaining power (the U.S.) to deprive all participating countries of a tax instrument that they already had in their possession—a result that would have been difficult for the U.S. to obtain acting alone. In fact, the smaller the scope of application of the newly-created taxing rights, the clearer it is that the *main* outcome of Pillar One is the prohibition of DSTs. On net, the countries with purportedly weak bargaining power may *lose* from the multilateral agreement.[124] This detracts from the rationalization of a multilateral tax agreement as *enabling* countries with weak bargaining.

An additional irony highlights the second set of questions about Pillar One. DSTs have been spontaneously adopted or proposed, in developed and developing countries alike, to tax MNCs. Both symbolically and in substance, they represent the opposite of a global "race to the bottom" of lowering tax rates for MNCs. Yet Pillar One, the linchpin of a global agreement purportedly aimed at ending tax competition, is premised on putting an end to this "race to the top." In what sense, then, does Pillar One contribute to limiting tax competition and MNC tax avoidance?

One technical argument, which has not been espoused by the OECD or the G7 countries, is that the method of profit allocation proposed under Pillar One offers a limited implementation of what is called "sales-based formulary apportionment."[125] Some scholars have argued that sales-based formulary apportionment reduces profit-shifting, because the location of a firm's customers is less subject to discretion and manipulation than the location of holding companies or even of plants and other productive activities. If this relatively fixed factor determines which countries get to tax MNC profits, then many profit-shifting techniques may become ineffective, and countries may engage in less tax competition to attract productive investment.[126] This argument has been debated in recent years, with other scholars countering that sales-based formulary apportionment simply creates new distortions and new opportunities for tax avoidance.[127] Moreover, advocates for sales-based formulary apportionment

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[121] M. Devereux & M. Simmler, *Who Will Pay Amount A?* 5:36 ECONPOL POLICY BRIEF (2021).
[122] Cite.
[123] Christopher Condon, *Yellen Sees U.S. Companies Pushing to Back Global Deal*, BLOOMBERG NEWS (2021).
[124] This would happen if the new taxing rights granted under Pillar One generated sufficiently little revenue when compared to the DSTs they could have adopted.
[125] Reuven S. Avi-Yonah, K.A. Clausing & M.C. Durst, *Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split*, 9:5 FLA. TAX REV. 497 (2009).
[126] *See*, *id*.; DEVEREUX ET AL., *supra* note 36.
[127] See Harry Grubert, *Destination-Based Income Taxes: A Mismatch Made in Heaven?*, 69 TAX L. REV. 43 (2015-2016); Wei Cui, *Destination-Based Cash-Flow Taxation: A Critical Appraisal*, 67:3 UNIVERSITY OF TORONTO L. J. 301, 322-328 (2017); Michael Keen and Kai Konrad, *The Theory of International Tax Competition and Coordination*, *in* 5 HANDBOOK OF PUBLIC ECONOMICS 257, 321 (Alan Auerbach, Raj Chetty, Martin Feldstein, & Emmanuel Saez, eds., 2013), at 314-317.

suggest that it is a unilaterally attractive policy to adopt: its adoption should not depend on international cooperation.[128] If the Pillar One proposal claimed credentials as a policy of limiting tax competition and tax avoidance on the basis of this argument, it would have involved both a substantial modification of the argument and something of a leap of faith.

In reality, many commentators—and the OECD itself—do not regard Pillar One as serving these purposes. Instead, a more common narrative is that MNC profit-shifting has largely been dealt with by the earlier OECD BEPS project, and residual profit-shifting issues (and tax competition) are subjects for Pillar Two. Pillar One solves a distinct distributional issue: countries are unhappy about the allocation of taxing rights under the international tax status quo, and they seek to renegotiate their allocation under a new international tax agreement.[129] Conveniently, this teleological narrative invokes the OECD's earlier BEPS project to lend credibility to the OECD's role for brokering unprecedented international negotiations, while trying to explain away why major international conflict in the tax area seems to have erupted after a recent international agreement.

This narrative, however, is so deeply in tension with the idea that nations need to cooperate to end tax competition and MNC avoidance that it almost undermines the latter. The narrative portrays the global profits of MNCs as a pie to be divided up among nations: the alleged problem with the status quo is that some countries are getting too little a piece of the pie while others are getting too much. The idea of tax competition, however, depicts countries as refraining from taxing what is in their right and ability to tax. More fundamentally, describing countries around the world as renegotiating to divide up a global pie depicts a community of nations already engaged in cooperation. Otherwise, they would not be discussing distributional issues: after all, dividing up a given pie is in itself a zero-sum game. But if countries are already cooperating so much that they are willing to negotiate different ways of sharing tax bases, how does the problem of tax competition even arise?

Some media reports portray the difficulty of reaching ultimate agreement regarding the OECD's Two Pillar solution as arising from the likelihood of bargaining failure, when countries negotiate the allocation of taxing rights under Pillar One. This understanding is inconsistent with the design of Pillar Two and the G7's global minimum tax proposal: Pillar Two contemplates a global system of rules ensuring that large MNCs' profits are taxed at least at the minimum tax rate, but treats, as merely a matter of convention, *where* such tax should be collected: in the residence country of the ultimate parent entity, the source country where the activities generating the income take place, some other country where the profit might be booked, or any combination of these. All that the minimum tax rules instruct is for countries to impose taxes that are conditional on other countries' taxation. This suggests that *who* collects revenue is a matter of indifference to countries cooperating to implement the system. Yet how can countries be so keen to claim additional taxing rights (or be so sensitive to ceding tax rights to others) under Pillar One, but at the same time be willing to merely follow a set of allocation conventions under Pillar Two, regardless of their distributional consequences?

In summary, it is quite plausible to see the OECD Pillar One proposal as securing a win for the U.S. and MNCs that are potentially targeted by DSTs, rather than for countries aiming either to claim greater taxing rights or to increase taxes on MNCs. It is far *less* plausible to claim that Pillar One

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[128] DEVEREUX ET AL., *supra* note 36. For a critique of this argument, see Johannes Becker & Joachim Englisch, *Unilateral introduction of destination-based cash-flow taxation*, 27 INTERNATIONAL TAX AND PUBLIC FINANCE 495 (2020).
[129] *See, e.g*. Mason, *supra* note 11.

introduces policies that reduce tax competition and substantially change MNCs' tax avoidance opportunities. In these respects, Pillar One resembles Pillar Two.

3. Is ending tax (and subsidy) competition good for the world?

I have argued so far that the OECD's Two Pillar proposal, as endorsed by the G20 and the IF in July 2021, does not actually support international cooperation to end corporate tax competition and MNC tax avoidance. This conclusion contradicts claims made by political leaders and the global media about what expected international agreements will accomplish. It is, however, consistent with a substantial body of scholarship on the nature of international tax competition and cooperation.

The standard idea of international corporate tax competition envisions countries setting their corporate tax rates in reaction to other countries—and lowering tax rates when others do so—to avoid an outflow of investment. While it is tempting to use this idea to explain the decline of CIT rates around the world in the last four decades, both theoretically and empirically, there is substantial doubt about whether corporate tax competition of this kind even *exists*.[130] But even assuming that corporate tax competition may be an important phenomenon, scholars are able to offer little support for the idea that countries can derive mutual gain from cooperating to *end* tax competition. Economists have extensively modelled the potential welfare gains from such cooperation.[131] Their general conclusion is that cooperation to raise CIT rates is beneficial to all parties *only* under patently counter-factual circumstances. In particular, at least three conditions must simultaneously hold.[132] First, there is no (effective) residence-country taxation: this assumption is necessary, because no country can attract foreign investment by lowering tax rates if the ultimate tax burdens of the foreign investors are determined solely by their residence countries. Second, the countries have no other, more efficient tax instruments at their disposal to raise revenue. Those that do would have no reason to levy the CIT in the first place.[133] Third, countries are symmetrical in size. When they are asymmetrical, there will be winners and losers from uniformly raising tax rates: for example, small countries may lose more by way of the ability to attract capital than big countries. If the losers are not compensated, they experience no gain from cooperation. When many countries are included in some proposed international agreement, all three of these conditions are likely to be simultaneously violated.

Viewed from this perspective, it is unsurprising that countries have previously not entered into any agreement to end tax competition. And if certain countries agree to end tax competition despite their own preferences—as some are said to have done[134]—to say that they have "cooperated" is no different from saying that they have been coerced. Even if an agreement enhances global welfare, can it be said to represent "international cooperation" if countries are coerced into the agreement (to their own detriment)?

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[130] This is explained in Part II.A *infra*.
[131] For an important overview, see Keen and Konrad, *supra* note 127.
[132] The conditions summarized here apply to both competitions to attract productive capital ("real investment") and competitions to attract corporate profit ("profit shifting").
[133] See text accompanying notes 150-152 *infra*.
[134] Jim Wyss, *Caribbean Tax Havens Fret They're at Risk from Global Crackdown*, BLOOMBERG (Jun. 30, 2021, 2:00 AM PDT); Gary Silverman, *It's a sovereignty issue': Bermuda digs in against global tax deal*, FINANCIAL TIMES (Jun. 22, 2021).

In reality, this is not even the relevant question: *it is not clear why maintaining a minimum CIT rate across all countries is good for the world*. There is nothing intrinsically good about the CIT in itself, and least of all in the form that countries have traditionally relied on (i.e. on the basis of corporate residence and legal conventions about the sources of income). Plenty of scholars have advocated for the abolition of the CIT (in its traditional form) in the last decade.[135] Even for countries that are interested in strong redistributive tax policies to secure high levels of economic equality, the CIT is non-essential: shareholder-level taxation, for example, could be just as effective an approach to redistribution.[136] It follows that having no CIT or only a low-rate CIT does not in itself make any country morally deficient. Moreover, tax competition is not the main reason—often, it is not even a *relevant* reason—why some countries have no CIT or only a low-rate CIT.[137] Unless one takes the CIT as immutable, the relevant question should be the following: *why* is a global minimum tax good for the world?

Implicit in recent discussions of the OECD's Pillar Two proposal is a different type of tax competition. Recall the anti-avoidance rules described in Part I.C.1 that allow the country containing corporate headquarters (HQs) to subject the low-taxed income of foreign subsidiaries to additional tax in the HQ country (e.g. IIR, GILTI, and other CFC-like rules). Historically, countries have introduced such rules on a unilateral basis.[138] However, it has been recently suggested that countries that host corporate HQs—especially major advanced economies such as the U.S., UK, and Germany—may face pressure to relax their anti-avoidance rules, because MNCs could relocate their HQs to countries with less stringent anti-avoidance rules.[139] In the absence of cooperation, such countries face "headquarter competition" that resemble a classic prisoner's dilemma: anti-avoidance rules are relaxed in all countries (and tax revenue is lost), but no country attracts more HQs than they would have with collectively stronger anti-avoidance rules. In this scenario, it is *not* in the unilateral interests of the HQ countries to adopt strengthened worldwide taxation, even though it is in their *collective* interest to adopt this policy. It makes sense for countries to rigorously tax MNCs' worldwide income only if other countries also do so. If this were true, then a case for international cooperation could emerge.

