

Can Multinational Enterprises be Taxed in an Egalitarian way?

Jacob Schneekloth and Leah Trueblood^{1#}

¹Oxford University, UK

#Advisor

ABSTRACT

Failure to properly tax multinational enterprises (MNEs) located in host states where their users are results in a loss of \$155 billion annually. The Organization for Economic Co-operation and Development (OECD) introduced two reform pillars in 2021 to address this gap. The first pillar provides a new taxing framework to replace the current one (Digital Services Taxes). It offers new taxing authority to host states where the consumers are located. The second pillar establishes a base rate for corporate taxes worldwide. Although the OECD proposals are a welcome step in the right direction, they fall short because they need to strike the proper balance between autonomy and flexibility. This paper promotes a compromise between incompetent digital services taxes (DSTs) and redistributing taxing authority. The proposal here aims to establish parameters that host states can work within while preserving countries' independence to determine their rates. To tax MNEs "appropriately" means striking this balance. The proposals in this paper are driven by liberal egalitarianism and impure welfare philosophies of taxation, which emphasize equal opportunity for more equitable MNE taxation and a more equitable world.

Introduction

Every year, \$155 Billion (USD) is lost by not appropriately taxing multinational enterprises (MNEs) where their users are located.¹ In 2021, the OECD proposed two pillars of reforms to address this gap.² The first pillar establishes a new framework as an alternative to the existing system. It reallocates some taxing rights to the host states where the consumers are located. The second pillar sets a minimum global corporate tax rate. These OECD proposals are a welcome step in the right direction but do not go far enough. This paper offers an idealized alternative to help identify some vulnerabilities in the reforms.

This paper is concerned with the reforms of the first pillar. It argues that the OECD proposals do not strike the right balance between autonomy and flexibility. Instead, this paper advocates a middle ground between the existing *ad hoc* digital services taxes (DSTs) and a reallocation of taxing rights. The proposal here aims to set guidelines that host states can work within while maintaining countries' autonomy to set their rates. Finding this balance is what it means to tax MNEs appropriately. The philosophies of taxation motivating the proposals in this paper are liberal egalitarianism and impure welfarism. These philosophies emphasize equal opportunity, which is needed for the fairer taxation of MNEs and a fairer world.

¹ Organization of Economic Cooperation and Development, '130 countries and jurisdictions join bold new framework for international tax reform' (1 July 2021)

<<https://www.oecd.org/newsroom/130-countries-and-jurisdictions-join-bold-new-framework-for-international-tax-reform.htm>> accessed 22 October 2022

² *ibid*

This paper has three parts. The first part provides an overview of the status quo and the OECD reforms. The second part offers an alternative middle ground and explores the philosophy on which that middle ground is based. The third part considers practicalities, the future, and counterarguments. One quick definition before proceeding: this paper argues for the ‘appropriate taxation’ of MNEs. While clearly, the word ‘appropriate’ invites an element of subjectivity, the claim here is that appropriate taxation is fair taxation, and fair taxation is driven by the main principle driving impure welfarism and liberal egalitarianism; equal opportunity. This principle applies to all parties involved, host states, home states, and MNEs.

Part I: The OECD Reforms and the Status Quo of Digital Services Taxes

1. The OECD Reforms

There are currently gaps in how MNEs are taxed. Currently, MNEs are significantly undertaxed in their users' jurisdictions.³ This gap is causing damage to emerging economies to the extent that action is necessary.⁴ Countries need to set guidelines to help tax MNEs appropriately. These guidelines must have global buy-in to have an impact. This is a worldwide problem requiring international leadership. In 2021, the OECD offered several proposals to provide this leadership and address this gap. This section offers an overview of the OECD reforms and the existing system of DSTs.

The first pillar of the OECD reforms has four parts.⁵ The first and most important reform is reallocating taxing rights of 25% of the residual profits of MNEs to the host state where their users are based.⁶ The rest of the reforms in the first pillar make these reforms feasible. The reforms create a ‘mandatory and binding’ dispute resolution mechanism, remove DSTs, and streamline coordination.⁷ These reforms focus on the needs of developing countries. Overall, this broad framework is a necessary step in the right direction. This paper focuses specifically on one part of pillar one: the reallocation of residual taxing rights. Inevitably, reallocating residual taxing rights involves balancing global cooperation and local autonomy. This paper argues that the OECD reforms do not get this balance quite right, and with the help of liberal egalitarianism, a more robust compromise can be found. First, however, it is necessary to explain in further detail the status quo and why it is unsustainable.