This hypothesis about the existence of "headquarter competition" is questionable both theoretically and empirically. The basic theoretical question is why it might not be in the unilateral interests of countries to enact rigorous worldwide taxation systems.[140] To put it differently, why might it be in the unilateral interests of countries to aid and abet "their own" multinationals in deferral, profit-shifting, and the generation of stateless income?[141] In the U.S., for example, there have been plenty of arguments that the U.S. worldwide taxation system puts U.S. companies at a disadvantage in their

135 Eric Toder & Alan D. Viard, *Replacing Corporate Tax Revenues with a Mark-to-Market Tax on Shareholder Income*, 69:3 NAT. TAX J. 701 (2016); DEVEREUX ET AL., *supra* note 36; Becker and Englisch, *supra* note 128 (characterizing the destination-based cash flow tax as CIT abolition).
136 Toder & Viard, *supra* note 135.
137 Steven Dean & Attiya Waris, *Ten Truths About Tax Havens: Inclusion and the 'Liberia' Problem*, 70:7 EMORY L. J. 1657 (2021).
138 Voget, *supra* note 95.
139 For a recent expression of this reasoning, see Michael P. Devereux & John Vella, *A historic global minimum tax has been agreed! But has it?*, OXFORD UNIV. CENTRE FOR BUS. TAX'N (JUL. 15, 2021).
140 Economists have generally portrayed the main challenges to rigorous residence-country taxation as arising from tax administration, rather than incentives. *See* Gordon & Hines, *supra* note 96, at 1945-1948; Auerbach, Devereux & Simpson, *supra* note 96, 879-882; Griffith, Hines & Sørensen, *supra* note 96.
141 This question is raised but not answered in Dharmapala, *supra* note 12.

overseas activities.[142] However, those who make such arguments do not make the claim that abandoning worldwide taxation necessarily makes the U.S. (or any other country) better off overall. Empirically, the claim that countries engage in "headquarter competition" has gained little evidence. Even evidence that MNCs' HQ relocation decisions are *responsive* to anti-avoidance rules is very preliminary.[143] No study has been done to determine whether countries vary their anti-avoidance rules to attract HQs.

But even if we assume that countries hosting HQs of major MNCs do compete for them by refraining from rigorous residence-based taxation, it does not follow that the world is better off if these countries end such competition. To see why, an analogy between lax residence country taxation and export subsidies is useful. If a country taxes its residence corporations' domestic and foreign income equally, then it may help to secure neutrality of corporate investment decisions.[144] If, instead, it taxes domestic income but allows foreign income to be subject to a lower tax rate, the foregone tax revenue represents a form of subsidy for foreign investment. Suppose that one country's policy to subsidize its multinationals' foreign investment invites other countries to enact similar subsidies, because the latter fear the loss of competitiveness of their MNCs. This may engender a form of "subsidy competition" for outbound investment, of which HQ competition is only an instance.[145] However, subsidies from either one country or a set of countries for foreign investment may well benefit other countries' hosting investment. It is thus far from clear that the removal of such subsidies would make *all* countries better off.[146]

In reality, neither the G7, nor the OECD, nor any existing scholarly analysis has claimed either that subsidy competition among capital exporting countries is significant or that such competition endangers global welfare. While trade tensions may erupt among the few countries that engage in such competition—as for example between the U.S. and the EU in the large aircraft manufacturing case[147]—the idea of such competition hardly offers a case for global cooperation.

II. Some Older Puzzles in International Taxation

The dearth of substantive justifications for recently proposed international tax agreements stands in stark contrast with widespread claims about the enormous promises of such agreements. Yet in some ways, this kind of situation—of gaping gaps between theory and practice—is a regular feature in the landscape of international taxation. Economic theory has long struggled to rationalize basic institutions in international income taxation, and in this Part, I highlight several longstanding puzzles

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[142] *See, e.g.* Michael S. Knoll, *Taxation, Competitiveness, and Inversions: A Response to Kleinbard*, 155 TAX NOTES 619 (2017); James Hines, Jr., *Hearing on How U.S. International Tax Policy Impacts American Workers, Jobs, and Investment: Testimony Before the U.S. Committee on Finance*, 117th Cong. (2021).
[143] See Voget supra note 95.
[144] As discussed in Part II *infra*, this is conditional on other countries not taxing the same income. If other countries also impose such a tax, a foreign tax credit (FTC) granted by the residence country could still maintain neutrality, but it may not be in the unilateral interest of the residence country to do so, and the FTC itself can be seen as a form of subsidy (for costly foreign investment).
[145] The supposition that such subsidy competition would kick off assumes that all countries value the competitiveness of their MNCs more than the revenue foregone in relaxing residence-based taxation.
[146] As discussed in Part III *infra*, economists in general are skeptical about the merits of WTO restrictions on export subsidies, and of WTO authorizations of the use of countervailing duties in retaliation for export subsidies. See Sykes, *supra* note 83, at 793-795.
[147] See Goulder, *supra* note 71.

that bear on current discussions of international tax cooperation.[148] I first offer three examples of basic institutions in international income taxation that economic theory has failed to rationalize, and explain how, in each case, the deficiencies in understanding continue to sow confusion in debates about the scope and benefits of international tax cooperation. I then discuss what major assumptions economists have made that may have contributed to this theoretical failure.

A. The puzzle of source country taxation

As discussed earlier, a major rationale offered for the G7 and OECD's global minimum tax proposal is ending tax competition—the race among countries to lower their corporate tax rates in order to attract foreign investment. Tax competition, however, connotes the idea that countries lower their tax rates *in reaction to* other countries doing so.[149] If, regardless of what other countries do, a country already has incentives to lower its tax on foreign investments, then tax competition may not be the right explanation of observed reductions in tax rates. Further, if the world as a whole is better off if no country taxed the investment returns of foreigners, then cooperation to maintain such taxes would clearly be misguided.

Economic theory, however, points precisely to these conclusions. The first important theoretical argument, traceable to the founding works of optimal tax theory, is that countries that are small open economies seeking to attract investment from a global capital market (and in particular, from foreigners who can easily invest elsewhere), should not try to tax the investment returns of foreigners at all: they should tax their own residents instead.[150] The reasoning for this conclusion is elegant and well-known. For any small open economy (Country X), any tax it imposes on foreign investors will not affect the rate of return faced by the latter. This is because foreign investors who are contemplating investments in Country X will require an after-tax rate of return determined by the interest rate that prevails on the world capital market. Given that Country X is small relative to the global economy, any tax increase it introduces on foreign investment will not affect this world price of capital; it simply implies that the investment in Country X must yield a higher pre-tax return, to leave an after-tax return not below the world price.

Because of this need for a higher pre-tax return, domestic investments that cannot achieve such returns would no longer be made. The reduction in investment will generally reduce the returns to local productive factors, such as workers' wages and rent paid to landlords. Any tax collected on mobile capital, therefore, does not reduce the after-tax returns of foreign investors, but instead comes at the expense of—i.e. it is *economically incident upon*—local workers and other factor providers. In light of this consequence, Country X would be better off directly raising the tax on local immobile factors: it would collect the same revenue from the same local population, but more domestic investments would be made to benefit that population.

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[148] In the next Part, we will see that before the "terms-of-trade theory" was offered for international trade. agreements, trade economists had also been mostly dismissive about global trade agreements such as the WTO.
[149] Keen & Konrad, *supra* note 127, at __; Michael P. Devereux & Simon Loretz, *What Do We Know About Corporate Tax Competition?*, 66:3 NAT'L. TAX J. 745 (2013); Michel P. Devereux, Ben Lockwood & Michela Redoano, *Do countries compete over corporate tax rates?*, 92 J. PUB. ECON. 1210 (2008).
[150] For an exegesis of this basic argument, *see* Gordon & Hines, *supra* note 96, at 1939-1943.

Given the assumptions made by economic theory,[151] therefore, it is in the interest of each country that is a small open economy to refrain from taxing the return to mobile capital, *regardless of what other countries do*.[152] If these assumptions hold, then countries acting in their own interest would not tax the capital income of foreigners in the first place—rendering the topic of tax competition moot. What about the conclusion that, from the perspective of the world's welfare, it is also bad for countries to tax the return to mobile capital owned by foreigners? The argument for this is also simple. If capital is conceived of as an input to production, then, when different countries impose different tax rates, the costs of production will differ among them (even when everything else is equal). This distorts how firms located in different countries use capital as an input. In contrast, if only the countries where the owners of capital reside tax the returns to such capital, then these owners will demand the same return wherever the capital is deployed, and users of capital everywhere will face the same cost of capital. Removing the distortion in the use of capital allows the world as a whole to enjoy greater output as a result.[153]

In summary, by a basic line of reasoning, it is in neither the individual nor the collective interests of countries to tax the return to investment owned by foreigners. Taxing the capital income of foreigners is akin to imposing protectionist tariffs on imported intermediate goods, whereas taxing only the capital income of one's own residents sustains free trade.[154] Yet imposing taxes on domestic investments made by foreigners—known as "source-based" taxation—is a common and fundamental feature of income tax systems around the world.[155]

To appreciate how this is a genuine puzzle, consider first some casual rationalizations of "source-based" taxation that have been offered to resolve it. For example, it might be suggested that countries tax investments made by foreigners just because they can, and because it might be politically expedient to tax foreigners as opposed to one's own citizens.[156] This clearly does not resolve the puzzle: if the economic incidence of the tax on mobile capital is on the local population, as the theory above predicts, domestic political constituents should not find it expedient to hurt themselves, or do so just because "they can."

Another possible rationalization is that when countries where investors reside—known as "residence countries"—tax their own investors' worldwide income but reimburse them for foreign taxes paid (through rules for foreign tax credits), the investors would be indifferent to source country taxes.[157] Source countries would then no longer shy away from taxing foreigners. The problem with this answer is that, as we will see below, the fact that residence countries offer foreign tax credits presents a genuine puzzle in itself; one thus cannot use this to resolve the puzzle of source country taxation.

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[151] I return to these assumptions in Part II.2 *infra*.

[152] This explains why, in theoretical models of tax competition to attract mobile capital, economists have to assume that governments do not have more efficient tax instruments—such as taxes on local immobile factors—at their disposal. See Keen & Konrad, *supra* note 127, at __.

[153] Gordon & Hines, *supra* note 96, at 1942-1943; Joel B. Slemrod, *Free Trade Taxation and Protectionist Taxation*, 2 INT'L. TAX & PUB. FIN. 471, 475-476 (1995).

[154] Slemrod, *supra* note 153 at 472-480.

[155] *Id.*, at 476-477; Gordon & Hines, *supra* note 96, at 1943.

[156] Slemrod, *supra* note 153, at 476; Hugh Ault & David Bradford, *Taxing International Income: An Analysis of the U.S. System and Its Economic Premises*, *in* TAXATION IN THE GLOBAL ECONOMY 11, 32 (Assaf Razin & Joel Slemrod eds., 1990).

[157] Roger H. Gordon, *Can Capital Income Taxes Survive in Open Economies?*, 47:3 J. FIN. 1159 (1992).

To reconcile the prevalence of source-country taxation and its sub-optimal character (even from nations' purely self-interested perspectives), economists have gone so far as to postulate that residence-based taxation is administratively so difficult that governments have no choice but to tax capital on a source basis, so that their own residents do not escape tax by disguising as foreigners.[158] Yet this conjecture has never been supported by much evidence and has increasingly seemed an implausible description of reality: countries have made much gain in the last two decades in reducing bank secrecy and deterring tax evasion through offshore accounts.[159]

Yet another explanation for source-country taxation is that some countries may be such large importers of capital that by taxing capital imports, they are able to depress the world price of capital, and thereby make their own capital users better off.[160] To put it differently, a large capital-importing country may be able to pass at least a part of the cost of the tax imposed on mobile capital to foreigners. As we will see in Part III, this idea lies at the foundation of the most important theory of international trade agreements (the "terms of trade" theory). Yet strong empirical evidence for the idea has emerged only recently.[161] In international income taxation, the idea has attracted little attention. At first blush, few countries seem to wield such monopsony power over world capital, while source-country taxation is by no means limited just to a few large capital importing countries. Moreover, if one considers a large country like the United States, which both imports and exports a lot of capital, its observed behavior is also inconsistent with what the idea predicts. On the one hand, the U.S. has increased its capital imports since the 1970s, but its tax rates on foreign investment have, for the most part, gone down rather than up.[162] On the other hand, as a large capital exporter (on a gross if not net basis), the theory would predict that the U.S. would specifically tax capital exports—which would raise the world price of capital to the benefit of U.S. capital owners. But as we will also see shortly, the U.S. has subsidized capital export instead through its foreign tax credit system and through rules that defer the taxation of foreign income.

There are in fact two additional explanations of source-based taxation that might make the latter less puzzling, yet neither received emphasis in prior scholarship nor were deemed decisive. First, it is possible for certain investments to generate "location-specific rent" (LSR)—above-normal returns that can only be earned by investments in a specific place. In such cases, the country where the investments are located can tax foreigners at high tax rates, because, by hypothesis, the foreigners cannot earn such above-normal returns elsewhere.[163] However, economists seem to have resisted using LSR to explain source-based taxation in general.[164] Instead, they have tended to assume that LSR arises only in

[158] *Id.*, at 1945-1948.

[159] Lisa De Simone, Rebecca Lester & Kevin Markle, *Transparency and Tax Evasion: Evidence from the Foreign Account Tax Compliance Act (FATCA),* 58 J. ACCT. RSCH. 105 (2020); Shu-Yi Oei, *The Offshore Tax Enforcement Dragnet*, 67:4 EMORY L. J. 655 (2008); Wei Cui, *Residence-Based Formulary Apportionment: (In-)feasibility and Implications*, 71:3 TAX L. REV. 551 (2018).

[160] Gordon & Hines, *supra* note 96, at 1948-1951.

[161] See discussion in text accompanying note 204-207 *infra*.

[162] Gordon & Hines, *supra* note 96, at 1949.

[163] Joseph Bankman, Mitchell Kane & Alan O. Sykes, *Collecting the Rent: The Global Battle to Capture MNE Profits*, 72 TAX L. REV. 197 (2019).

[164] Gordon, *supra* note 157, at 1163. Gordon & Hines, *supra* note 96, consider the possibility that each country's investment risk is largely uncorrelated with risks in other countries, making each country thereby unique as a diversification opportunity. They acknowledge that in such cases, even small open economies can impose source-country taxes and suggest that countries may cooperate to reduce excessively high taxes.

connection with a small set of industries, such as natural resource extraction.[165] The basis of this assumption is often not explicitly discussed. One possible reason for it is that the wide prevalence of LSR would be incompatible with the supposition that the subject of international taxation is perfectly mobile, homogenous capital. If income taxation of foreigners mainly applied in cases where investments have sunk cost, are uniquely matched to specific markets, involve bilateral monopolies or other forms of imperfect markets, or are not about the taxation of capital at all (but instead apply to services), economists' most familiar models of international taxation would cease to apply.[166]

Second, much of what is called "source taxation" in international taxation may just be a misnomer for corporate income taxation: taxation of the income accruing to corporations as legal persons. A corporation formed in Country X may be subject to CIT there, regardless of where it derives its income from and who its shareholders are. But because the CIT is imposed on the corporation regardless of shareholder identity, it in effect taxes foreigners (along with domestic shareholders). It is thus often difficult to distinguish between taxation by source and taxation by corporate residence. The prevalence of "source-based taxation" may in part simply reflect the prevalence of the CIT. In this case, the puzzle of source-based taxation is traceable partly to the question of why countries should tax corporations instead of just their shareholders.[167] Economic theory, however, has had little to say about why the CIT is used as a tax instrument in the first place. In theoretical analyses of international taxation, the existence of CIT is simply taken for granted.

These last two explanations, therefore, would rationalize the prevalence of "source-based taxation" only at the expense of overthrowing not only much of economic theory but also presumptions in practical discourses about international tax that have prevailed for more than half a century. Unless they are better understood—we return to them in Part IV—the puzzle of "source-based taxation" remains.

B. The puzzle of unilateral relief from double taxation

A second longstanding theoretical puzzle concerns another basic arrangement in international income taxation: countries from which investment capital originates—the "residence countries"—tend to unilaterally lower taxes on their residents' foreign income to reduce the risk of such income being "double taxed" in both the residence and source countries. Such tax reduction can take the form of offering credits for foreign income tax paid against domestic tax liability, or (usually for more limited categories of income such as business income and dividends) by exempting the foreign income of taxpayers altogether. Scholars have long observed that such policies would not make sense if residence countries were motivated by their own national interests.[168] Under the FTC system, for example, the residence country in effect helps its own taxpayers ignore the costs of foreign taxes when considering investment abroad, by providing a reimbursement against such costs. If each country thinks of its national welfare as the sum of its own residents' incomes and the tax revenue it collects, however, taxes

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[165] See De Mooij et al., *supra* note 9, at __.

[166] I further discuss these possibilities in Wei Cui, *The Myth of Capital Mobility*, working paper available upon request.

[167] For example, it is possible that if only shareholders are taxed but not corporations, the taxation of capital owned by foreigners would be less frequent.

[168] Slemrod, *supra* note 153, at 479; John Whalley, *Puzzles Over International Taxation on Cross-border Flows of Capital Income* (NBER, Working Paper 8662, 2001), 11-14; Gordon & Hines, *supra* note 96, at 1945.

paid to foreign governments represent a genuine cost, and governments should not want their taxpayers to be indifferent to such costs.

Policies of reimbursing taxpayers for foreign taxes thus seem to irrationally (from a unilateral perspective) transfer wealth to foreign governments. The appropriate treatment of foreign taxes paid, from a unilateral, self-interested perspective, is to allow them to be deducted in the calculation of a resident taxpayer's income, just like other business costs. This is how most countries operating FTC systems treat foreign, non-income taxes paid. However, income taxes are eligible for unilateral FTCs.[169]

Historically, the fact that residence but not source countries are expected to provide relief from double taxation is often justified by a normative claim that source countries deserve primary taxing rights because foreign investments benefit from the public goods and services source countries provide.[170] The argument for such a normative claim, however, often comes to no more than that people have made it in the past. The oddity of the claim can be seen in light of the economic argument against source country taxation described above: *that* argument applies precisely when residence countries cede the primacy of their taxing rights. When countries exempt their residents' foreign income from taxation, source country taxes determine the tax burden of this income. In such situations, it is both in their unilateral interests and in the interest of the world for source countries not to tax foreign capital.[171] When residence taxation is efficient, but source taxation is inefficient, the normative case for the primacy of a source country's taxing right is not at all obvious.

Another prominent justification for FTC systems offered in the past is that it promotes worldwide welfare by securing "capital export neutrality" (CEN). If a capital-exporting county (Country Y) has a higher tax rate than capital-importing countries, then Country Y's implementation of the FTC system means that its investors will face the same tax rate—that of Country Y—wherever they invest. [172] In the face of distortionary source country taxes, this restores the efficient allocation of capital—which purely residence-based taxation would have achieved. Economically, the effect of FTCs can be explained by analogy to tariffs and subsidies on the trade in goods. If an importing country imposes a tariff on imports, that tariff can be neutralized—and free trade restored—by an equal subsidy by the exporting country.[173] Similarly, a distortionary source-based tax can be neutralized by the residence country's use of FTCs. However, this amounts to a very awkward *explanation* of FTC's adoption. Essentially, one must assume that source countries irrationally tax foreigners, self-inflicting the wound of import tariffs against both the individual and collective interests of nations, and that residence countries then act against self-interest to cure this wound.[174]

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[169] Since foreign income is completely exempt in an exemption system, no distinction is made between the payment of income-based foreign taxes and non-income-based taxes.

[170] Michael J. Graetz & Michael M. O'Hear, *The "Original Intent" of U.S. International Taxation*, 46 DUKE L. J. 1021[, pin location] (1997); Mitchell A. Kane, *A Defense of Source Rules in International Taxation*, 32 YALE J. ON REG. 311[, pin location] (2015).

[171] Gordon & Hines, *supra* note 96, at 1955.

[172] *Id.*, at 1945.

[173] Slemrod, *supra* note 153, at 479.

[174] As Part II.A *infra* discusses, some scholars have suggested that FTC allows residence countries to transfer revenue to source countries, which could be good from a distributional perspective. The difficulty with this view is why countries do not transfer revenue *directly*; even if they do make transfers through the tax system, why do so through the income tax (and no other tax) system?

The puzzle of residence country measures of unilateral relief from double taxation raises a basic challenge for understanding international tax cooperation, for at least two reasons. First, it creates ambiguity for scholarly analyses as to whether countries should be assumed to act in their own self-interest, or whether countries may also act altruistically to enhance world welfare (in the face of irrational actions of other countries.) If countries act altruistically in adopting the FTC, what are the boundaries of this altruism—should countries be assumed to act altruistically in other contexts as well?

Second, the puzzle also introduces uncertainty regarding whether residence and source countries act strategically with respect to each other. In an FTC system, if source country income taxes are reimbursed, would source countries have incentives to raise or expand their income taxes (while reducing other taxes)?[175] And if they do, would the residence countries simply remain indifferent to such strategic action? In an exemption system, if source countries, acting unilaterally or in competition with one another, reduce their tax rates, would the residence country recognize that the purported primacy of source country taxing rights is foregone, and therefore assert its own taxing right more? International tax scholarship has generally identified no clear and persistent instances of such strategic interactions, which has suggested to some that countries do not behave strategically in the international tax sphere.[176]

These ambiguities have permeated recent discussions of international tax agreements. The OECD's Pillar Two proposal, in both its IIR and the UTPR aspects, in effect advocates the FTC system over the exemption system. The impetus for introducing an IIR is that exemption systems that applied even when foreign income was subject to low taxation allow MNCs to get away with "stateless income" or "double non-taxation." Under the IIR, residence countries may still adopt either the FTC or the exemption system when the foreign income of resident taxpayers has been subject to a minimum tax rate (of 15%), but below that minimum rate, an FTC system is to be adopted. This suggests that the aim of the OECD's proposal is *not* to enhance efficiency in global capital allocation through collective action (if the residence country tax rate is above the minimum rate, the exemption system does not secure CEN). Instead, an explicitly alleged aim of the IIR is to incentivize countries with low taxes to raise their tax rates.[177] But this aim relies on an assumption that source countries do act strategically in respect of residence countries' tax rules. This assumption not only lacks clear evidence, but also further clouds our understanding of the motives of the residence countries' decisions.