³ Organization for Economic Cooperation and Development, *Corporate Tax Statistics* 3rd edn <<https://www.oecd.org/tax/tax-policy/corporate-tax-statistics-third-edition.pdf>> accessed 22 October 2022 Figure 17

⁴ Favourate Sebele-Mpofu, Eukeria Mashiri, Samantha Chantelle Schwartz, ‘An exposition of transfer pricing motives, strategies and their implementation in tax avoidance by MNEs in developing countries.’ (2001) 8 *Cogent Business and Management* 1

⁵ Organization for Economic Cooperation and Development, ‘Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitisation of the Economy’ <<https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-july-2021.pdf>> accessed 22 October 2022

⁶ *ibid.*

⁷ *ibid.*

2. The Status Quo: Digital Services Taxes

The OECD reforms aim to replace an *ad hoc* system of DSTs. DSTs take a country-specific approach. They are created only by the host state. They are flat rate set taxes of MNEs and gross taxes on the provision of digital services.⁸ Some states will tax 5%, such as European countries, and others, like Kenya, a much lower 1.5%.⁹ 'Of the 38 OECD countries, 15 had DSTs in 2021.¹⁰ These taxes tended to be higher in Europe than in the Global South.¹¹ There can be the potential for exploitation in that MNEs can move from a host state with high DST to one with lower DSTs. A global agreement must be in place for global tax reform to work. That is precisely what DSTs did *not* do.

In contrast to the bilateral relationships established by DSTs, the OECD reforms seek to create a relationship between the host state, the home state, and the MNE. DSTs are a flawed stopgap measure that cannot address the under-taxation of MNEs. They create a potential race to the bottom, and the *ad hoc* nature of the taxation results in the under-taxation of MNEs. This race to the bottom demonstrates that the real problem with DSTs is the absence of a global consensus. This consensus is needed to make tax reform happen. The absence of reform results in unfairness. The response by the OECD in the form of two pillars of reforms was both necessary and welcome, but these reforms also have their limitations.

It is important to recognize that DSTs also have their strengths. The principal strength of DSTs is that they give states the autonomy to set their tax rates. This must, in some way, be preserved to maintain state sovereignty. The second strength of DSTs is simplicity, although this cuts two ways as both a strength and a weakness. Although DST is simple in the sense that it allows countries to create their rate, simplicity is also its downfall. A primary example is the inappropriate taxation of the MNEs based in the United States. From 2010 to 2019, American MNEs offshore paid \$155 billion less than what the actual tax would have required them to pay.¹²

Both DSTs and the OECD reforms have their limitations. What is required is a middle ground. One that takes the autonomy of the DSTs, and the framework of the OECD reforms and establishes a balance of both. The agreed guidelines of the OECD need to set a framework in which three parties: (i) host states, (ii) home states, and (iii) MNEs can establish their relationships. The following section explains the shortcomings of the OECD reforms and why greater flexibility is required.

3. Limitations of the OECD Reforms

It is admirable what the OECD is trying to do. While the motive and mindset of their approach are correct, the reforms are not ambitious or bold enough to establish appropriate taxation. This paper argues that a middle ground is required between the OECD proposals and existing DSTs. A middle ground is possible between the wild west of DSTs and the OECD reforms' ideological rigidity. This paper highlights two concerns in particular with the OECD reforms: the comprehensiveness worry and the autonomy worry. These two worries are discussed below.

While the ambition of the OECD reforms is to be welcomed, the reforms are almost *too* comprehensive. They include 130 countries. The difficulty is that these countries have very different circumstances. The differences in the

⁸ Gary Clyde Hufbauer and Megan Hogan, 'How do Digital Services Taxes Work?' Peterson Institute for International Economics <<https://www.piie.com/research/piie-charts/how-do-digital-services-taxes-work>> accessed 22 October 2022

⁹ Apoorva Lalwani, 'OECD's global tax deal: Its impact on India and the way forward' *Observer Research Foundation*, 24 June 2022 <<https://www.orfonline.org/expert-speak/oecd-global-tax-deal/>>, accessed 22 October 2022

¹⁰ n 7

¹¹ n 8

¹² n 2

country's positions make the reforms too prescriptive. While the OECD has the right motive in bringing these countries together, when 130 countries are involved, they will all have different governments, economies, and consumers. Not taking these differences seriously undermines individuality, autonomy, and sovereignty. Maintaining this autonomy is essential to the success and resilience of the reforms.