The UTPR further confounds our understanding of the basis of unilateral relief from double taxation. The UTPR can be seen as a reverse FTC: a source country from which a payment is made would raise its tax if the residence country does not sufficiently tax the payment but would lower its tax if the residence country raises its tax on the payment. The source country now reimburses the residence country's taxes. Normatively, this suggests the notion of a primacy to residence country taxing rights—which is incompatible with traditional rationales for residence country unilateral relief. Further, it suggests that residence countries will respond to source country tax rates, raising their own rates when source country tax rates are raised. It is unclear why residence countries would do so while at the same time maintaining FTC systems (or exemption systems above the minimum rate).

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[175] Gordon, *supra* note 157, at 1175; *see also* Eric Bond, *Optimal tax and tariff policies with tax credits*, 30 J. INT'L ECON. 317 (1991).
[176] Whalley, *supra* note 168, at 14.
[177] See text accompanying note 110 *supra*.

C. The puzzle(s) of bilateral tax treaties

A third longstanding puzzle for scholars of international taxation arises from bilateral income tax treaties. The puzzle is multifaceted, and some of its aspects are better-known than others. Perhaps the best-known aspect of the treaty puzzle arises from the co-existence of unilateral reliefs from double taxation and treaties.[178] Since many countries already unilaterally adopt the exemption or foreign tax credit system—thereby ceding primary taxing rights to source countries—little explicit cooperation between countries through tax treaties seems to be needed to prevent double taxation. This does not mean that treaties are completely useless in removing double taxation. For example, they offer mutual agreement procedures for tax authorities from the contracting states to agree on profit allocations in transfer pricing cases, where such agreement is necessary to prevent double taxation.[179] However, most of the provisions of income tax treaties play no role in reducing double taxation beyond unilateral reliefs. Importantly, treaties usually require elimination of double taxation only according to the provisions of domestic law, thus giving eminent primacy to domestic rather than treaty law.[180] A major purported goal of income tax treaties, that of preventing double taxation, therefore seems redundant.

Further, income tax treaties tend to reduce the taxing right of source countries by limiting the latter's taxation of business profits, dividends, interests, royalties, capital gains, income from shipping, and other types of income earned by residents of the other contracting state. The situation of taxpayers, however, would remain unaffected if they still need to pay tax on such income in the residence country. If the residence countries already offer relief from double taxation, treaty-based reductions of source country taxes simply lower the burden of reimbursement for the residence countries and in effect transfer revenue to the latter.[181] Scholars have found the implicit revenue transfers in tax treaties paradoxical. When two countries engage in roughly symmetrical trade, such transfers roughly cancel out, making the negotiated tax reductions pointless. When two countries engage in asymmetrical trade, revenue is transferred to the country the residents of which receive more of the types of income affected by treaties—typically the richer country. This has struck many scholars as morally perverse.[182]

However, underlying this aspect of the treaty puzzle is the puzzling nature of the policy of unilateral relief from double taxation offered by residence countries. If it weren't for this latter puzzling phenomenon, tax treaties would not easily be regarded as redundant.[183] There is in fact a different way of seeing the puzzle presented by income tax treaties, without taking unilateral relief by residence countries as a given. The fact that treaties reduce source country tax rates suggest that without

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[178] Tsilly Dagan, *The Tax Treaties Myth*, 32 N.Y.U. J. INT'L. L. & POL. 939 (2000).

[179] Bruce A. Blonigen, Lindsay Oldenski & Nicholas Sly, *The Differential Effects of Bilateral Tax Treaties*, 6:2 AM. ECON. J.: ECON. POL. 1 (2014).

[180] *See*, Frank Pötgens & Georg Kofler, *Article 23 "Relief" (Methods for Elimination of Double Taxation), in* IBFD GLOBAL TAX TREATY COMMENTARIES (Pasquale Pistone & Betty Andrade eds., 2014).

[181] One early and prominent economic explanation of tax treaties assumed that relief of double taxation using the FTC method was available only through income tax treaties. In this explanation, the source country (borrowing capital) would lower its tax rate to induce the residence country (lending capital) to offer the FTC, whereas the latter would not have offered FTC otherwise. This results in mutual benefits. Koichi Hamada, *Strategic Aspects of Taxation on Foreign Investment Income*, 80:3 Q. J. ECON. 361 (1966). However, countries do not generally offer FTCs only to countries with which they have entered into tax treaties.

[182] Dagan, *supra* note 178, at __.

[183] *See*, Hamada, *supra* note 181; Gordon, *supra* note 157. Just as we would not want to explain away the puzzle of source-based taxation by assuming the puzzling arrangement of unilateral relief by residence countries, we should not want to assume this latter arrangement in postulating another puzzle.

cooperation, source country taxation is too high. If countries gain from cooperation to reduce source country taxes, then treaties can be useful even without purporting to serve the function of removing double taxation.[184] In other words, the gain from reciprocal reductions of source country taxes, rather than the prevention of double taxation, might be the main reason for entering into tax treaties. However, the idea that source countries unilaterally would set taxes too high stands in contrast with the prediction that they would set taxes low—either due to tax competition, or due to considerations of the inefficiency (and irrationality) of taxing mobile capital. The treaty puzzle can then be seen as a form of the puzzle of source country taxation: we cannot explain what treaties are for unless we can explain why source countries tax so much.[185]

These two aspects of the tax treaty puzzle correspond to what are believed to be two of the main purposes of tax treaties: the relief of double taxation and the reduction of source-country tax rates. Tax treaties contain other major features, many of which raise puzzles of their own. For example, why do source countries reduce only their withholding tax rates in treaties, but not their corporate tax rates? As another example, although tax treaties contain some non-discrimination provisions, they are generally quite weak, and crucially, permit the most basic form of discrimination, between residents and non-residents.[186] In contrast, as Part III will discuss, trade agreements tend to contain many other key provisions besides tariff reductions, most importantly, those that prohibit non-tariff barriers to market access and discrimination. In reality, there has been generally little attempt to explain the features of income tax treaties in economic or social scientific terms Perhaps the puzzles of source country taxes and of residence country unilateral reliefs from double taxation are already so daunting that there is little solid theoretical ground for tackling the explanation of this form of apparent international cooperation, despite its utter familiarity.

D. Predicaments for economic analysis

The three older puzzles of international taxation described in this Part generate three serious predicaments for the economic analysis of the subject.

First, because of the puzzles of source-country taxation and residence country unilateral reliefs from double taxation, economists have, to a large extent, given up the assumption that countries act rationally and purely in their own national interests in the international tax arena. If countries did so act, small open economies would not impose taxes on the income accruing to foreign owners of mobile capital, and residence countries would not provide foreign tax credits to their residents (or exempt such income altogether). But since these are key features of international income taxation, depicting countries as acting rationally in pursuit of some coherent conception of national self-interest becomes difficult.[187] As a result, scholars in international taxation—even economists—often fail to consider what

[184] Gordon & Hines, *supra* note 96, at 1950.
[185] Some proposed (and unsatisfactory) solutions for the source country taxation puzzle also stumble at explaining tax treaties. For example, source country taxes may be explicable in the case of large capital-importing countries, which may pass some of the cost of such taxes onto capital owners elsewhere. However, this theory does not explain why there are so many bilateral tax treaties in the world, including ones signed by small countries that are clearly price takers in the global capital market.
[186] Alvin C. Warren Jr., *Income Tax Discrimination Against International Commerce*, 54 TAX L. REV. 131 (2000-2001).
[187] In traditional explanations of why countries impose tariffs when that seems to reduce their national welfare (defined as national income), it has been suggested that governments may be seized by domestic special interest groups to adopt protectionist policies. Such policies may benefit some politically organized group (e.g. import-

it is in countries' unilateral self-interest to do.[188] Proposals for reforming international taxation usually do not separately consider the implications of unilateral and multilateral adoptions of the proposals.[189]

Second and even more importantly, scholars of international taxation have had to abandon an intuitive, and widely applied, template for explaining human cooperation–whether among individuals, tribes and communities, large organizations, or nations. In this template, one must first identify the need for cooperation. To do so, one usually must examine what the potential participants in cooperation would do in its absence. This is often analyzed in terms of what course of action each participant would choose when pursuing its own interest, taking what others do as given—a way of making decisions that economists call "Nash-optimization." One then considers whether there are courses of action for the participants to take so that everyone is better off than in the scenario in which each participant Nash-optimizes. If there are, then the Nash-optimal courses of action can be criticized as "inefficient" or "socially non-optimal," since *everyone* can be better off following the alternative courses of action. The need for cooperation is thereby identified: by cooperating, participants can follow the alternative courses of action to reach the socially optimal or the "efficiency frontier." After identifying the need for cooperation in this way, one would then, as a next step, explain how the participants are or can be incentivized to act cooperatively instead of Nash-optimizing.

But when countries do not seem to Nash-optimize even in circumstances where they are unlikely to be cooperating, this basic template for explaining (actual) and justifying (actual or potential) cooperation ceases to be applicable. For example, the decision of how much (or little) to tax foreign owners of mobile capital under the CIT is generally regarded as a decision that each country can (and generally does) make by itself, without coordinating with others. Indeed, this is very often assumed in the tax competition literature. However, if countries are found not to Nash-optimize in this non-cooperative context—e.g. if it is against their self-interest to tax foreigners, but they nonetheless do so—then one cannot justify cooperation either to lower taxes or to raise taxes. Cooperation is not needed to lower taxes on foreigners because that's what countries *should* do already while not cooperating. Cooperation is not needed to raise taxes on foreigners because that's what countries *actually* do already while not cooperating, and because it is not clear why countries are better off engaging in such cooperation.

This is remarkable: in many areas of social science, it is the second step of explaining cooperation—identifying how agents can be motivated to act to secure the socially optimal and not the Nash-optimal—that is challenging, whereas the need for cooperation is easy to identify. Yet strangely, in the field of international corporate taxation, what has challenged both theorists and policymakers is the first step, identifying the need for cooperation.

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competing industries) at the expense of other domestic constituents (e.g. consumers) that are less politically organized and of overall loss of national welfare. However, no such story is plausible for taxing mobile capital, as business groups are not often seen to lobby *for* the corporate income tax.

[188] This is striking, because the dominant approach in economics to explaining behavior is to assume agents are rational maximizers of self-interest (suitably defined): abandoning such an assumption in a particular area implies giving up the generality of the social scientific explanations one can ultimately produce.

[189] Consider a new tax design that has received much attention in recent years—the destination-based cash flow tax (DBCFT). Proponents of DBCFT give great emphasis to the fact the tax is "incentive compatible," which means that countries have sufficient reasons to adopt it acting on their own, regardless of what other countries do. DEVEREUX ET AL., *supra* note 36, at __. This is the same as saying that Nash-optimizing countries would adopt the DBCFT. If other tax reform proposals also considered whether Nash-optimizing countries would adopt them, the DBCFT would not be so distinctive in being characterized by incentive compatibility.

This second predicament leads to the third: the difficulty in identifying the need for cooperation has undermined theoretical interest in specifying the "social optimal" in the international tax area. The "social optimal," when the relevant set of agents comprises countries, is usually thought of as the arrangements that maximize the aggregate welfare of countries. For example, as discussed earlier, if the main impact of international income tax regimes is on mobile capital, and if capital is conceived of as a homogeneous intermediate good, then under traditional optimal tax theory, any optimal tax system must be characterized by production efficiency, which source country taxation violates (if different countries adopt different tax rates). Therefore, source-based taxation is not socially optimal from a global perspective, in this traditional view. In general, it is unlikely that what countries do, without coordination, will produce exactly the social optimal: a "social planner" would always be able to dictate a different configuration of national policies that improve upon the actual configuration. At the same time, since there is no single global social planner dictating countries' tax policies, not all configurations that are superior from an efficiency perspective are relevant. Only the improvements that countries can cooperate to achieve are of interest. But if it is not possible to explain or justify cooperation in the international tax context, characterizing the social optimal becomes less disciplined.[190]

The severity of the predicaments may in fact explain why the puzzles identified in this Part are not more widely discussed among economists and other tax scholars (even those whose work is much informed by economic scholarship). This is because they lead to a general state where both economic and legal scholars take much of international taxation as simply *given*, while making minimal efforts to rationalize them. Puzzles disappear when one is no longer even trying to make sense of things. This state of affairs is not only intellectually unsatisfying; it is especially dangerous during periods of rapid policy change. Incoherent and misleading rationales offered for proposed international agreements go challenged; the narratives that emerge from political announcements and press reports become even more devoid of the self-understanding that social science is supposed to provide. If the arguments in Part I about the untenability of the justifications for proposed international tax agreements are right, the louder are the claims of political success, the deeper is the underlying intellectual crisis facing the study of international taxation.

III. A Tale of International Cooperation from Trade Agreements

In contrast to the economic analysis of international taxation, there is a significant economic literature studying the normative rationale underlying the major international institutions governing international trade, especially the WTO.[191] Rather than summarizing that literature, this Part highlights certain features of the literature's most prominent theory: the "terms of trade" theory of trade agreements (abbreviated as "TTT" in this discussion). The aim is to show how TTT illustrates a

[190] Scholars have observed in recent years that the economic analysis of international taxation no longer adopts the standard welfarist approach that incorporates efficiency and distributional concerns into a single normative framework. Instead, the use of ad hoc normative criteria is widespread. The basic paradigm of welfare analysis—which compares the outcomes of Nash-optimizing and cooperative behavior in terms of individual and global welfare—has little traction in the analysis of international tax. *See*, David A. Weisbach, *The Use of Neutralities in International Tax Policy*, 68:3 NAT. TAX J. 635 (2015); Cui, *supra* note 127.
[191] For helpful introductory literature reviews, see Kyle Bagwell, Chad P. Bown & Robert W. Staiger, *Is the WTO Passé?*, 54:4 J. ECON. LITERATURE 1125 (2016); Bagwell & Staiger, *supra* note 82. For more comprehensive literature reviews, see the chapters in HANDBOOK OF COMMERCIAL POLICY (Kyle Bagwell & Robert W. Staiger, eds., 2016).

compelling template for explaining international cooperation, how it has been applied both to rationalize and critique key aspects of the WTO, and how its explanatory strategy contrasts with the state of intellectual ambivalence and confusion about international tax cooperation revealed in Parts I-II.

A. Cooperation to eliminate terms-of-trade manipulations

TTT explains trade agreements, especially the GATT and other agreement within the WTO regime, by first identifying the problem such agreements are supposed to solve.[192] This can be done if it is clear what countries would do in the absence of an agreement, and what is undesirable (or "inefficient") about the outcomes of this non-cooperative behavior. In particular, TTT assumes that countries Nash-optimize in the trade arena when not cooperating. By identifying the inefficiencies resulting from Nash-optimal strategies, the *need* for cooperation—in the form of trade agreements—becomes clear.

What do nations do in the trade area when they Nash-optimize?[193] TTT allows a wide range of preferences and behaviors on the part of national governments. For one, governments may aim to maximize national income. In this case, according to traditional economic theory, they generally should adopt unilateral free trade policies, which allow a country to benefit maximally from comparative advantage. But governments may also hold particular distributional objectives. Consequently, they may, for example, impose protectionist tariffs to benefit capital owners or workers in import-competing sectors.[194] Regardless of what preferences national governments hold, TTT points to a particular form of Nash-optimal behavior that they will always have incentives to engage in. Some large economies like the United States represent major trade destinations for exporters from other countries. Other, much smaller economies may nonetheless be substantial importers of particular types of goods. By virtue of their importance to exporters from other countries, both types of countries wield *monopsony power* in the various world markets they occupy—the options of selling to buyers in other countries are limited. Because of this, when they impose tariffs on imports, they will be able to pass a part of the cost of the tariff onto exporters from other countries—thus transferring wealth from foreigners to themselves.[195] It seems plausible that each national government—whether it aims to maximize only national income or whether it pursues other domestic policy objectives as well—would see its own welfare as enhanced by such wealth transfers. Therefore, governments will always be motivated to set tariff rates higher than would otherwise be set in the absence of the ability to extract surplus from foreigners. Yet such transfer,

[192] Bagwell & Staiger, *supra* note 82, at 225 ("All theories of trade agreements must identify a reason why negotiating governments can gain from the agreement. This involves identifying a problem that would arise absent an agreement, when governments make noncooperative trade-policy choices. The purpose of the agreement can then be viewed as providing a solution to the problem, and the negotiating governments may share in the associated benefits.").

[193] TTT pertains primarily to the trade in goods. The discussion of trade in this Part therefore implicitly refers only to the trade in goods.

[194] In other words, either free trade or protectionist policies can be unilaterally optimal for national governments, depending on their preferences.

[195] In particular, an import tariff depresses domestic demand, which (because of the country's monopsony power) lowers the world price of the good subject to the tariff. This improves the country "terms of trade," defined as the relative price of a country's exports to its imports. Bagwell, Bown, & Staiger *supra* note 191, at 1142-1144. Changes in "terms of trade" are characterized in a general equilibrium context, whereas in a partial equilibrium context, the equivalent idea to the improved terms of trade is just that the cost of a tariff is partially passed onto foreign exporters. *Id*. at 1148-1149.

of course, comes at the expense of foreign exporters. The higher import tariff imposed by a country exploiting its monopsony power therefore creates a negative pecuniary externality for other countries.

However, when many countries (i.e. countries that are large importers relative to specific traded goods) try to transfer wealth from one another this way, they gain much less overall. A nation's terms of trade may improve as a result of its tariffs but will worsen as a result of the tariffs of others. At the same time, high tariffs all around decrease trade and result in welfare losses to all. Countries engaged in terms-of-trade manipulations using their monopsony powers therefore are in a prisoner's dilemma: manipulation is individually rational to pursue, but all will be better off refraining from it. TTT posits that the main function served by multilateral trade agreements—going back to the GATT and under the current WTO system—is to curtail such beggar-thy-neighbor policies.[196]

TTT's basic logic is thus attractively simple. Yet its rationalization of the GATT/WTO as a case of international cooperation that genuinely enhances global welfare is at once radical and important from a policy perspective. TTT is radical because it does not conceive of trade agreements as promoting free trade.[197] Even after countries act cooperatively to reduce tariffs motivated by terms-of-trade manipulations, they may still retain positive tariffs for protectionist reasons. Protectionist tariffs may hurt foreign exporters and even domestic constituencies and may reduce overall global welfare. But according to TTT, it does not follow that there is opportunity for international cooperation to curtail protectionism. This is because protectionism may be individually optimal for a given country—it may maximize national welfare given governments' distributional preferences. Curtailing protectionism therefore may not be in every nation's self-interest, and trade agreements aimed at curtailing protectionism may simply make some countries better off and others worse off. By contrast, trade agreements that aim to eliminate terms-of-trade manipulations can make everyone better off (or at least make some countries better off without making others worse off). Countries can stay as protectionist (or pro-free-trade) as they like under the GATT/WTO; they would simply remove the mutually destructive terms-of-trade manipulations. The implication of TTT is that it is only this latter kind of agreement that represent international cooperation for *mutual* benefit.[198]

While it thus contradicts naïve conceptions of the purpose of trade agreements, TTT provides a much-needed intellectual justification for the GATT/WTO—and this is the basic reason for its policy importance. If one does not seriously consider the possibility of terms-of-trade manipulations, trade agreements are actually hard to make sense of. Before TTT gained ascendance, many economists were skeptical that trade agreements served any rational purpose.[199] This is because, on the one hand, governments trying to maximize national income should unilaterally embrace free trade if they are unable to manipulate terms of trade. They should therefore not condition their own free trade policy on

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[196] Bagwell & Staiger, *supra* note 82, at 224.
[197] *See* Donald H. Regan, *Explaining Trade Agreements. The Practitioners' Story and the Standard Model*, 14:3 WORLD TRADE REV. 391 (2015).
[198] *Id*. The GATT emerged in the aftermath of the World War Two (WWII) as addressing the outbreak of protectionism and retaliatory tariffs in the 1930s following the U.S.' Smoot-Hawley Act. TTT proponents sometimes present this history as illustrating the turn from Nash-optimization to cooperation. *See, e.g*. Bagwell & Staiger, *supra* note 82, at 237-238. However, motives for large countries' term-of-trade manipulations exist even for governments without protectionist preferences and even if they are not reactions to similar actions taken by other countries. Nash-optimal tariffs are thus found also in times of "peace." See Christian Broda, Nuno Limão, & David E. Weinstein, *Optimal Tariffs and Market Power: The Evidence*, 98:5 AM. ECON. REV. 2032 (2008).
[199] *See, e.g.* P.R. Krugman, *What should trade negotiators negotiate about?*, 35 J. ECON. LITERATURE 113 (1997).

other governments adopting similar policies, as they seem to do in trade agreements.[200] On the other hand, if governments do not aim to maximize national income, because they have distributional reasons to engage in protectionism, then they should not want to enter into agreements liberalizing trade for these same reasons: such agreements may enhance trade but lead to loss of national welfare once the distributional concerns are considered.

In other words, without identifying the terms-of-trade motive, countries can only be seen as either entering GATT/WTO unnecessarily or doing so against their own interest.[201] This hardly presents a satisfactory understanding of “one of the most successful international institutions ever created.”[202] But because of TTT, economists no longer need to take the existence of international trade agreements as un-rationalizable and exogenously given; instead, institutions like the WTO come to be seen as serving economically sensible purposes. This is one of the reasons why the TTT has become economists’ “standard model” for trade agreements.[203]

Another attractive feature of the TTT is the impressive empirical evidence that has been gathered to support its logic. A basic empirical issue concerns whether countries possess market power in world markets and whether they set tariffs on the basis of this power. The evidence is that most countries, even small economies, have significant ability to alter their terms of trade on many imported products through tariffs. Moreover, researchers have shown that prior to joining the WTO, countries set higher tariffs on imports for which they could exert large effects on world prices, as compared to tariffs on imports where they have less market power.[204] In contrast, negotiated tariffs under the WTO appear unrelated to market power, suggesting that trade agreements *do* limit the exercise of market power.[205] Similarly, rigorous empirical analysis suggests that the magnitude of tariff cuts secured by negotiations through the WTO on particular products is a function of the market power that countries agreeing to the tariff cuts hold with respect to the products: the greater the market power, the deeper the tariff cut.[206] Combined with other studies,[207] the relevance of terms-of-trade manipulations both for unilateral tariff-setting and tariff negotiations within the WTO now seems, empirically, quite plausible.

B. Rationalizing trade agreements

Having identified the basic function that cooperation through trade agreements can serve, TTT scholars devote substantial attention to how historical and institutional features of the GATT/WTO regime facilitate(d) such cooperation.[208] Three examples illustrate the thrust of this scholarship: the

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[200] Or, as Paul Krugman puts it: “Countries seem willing to do themselves good only if others promise to do the same.” *Id*. at 113.
[201] This, of course, is how economists have awkwardly interpreted major international tax practices, as discussed in Part III.
[202] Bagwell & Staiger, *supra* note 82, at 224.
[203] Regan, *supra* note 197; see Bagwell, Bown & Staiger, *supra* note 191 for a review of main alternative theories of trade agreements.
[204] Broda et al., *supra* note 198 (finding that this terms-of-trade motive explains much of the cross-industry variation in tariffs).
[205] *Id*.
[206] Kyle Bagwell & Robert W. Staiger, *What Do Trade Negotiators Negotiate About? Empirical Evidence from the World Trade Organization*, 101:4 AM. ECON. REV. 1238 (2011).
[207] For a summary of such evidence, see Bagwell, Bown & Staiger *supra* note 191, at 1147-1152.
[208] They thus undertake the second step in the common social scientific approach to explaining cooperation—explaining how parties organize to enter and maintain cooperative arrangements.

agreement to use tariff rather than non-tariff barriers to trade to pursue protectionist policies; the WTO norm of reciprocity; and the enforcement mechanism of disciplined retaliation.[209]

A most salient aspect of the GAAT/WTO architecture is the agreement to use only tariffs to limit market access of foreign suppliers. Many protectionist measures can impose costs on foreign exporters, resulting in worsening terms of trade for foreign countries. However, insofar as the goal of terms-of-trade manipulation is concerned, the best means for achieving this goal is tariffs. This is because in addition to altering the terms of trade, tariffs generate tax revenue for the country that imposes them: other means for manipulating the terms of trade do not bring this benefit.[210] TTT thus assumes that the tariff is the only policy that is distorted when countries Nash-optimize: behind-the-border measures are set efficiently under unilateral choices.[211] It follows from this assumption that countries should be quite willing, when entering into trade agreements, to commit to refraining from erecting other non-tariff barriers (NTBs) to trade. This is exactly what the GATT/WTO rules do, as evidenced by the general prohibition on quantitative restrictions, import licensing schemes, and similar measures (GATT Article XI) as well as other rules. That is, countries follow a process of “tariffication”—"the conversion of most protectionist measures into tariffs.”[212]

Importantly, such collective strategy substantially facilitates the process of reaching and maintaining agreement. This is because focusing on bargaining about tariffs alone “lowers the transactions costs of reciprocal trade negotiations . . . by reducing the number of protectionist instruments that are part of the negotiation.”[213] Moreover, tariff changes are transparent and easy to detect, making tariff commitments easier to enforce than other types of commitments. Overall, the dominant focus on tariff as opposed to other protectionist measures defines the “shallow integration” approach of GATT/WTO. In contrast, a “deep integration” approach to trade agreements would involve negotiating about and monitoring changes in domestic regulatory policies of participating countries, making international cooperation much costlier. Thus, while unilateral motives for terms-of-trade manipulation give rise to the need for cooperation, the fact that tariffs are unilaterally the best way to manipulate terms of trade also makes cooperation based on “shallow integration” feasible.

Another fundamental feature of the GAAT/WTO architecture is the principle of reciprocity. Tariff reductions under the GATT/WTO commonly occur through bilateral bargaining, with the bilaterally-negotiated tariff cuts subsequently “multi-lateralized” to all participants through the most-favored-nation (MFN) rule. Reciprocity is important both for the initial bilateral bargaining, and for subsequent adjustments and the determination of remedies for the breach of obligations. The principle connotes the idea of “mutual changes in trade policy that bring about changes in the volume of each country’s imports that are of equal value to changes in the volume of its exports . . . a rough equivalence between the market-access value of the tariff cuts offered by one government and the concessions won from its trading partner.”[214] TTT gives a particular interpretation to this principle: when two countries bargaining

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[209] TTT scholars examine many more historical and doctrinal aspects of the GATT system from the “terms of trade” lens, such as the most-favored nations norm, the principal supplier rule, sequential partial tariff cuts, and particular bargaining protocols. See Bagwell & Staiger, *supra* note 82, at 238-41, 244-247; Kyle Bagwell, Robert W. Staiger & Ali Yurukoglu, *Multilateral Trade Bargaining: A First Look at the GATT Bargaining Records*, 12:3 AM. ECON. J.: APPLIED ECON. 72 (2020); and generally, Bagwell, Bown & Staiger, *supra* note 191.
[210] See Sykes, *supra* note 83, at 792.
[211] Bagwell, Bown & Staiger, *supra* note 191, at 1147.
[212] Sykes, *supra* note 83, at 791.
[213] *Id*.
[214] Bagwell & Staiger, *supra* note 82, at 241.

with each other secure reciprocity in this sense, they ensure that their terms of trade remain fixed before and after the negotiated tariff cuts. This gives support to TTT's central tenet that trade agreements neutralize the terms-of-trade effect of tariff increases.[215] Moreover, when a member takes actions that "nullify or impair" another government's expected benefits under the agreement, GATT/WTO rules permit the latter government "to withdraw substantially equivalent concessions and thereby to retaliate in a reciprocal manner."[216] This again ensures that as long as countries remain under the GATT/WTO, changes in tariff rates do not lead to terms-of-trade changes.[217]

Perhaps even more important to the GATT/WTO architecture than its specific doctrines are the mechanisms of enforcing trade agreements. TTT envisions that countries will always face the temptation to unilaterally select high tariffs and shift costs, and that "this temptation does not go away simply because an agreement is signed."[218] There is no supra-national body that can sanction countries in breach. Therefore, the only thing that presses back against the temptation to breach is the threat of retaliatory responses. TTT thus sees the enforcement of WTO obligations as entirely a matter of the ability and willingness of participants to retaliate in repeated games.[219]

If retaliation does occur, it must then be the case that a breach was not deterred by the threat of retaliation. However, it does not follow that cooperation completely breaks down. This is because the WTO dispute resolution mechanism enables two types of responses to apparent breaches. First, an aggrieved party can file a complaint with the WTO, thereby publicizing the other party's breach. This publicity potentially enables countries other than the complainant country to threaten retaliation against the country in breach.[220] Second, the WTO requires countries to adopt commensurate measures in retaliation.[221] This requirement ensures that even retaliation reflects the norms of cooperation—in particular, the norm of reciprocity and the goal of restoring the terms of trade. Indeed, in some cases, new tariffs that are in breach of original trade agreements and WTO-authorized countermeasures amount to renegotiations or adjustments of the trade agreement. Such adjustments may often be necessary from the perspective of TTT. Countries' market powers vary over time; to ensure that the countries experiencing a significant increase in market power still derive benefit from a trade agreement, the terms of the agreement may need to be altered.

TTT of course does not rationalize every aspect of the GATT/WTO regime. Far from it: a significant number of the regime's features present a poor fit for TTT. A prominent example is that many

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[215] Bagwell, Bown & Staiger, *supra* note 191, at 1155 discuss empirical evidence that countries in fact negotiate tariffs cuts on a reciprocal basis.

[216] Bagwell & Staiger, *supra* note 82, at 241.

[217] TTT offers two additional conjectures regarding the principle of reciprocity. First, the principle, in conjunction with MFN, helps to insulate the benefits of tariff cuts to the bargaining parties. This encourages the parties to enter into bilateral negotiations in the first place. See Bagwell, Bown & Staiger, *supra* note 191, at 1159-1160. Second, in anticipation of subsequent modifications of prior tariff agreements that will be governed by the norm of reciprocity, governments will be less tempted to use their bargaining power at the tariff negotiations to secure better terms of trade for themselves. Instead, they will only aim to negotiate terms that are optimal from their own perspective, disregarding terms of trade effects. Bagwell & Staiger, *supra* note 82, at 242-243.

[218] Bagwell & Staiger, *supra* note 82, at 248.

[219] Because of this, the weaker ability for retaliation on the part of many WTO member countries—especially small developing countries—has been a major source of concern. *See* Bagwell, Bown, & Staiger, *supra* note 191, at 1213-1214.

[220] *Id*. at 1166.

[221] *Id.* at 1210.

countries hold significant market power over world markets for specific exported products. In such cases, by TTT's logic, countries could significantly improve their terms of trade by imposing *export tariffs* on the products, the cost of which would be partially passed onto importing countries.[222] However, even though import tariffs and export tariffs can all be used to manipulate the terms of trade, the latter seem much less common. [223] Although this means that no trade agreement is needed to internalize the externalities of export tariffs, it seems to point to an incompleteness of TTT as a theory of countries' unilateral policy choices. A related problem is the WTO's treatment of export subsidies. Export subsidies in many contexts have the same effect as lowering import tariffs—both improve foreign countries' terms of trade—but while the WTO aims to achieve tariff reduction, it *prohibits* export subsidies.[224] This, from TTT's perspective, is an unresolved mystery.[225]

However, where TTT cannot rationalize a policy adopted by actual trade agreements, it simultaneously and naturally leads to a normative critique of such agreements—for example, perhaps it is a bad idea for the WTO to prohibit export subsidies. The plausibility of such a critique in turn derives from the theory's strength, which is a matter of how it well it identifies other aspects of trade agreements that actually enable international cooperation to enhance global welfare. In this sense, TTT illustrates a positive theory that is at the same time *policy-relevant*.[226]

In fact, TTT's influence as a theory relies not only on its ability to rationalize and critique existing trade agreements such as the GATT/WTO. Even more importantly, it serves as a frame of reference for further scholarship aimed at identifying additional externalities of countries' unilateral trade policies and the opportunities and challenges for cooperation. This is illustrated by a recent theory about trade policy coordination in the era of global offshoring, developed by Pol Antràs and Robert Staiger.[227] Antràs and Staiger start with the observation that the majority of the world's merchandise trade is in intermediate inputs, and the share of differentiated products in such trade has been rising—a phenomenon commonly referred to as the "offshoring" of production.[228] They suggest that cross-border contracts on the trade in differentiated inputs tend to be incomplete, and prices in such contracts between input suppliers and final good producers are often determined by bargaining after investment in input supply has been made, instead of through price clearing on anonymous markets.[229] Such "bilateral monopolies" can create substantial inefficiency—in particular, an inefficiently low volume of input trade—when there is "free trade" (i.e. in the absence of government interventions). Appropriate trade policy interventions such as import and export subsidies can therefore improve global welfare.

However, Antràs and Staiger go on to show that Nash-optimal policy countries choose tend also to be inefficient. This is because in the context of bilateral price determination, trade policies can also

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[222] *Id.* at 1173.
[223] Regan, *supra* note 197, at 413 (Regan, a critic of TTT, discusses other aspects of the WTO that TTT fails to rationalize in D. Regan, *What Are Trade Agreements For? Two Conflicting Stories Told by Economists, with a Lesson for Lawyers,* 9:4 J. INT'L ECON. LAW 951 (2006).
[224] Bagwell, Bown & Staiger, *supra* note 191, at 1170-1171.
[225] *Id.* at 1176-1177.
[226] Regan, *supra* note 197, at 415-416 (arguing that whether TTT is true matters for trade policy).
[227] A. Antràs & R. Staiger, *Offshoring and the Role of Trade Agreements*, 102:7 AM. ECON. REV. 3140 (2012).
[228] *Id.* at 3140-3141.
[229] Trade economic scholarship has uncovered other ways in which firms exercise monopoly or monopsony power with one another in international trade. See C. Gaubert & O. Itskhoki, Granular Comparative Advantage, 129:3 J. POL. ECON. 871 (2021); V. Alviarez et al., *Two-Sided Market Power in Firm-to-Firm Trade* (Inter-Am. Dev. Bank, Discussion Paper No. IDB-DP-884, 2021).

shift costs onto foreign trade partners. For example, import tariffs can change the conditions of *ex post* bargaining between foreign suppliers and domestic producers, leading to the shift of surplus from the former to the latter. Driven by this motive, Nash-optimal trade policies will continue to depress the volume of input trade.[230] In addition, the country importing inputs and exporting final goods may be motivated to intervene in the trade of the final good—making the domestic price of the final good inefficiently low—because this can also help shift surplus from foreign input suppliers to domestic producers. As a result, simply negotiating about market access and trade volumes—which is the WTO's "shallow integration" approach—will no longer be sufficient to undo the harm of Nash-optimal policies.

Overall, Antràs and Staiger argue that the distinctive features of offshoring introduce novel reasons for trade policy intervention, new externalities from Nash-optimal policies, and new challenges for policy cooperation relative to an economy with market price clearing (which TTT studies). Like TTT, Antràs and Staiger clearly identify *why* countries should cooperate in the face of offshoring. But unlike TTT, there is no ready answer to the question of *how* countries can cooperate to achieve mutual gain. One implication of their theory is that further trade policy coordination may have to pursue a "deep integration" approach, where countries commit to constraining their behind-border, hard-to-monitor policies that affect trade.[231] This in turn implies that the GATT/WTO do not adequately advance the objective of policy coordination. At the same time, both theory and practical experience suggest that the "deep integration" approach to trade agreements is much less likely to be successful than the GATT/WTO.[232] Antràs and Staiger's story has come to be recognized as plausible not only for differentiated inputs, but also especially for the trade in services.[233] And the very limited success of the WTO's General Agreement on Trade in Services (GATS) offers a basic illustration of the difficulty of deep integration.

C. Assessing "folk theories" of tax cooperation

I explained in Part II how standard economic scholarship on international taxation, which views the CIT's chief international effect to be on mobile capital, has been unable to make sense of core international income tax practices of the 20th century: it has convincingly identified neither countries' Nash-optimal policy choices nor opportunities for cooperative gain. It is now useful to briefly consider, against the benchmark of TTT, how well the broader legal and policy discourse on international taxation has delineated the scope of actual or potential cooperation. There are two "folk theories" about the rationale for cooperation in such discourse, corresponding to two distinct policy goals: the prevention of "double taxation," and tax competition.[234] It is useful to consider how each addresses three issues that TTT shows to be important in any story about cooperation: (1) What is *harmful* about non-cooperative

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[230] Likewise, an export tariff imposed by the country of the foreign input supplier can also shift cost onto the final good producer and reduce the volume of trade. Antràs & Staiger, *supra* note 227, at 3142-3143.
[231] *Id.* at 3163-3164.
[232] R. Staiger & A. Sykes, *The Economic Structure of International Trade-in-Services Agreements*, 129:4 J. POL. ECON. 1287 (2021).
[233] Bagwell, Bown, & Staiger, *supra* note 191, at 1184.
[234] By contrast, the prevention of MNC tax avoidance did not emerge as a cause for international cooperation until the OECD's original BEPS project. Even under that project, cooperation was mainly intended to produce "certainty" for businesses and reduce the risk of undue burdens for MNCs from governments' unilateral actions (which can be thought of as a variant of the objective of preventing double taxation). The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting that emerged from the original BEPS project purportedly facilitated the amendment of tax treaties as a matter of legal procedure, but did not otherwise require countries to change policies or make mutual commitments.

conduct? (2) What *mutual benefits* may parties derive from cooperation? And (3) What *enforces and sustains* cooperation?

In terms of the prevention of "double taxation," tax scholars and practitioners voice the intuition that since both source and residence countries can tax the same income, non-coordination may lead to excessive taxation of such income—which reduces global welfare by reducing cross-border trade and investment. This intuition implies that no single government's tax policy is necessarily harmful in itself. It is when governments do not coordinate in their policies that harms arise. And the solution to the problem of double taxation is commonly thought to be mutual agreements about the allocation of taxing rights, over different types of income, among governments—a solution implemented by bilateral tax treaties.[235]

Yet it is easy to see how this "theory" carries little explanatory power. To begin, is *double* taxation harmful for cross-border trade and investment, or taxation itself? *Any* change in the cumulative, tax burden cross-border transactions may have an impact on cross-border flows. Therefore, any change in unilateral tax rate-setting may have an impact on such flows, *given* the tax rate set by the other country. Therefore, the narrative about double taxation casts all unilateral choices of tax rates as having a potential negative effect, which is implausible.[236] Moreover, allocating taxing rights among nations is not like deciding which side of the road cars should drive on: countries should not be expected to be indifferent about who gets to tax what income. Countries would benefit from cooperation to prevent double taxation only if what they lose from foregoing taxing rights is compensated by the benefits they derive from increased cross-border trade and investment. Yet there is no general intuition about who benefits *more* from cross-border trade and investment to guide the allocation of taxing rights. Nor does the general approach of bilateral tax treaties evidence any coherent intuition. As discussed in Part II.C, residence countries offer unilateral relief from double taxation, suggesting that they are more willing to forego taxing rights to restore cross-border flows. Because of this unilateral stance, tax treaties provide little additional relief and therefore would have little effect on such flows. Yet tax treaties also reduce source country tax rates, suggesting that source countries tax too much in the absence of coordination. The intuition about double taxation therefore addresses neither issue (1) or issue (2) in the explanation of cooperation.[237]

Postulating the limitation of tax competition as the goal of international tax is problematic for different reasons. In the typical conception of tax competition, the harm of non-cooperative conduct is clear: a country's decision to lower its tax rates has a negative externality on others—capital flows away

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[235] *See, e.g*. M. Graetz & M. O'Hear, *The 'Original Intent' of U.S. International Taxation*, 46 DUKE L. J. 1021 (2021). For those who find this explanation of the need for international tax cooperation intuitive, the world has long settled into tax cooperation—shortly after countries began to levy income taxes in the 20th-century.

[236] Consider two countries, each taxing an item of income at 30%. Suppose they believe the cumulative tax burden of 60% is too high, and one country agrees to reduce its tax rate to 20% while the other reduces its rate to 10%. Yet, for cross-border transactions, this is no better than a scenario where the two countries do not coordinate, but one country initially sets a tax rate of 20% and the other at 5%. This shows that the lack of coordination itself is not the issue; an implicit judgment has to be made about what is "too high" a level of taxation. *See* DANIEL N. SHAVIRO, FIXING U.S. INTERNATIONAL TAXATION 4-7 (2014).

[237] As a technical matter, bilateral tax treaties do not even aim to address double taxation of the same income: they address only "juridical double taxation"—taxation of the same income *of the same person* by two different governments. If the same income is subject to tax in the hands of two different persons—e.g. payor and payee—tax treaties generally do not offer any remedy.

from other countries to the rate-lowering country.[238] This addresses issue (1) in the explanation of cooperation. Yet issue (2)—how countries can mutually gain from cooperation—would go unaddressed, unless countries are assumed to be symmetrical and constrained in using the tax instrument they compete upon.[239] These assumptions are generally false in contexts where the problem of tax competition is said to arise.

The point of this quick review is that "folk theories" of international tax cooperation are rather unhelpful, and taking international tax cooperation for granted on the basis of such theories is unjustified. This becomes even more obvious when we consider how purported tax cooperation is enforced—issue (3) above. For bilateral tax treaties, if one contracting state breaches a treaty (e.g. it deviates from its allocated taxing rights), the only remedy for the other contracting state is to renegotiate the treaty or terminate it. There is no counterpart to the measures of commensurate, authorized retaliation under the WTO, and there is no mechanism for collective approbation of a breach. The threat of termination has apparently also not deterred many treaty overrides. As for proposals for ending tax competition, envisioned enforcement tends to take two forms: "blacklisting" countries engaging in "harmful tax practices"—"naming and shaming" such countries—or exercising "peer pressure" on countries that already belong to some other, more extensive cooperative (usually collective governance) regime, such as the EU. That is, the countries exercising sanctions are clearly unwilling to "retaliate" by resuming tax competition themselves. This highlights the asymmetries that the basic argument for tax competition seeks to ignore: countries do not *all* want to raise their tax rates; it is some high-tax countries that want other low-tax countries to raise their taxes.

IV. Two Obstacles to Conceptualizing International Tax Cooperation

TTT (along with theories building upon it, such as the theory of offshoring) is a specialized economic theory about the WTO and other trade agreements.[240] Its strength lies not in how it resonates with "folk theories" of trade agreements,[241] but in its rigorous logic, the empirical evidence in its support, and its clear (even if counter-intuitive for some) implications for policy. Its example suggests that to identify, explain, and criticize instances of international tax cooperation, one need not be bound by folk theories of cooperation. From this perspective, the problem with the economic models of international taxation discussed in Part II is not that they are obscure, but that the unresolved puzzles they generate lead to an intellectual stalemate in explaining countries' non-cooperative and cooperative behavior.

TTT actually possesses even more direct relevance to explaining unilateral policy choices in international taxation. The main Nash-optimal policy choice that TTT highlights is the imposition of import tariffs when the cost of such tariffs can be shifted onto foreigners. This form of "pecuniary externality" should be familiar to international tax scholars, since the idea that the economic incidence

[238] Conversely, a country's decision to raise its tax rates has a positive externality on others.
[239] Indeed, even for symmetrical countries, tax competition would not end simply because countries agree not to compete on tax rates: they may still compete on tax bases, subsidies, the strengths of their anti-avoidance rules, etc., all of which may have equivalent effects as varying tax rates.
[240] The original insights of TTT date to John Stewart Mill and Robert Torrens in 1844, but the insights were not formally developed until the 1980s. Bagwell & Staiger *supra* note 82, at 225.
[241] *See* Regan, *supra* note 197 and Regan, *supra* note 223 for discussions of conflicts between the TTT and practitioners' interpretation of trade agreements.

of a tax might be borne by foreigners has always potentially justified source-based income taxation. However, as discussed in Part II.A, economists have treated this possibility as a secondary consideration because they assume the CIT's main effect is on globally mobile and homogeneous capital. Given this assumption, the CIT imposed by a small open economy *cannot* be borne by foreign capital owners and can *only* fall on local immobile productive factors. The counterpart to this tax orthodoxy in trade would be an assumption that import tariffs are always borne by domestic consumers and input users and have no effect on world prices. Clearly, TTT and other trade theorists reject this latter assumption: both theory and empirical evidence demonstrate that tariffs imposed on specific lines of traded goods *do* affect their world prices.

As also discussed in Part II.A, the thesis that the burden of a source-based CIT can fall on foreigners is associated, in the analysis of international taxation, with the notion of "location-specific rent" (LSR). Tax economists have tended to assume that LSR is important only in a few industries such as natural resource extraction. Trade economists would probably find this quite surprising. Consider intellectual property (IP) rights, the deployment of which is central to MNC activity. *By their very definition*, IP rights such as patents possess two properties: they embody unique inventions and therefore are inherently non-homogeneous, and the market price of a product embodying an IP is higher than its marginal cost of production. Moreover, most types of IP afford *simultaneous, non-rival* deployment in different countries.[242] This implies that MNCs owning IP rights will practice geographic price discrimination, and that there will likely be no world price for products embodying IP. Imperfect markets, differentiated inputs, and bilateral monopolies thus pervade MNC activities. In such contexts, as Antras and Staiger have shown, potentials abound for unilateral fiscal instruments to shift costs onto foreigners and thereby generate pecuniary externalities.

If, however, LSR (or cost-shifting onto foreigners) is as pervasive as recent advances in trade economics suggest, then interpreting source country income taxation as a unilateral, Nash-optimal policy becomes as plausible as TTT's basic premise that countries pursue "optimal tariffs." In other words, explaining source-based taxation should not be so difficult after all. Such an approach would also directly rationalize numerous other tax policy choices. For example, the DST recently adopted by some countries—and which the OECD's Pillar One proposal bans—can be analogized either to resource royalties[243] or self-assessed tariffs on imported digital services.[244] The ability of DST to shift costs onto foreign platform companies is well-supported by the zero marginal cost of many digital services, the presence of imperfect competition (through IP protection or network effect), and the non-rival nature of the technology involved.[245] While the DST has widely been demonized as both unilateral and self-defeating,[246] from the perspective of economic theory it is easily explained as Nash-optimal policy—and, it must be recognized, international taxation would make more sense if we could rationalize the CIT in the same way.

Yet identifying unilateral optimal policies is only the first step to the analysis of international cooperation. As Part III emphasized, if some countries' Nash-optimal policies exert pecuniary

[242] *See* Cui, *supra* note 52.
[243] Cui, *supra* note 38.
[244] Richter, *supra* note 86; Cui, *supra* note 58.
[245] Under most conditions, even a small country imposing the DST can get the foreign platform company to bear a part of the DST's burden. Wei Cui & Nigar Hashimzade, T*he Digital Services Tax as a Tax on Location-Specific Rent* (CESifo Group Munich, Working Paper no. 7737, 2019).
[246] Cui, *supra* note 58.

externalities on other countries (and especially if the *purpose* of such policies is to profit from such externalities), their removal through cooperation would make sense only if countries can derive mutual gains.[247] According to TTT, countries engaged in reciprocal reductions of import tariffs through the GATT can gain from the more efficient (i.e. increased) volume of resulting trade; the loss of tax revenue that would have been collected at the expense of foreigners is compensated by recouping the loss to one's own exporters created by the other country's optimal import tariffs. Along the same lines, one can imagine that reciprocal reductions of source country CITs may allow countries that are roughly symmetrical with each other to increase trade and investment flows among them, without either losing net tax revenue. This possibility may explain the early bilateral tax treaties between pairs of advanced countries. At the same time, it would support criticisms that many legal scholars have levied against the proliferation of bilateral tax treaties, based on the OECD model tax convention between pairs of developed and developing countries, since trade and investment flows between them tend to be far from symmetrical.[248]

Nonetheless, there is a basic difficulty in transposing TTT directly into the analysis of international tax cooperation. A key assumption of TTT is that important tariffs are the "first-best" instruments for countries intent on pursuing terms-of-trade manipulations. It is because of this that countries can pursue cooperation through the GATT's and WTO's shallow integration approach (which in turn, according to TTT, explains the GATT's and WTO's successes.) By contrast, it is far from obvious—in fact it is quite unlikely—that the CIT is the first-best policy instrument for capturing LSR. This is first because the CIT applies across all corporations, as opposed to individual products and markets—LSR is much easier to isolate at these latter levels.[249] For capturing LSR, in other words, the CIT is a very blunt instrument. Secondly, the CIT also serves as a purely domestic policy instrument—as a substitute for or complement to taxing shareholders that are resident individuals—and must therefore be coordinated with the personal income tax. Thus, even if the source-based CIT has optimal-tariff-like effects, its dissimilarities from tariffs in these two respects render it more like non-tariff methods for manipulating terms of trade—what trade specialists call non-tariff barriers (NTBs) to trade.

Analyses from trade economics would thus predict that CIT—if it is used as a tariff-like instrument—is very difficult for countries to cooperate on. This is for at least two reasons. First, since the CIT serves both purely domestic policy purposes and as a way of extracting surplus from foreigners, it will be difficult to distinguish between a policy change that accomplishes legitimate domestic policy purposes and one that has a beggar-thy-neighbor intent. In this and other ways, the CIT is far less

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[247] There may be additional sources of cooperative gain. For example, Richter supra note 86 argues that the wide adoption of DSTs may hamper technology progress that improves the quality of digital services.

[248] For a recent review and development of this critique, see Eric Zolt, *Tax Treaties and Developing Countries*, 72 TAX L. REV. 111 (2018-2019). While tax scholars have long been interested in the asymmetries between developed and developing countries as undermining the bilateral tax treaty as a mode of mutually beneficial cooperation, such asymmetries are not unique to tax treaties; they also characterize international trade agreements. There are other general challenges to international cooperation that apply to both tax and trade. For example, whereas TTT suggests that terms-of-trade manipulations are the same regardless of whether a government pursues protectionist policies because of distributional considerations, Antras and Staiger argue that when pecuniary externalities arise from incomplete markets in the absence of world prices, the Nash-optimal trade policies adopted will depend on the government's specific policy objectives. That is, countries will be motivated to adopt different strategies for extracting rent from foreigners when domestic political considerations change. This would require countries to renegotiate their agreements over time as these changes occur.

[249] Economists' tendency to attribute LSR only to a few industries may reflect the practice that variations of CIT treatment tend to apply on an industry, rather than product, basis.

transparent than tariffs, making monitoring compliance (with any agreement that constrains the CIT's pecuniary externalities on foreigners) more difficult. Second, the CIT is not a stable policy instrument. Even for purely domestic policy purposes, and even if domestic political configurations do not change, there are plenty of substitutes for the CIT (such as shareholder-level taxation), as well as more and less efficient forms of the CIT (such as those that tax only corporate rent and those that tax the normal return to capital). And for the purpose of extracting rent from foreigners, there are eminently superior (e.g. more targeted) policy choices, such as sector-specific rent taxes and product-/service-specific excise taxes such as the DST.

To summarize, one can point to two fundamental intellectual obstacles to understanding the scope of potential international cooperation that are unique to policy and scholarly discourses about the CIT. The first is an unwarranted assumption that the international economic impact of the CIT is primarily on mobile, homogeneous capital. The second is the assumption that the CIT's importance as a tax instrument is immutable and must be taken as a given. The former assumption poses insuperable challenges in the characterization of Nash-optimal behavior. The latter assumption dramatically limits the type of international cooperation studied and that can be feasibly envisioned. There is no counterpart to either of these two peculiar assumptions in the theory of trade agreements.

It is thus deeply ironic that the new international tax agreements promoted by the G7 and OECD in 2021, which purport to usher in the most important changes to international taxation in 100 years—essentially the CIT's entire history—are justified precisely on these two outdated assumptions. As discussed in Part I, the G7 and OECD falsely portray tax competition over globally mobile capital as a *global* first-order problem, one that all countries can gain from solving. At the same time, they promote the idea that countries are morally deficient if they adopt CIT rates that are too low. The United States, in particular, which came close to abolishing the CIT in 2017 when considering the adoption of the destination-based cash-flow tax,[250] did a 180-degree turn and now calls for an international alliance to punish all countries that rely on the CIT less than it does.[251] And while it is far from clear that world will succeed in propping up the CIT this way—Part I.C argued that the OECD's Two Pillars do not even really try—the OECD agreement will ensure that countries surrender a unilaterally efficient tax instrument, targeted at highly location-specific rent, that incurs the displeasure of a few powerful countries.

Conclusion

In proposing new international tax agreements in 2021, the governments of the G7 countries and the OECD have presented the rationales for international tax cooperation as self-evident. A broad population of journalists and non-specialist commentators also assume that the new agreements aim at ending tax competition and MNC tax avoidance, and strongly support these objectives. This Article has argued that, in fact, the rationales for international cooperation on the CIT are anything but self-evident. Not only has there been no single answer to the question, "Why should countries cooperate in international tax?", there has also been *not one* persuasive answer.

Ending most forms of MNC tax avoidance does not require global cooperation. Nor is requiring all countries to impose CITs with a minimum rate a worthy objective for the global community. Consistent with these assessments, the OECD's Two Pillar proposal is designed neither to significantly

[250] *See* Cui, *supra* note 127, Becker & Englisch, *supra* note 128.
[251] *See supra* notes 110-112 and accompanying text.

reduce tax avoidance (relative to what is unilaterally feasible) nor to limit tax competition. Instead, it aims to secure favorable outcomes for MNCs by limiting unilateral anti-avoidance rules and novel instruments for taxing MNCs. Both come especially at the expense of developing countries, but the MNC-favorable outcomes hardly command public support even in rich countries.

The spurious claims about why and how nations should cooperate in international taxation are widely circulated in recent policy discussions and have thrust international tax scholarship into a state of intellectual crisis. The Article argued that standard economic theory in international taxation has offered little useful guidance about how to conceive of international cooperation. One might say that as far as economists are concerned, whatever happens in international tax just happens. Consequently, the interpretation of 20th-century international tax practices is left to folk theories about preventing double taxation or tax competition. The ad hoc and self-contradictory theories espoused in 2021 threaten to become new occupants of this intellectual vacuum.

This Article contrasts this state of intellectual crisis with economic theories of trade agreements. The terms-of-trade theory has supplanted folk theories about the WTO, offers testable interpretations of trade agreements, and identifies both old defects in and new challenges for trade agreements. It does so by following a basic social scientific template for explaining cooperation—convincingly characterizing Nash-optimal behavior, identifying the inefficiencies of such behavior, and delineating the mechanisms of cooperation. The Article also highlights two basic unquestioned assumptions, generally made by international tax scholars, that may prevent the development of an analogue of TTT in international tax: the primary subject matter of international taxation is capital mobility, and the CIT is immutable. The new international tax agreements of 2021 seek to lock in these outdated assumptions. But we may only be able to understand and envision international tax cooperation by casting these assumptions aside.