The reallocation of taxing rights sets up a new three-way relationship between the host state, the home state, and the MNE, but the dynamics of these relationships will vary greatly. It is not possible to structure these relationships in the abstract. A middle ground is required, providing guidance but greater autonomy. Therefore reforms should set a range of taxation. The range would be set to where it would not create inequities between economies, no matter what the value inside the range. Relationships between host states and MNEs would be regulated by international institutions to avoid exploitation. The proposed reforms benefit all parties because they allow both MNEs to expand and host states to tax that expansion sustainably. Without a clear foundation in fairness, reforms of this kind will not be sustainable. The strongest conceptual foundation for these reforms is liberal egalitarianism and impure welfarism.

Part II - A Philosophy for Finding a Middle Ground

4. A Middle Ground

The aim of the reforms proposed in this paper is the mutual benefit of all parties. This middle ground draws on two concepts: liberal egalitarianism and impure welfarism. The following section explains these concepts, and the subsequent section connects them to the proposals for tax reform. While these concepts represent abstract ideals, they nevertheless provide guidance for reforms in practice.

5.1 Liberal Egalitarianism

Egalitarianism is the philosophy that all parties are equal and deserve equal opportunities.¹³ Impure welfarism is a related philosophy under the umbrella of egalitarianism. It is impure in the sense that it is different from the concept of pure welfarism, which is the idea that says welfare is measured through the individual sense of well-being. It focuses on the equal distribution of these opportunities.¹⁴ These two philosophies are crucial to understanding how appropriate taxation and fairness can be achieved.

In the context of tax policy decisions about MNEs, egalitarianism offers the best guiding philosophy. This is because egalitarianism's primary focus is giving equal opportunities to every party. This is what appropriate taxation requires: neither punishing the MNE nor allowing the host state to be exploited. It cannot be appropriate or fair taxation if it is impossible for MNEs to do business or for host states to collect revenue. There is nothing morally unacceptable or unfair about MNEs seeking to expand or host states seeking to tax their endeavors. The most useful question is how to maximize the benefit for both parties.

This element of mutual benefits is essential. This concept of mutual benefits can be understood through *pareto optimality*.¹⁵ The mutually beneficial relationship is mainly about the host state and the MNE. Appropriate taxation is where both the host state and the MNE benefit, and neither is taking advantage of the other. If they are benefiting and not taking advantage of each other, this is the level of appropriate taxation that reforms should seek to establish.

¹³ Alexander W. Cappelen and Bertil Tungodden, 'Tax Policy and Fair Inequality' in Martin O'Neill and Shepley Orr (eds) *Taxation: Philosophical Perspectives* (OUP 2018) 111

¹⁴ Ben Bramble, 'Welfarism' <<https://philarchive.org/archive/BRAW-8>> accessed 22 October 2022

¹⁵ n 14

Pareto optimality is the right approach because the aim is not to punish MNEs for making a profit. The ideal guidelines should set a range within which the parties can work, but the reforms would regulate it. If the OECD detects exploitation, it ought to be able to step in and respond to protect the equality of opportunity.

These reforms protect rather than undermine sovereignty because the OECD intervenes only when exploitation threatens sovereignty and the host state's capacity to act autonomously. It is egalitarian in that it provides autonomy, and equal opportunity, to every party. These reforms also draw on the philosophy of impure welfarism, which holds that in addition to equal opportunity, taxation is distributed equally as well.

Egalitarianism helps establish a general standard of fairness globally while taking country-specific considerations seriously. Finding this balance is what it means to tax MNEs appropriately. Taxing MNEs appropriately means there is no exploitation on either side. The MNE is not taking advantage of the host state, and the host state is not taking advantage of the MNE. The relationship is mutually beneficial. While liberal egalitarianism does not exhaust what it means to tax MNEs appropriately, it is necessary for appropriate taxation.

5.2 Impure Welfarism

In addition to liberal egalitarianism, impure welfarism should guide reforms to the taxation of MNEs. Impure welfarism is under the umbrella of liberal egalitarianism but emphasizes the importance of equal distribution. Equal distribution of taxation is essential because that is the only way to achieve appropriate taxation. Taxation cannot be appropriate if it disproportionately impacts one party at the expense of others. This does not mean equal rights across the world but instead creating a framework in which equal opportunity can be established and the autonomy to define equality in a country-specific way.

Part III - Practicalities, the Future, and Counterarguments

6. Considering Counterarguments

Although the philosophies mentioned are required for an ideal taxation system, it is important to be clear-eyed about the practical challenges as well. Reforming the taxation of MNEs is difficult in general, and the reforms proposed here may be seen as impractical. There can never be a perfect balance of tax among every party, particularly globally. The reforms advocated here are an essential next step but are vulnerable to the charge of being unrealistic. The OECD reforms take the approach they do to avoid some of these challenges.

While the reforms proposed here are idealistic, insofar as they are driven by ideals, these ideals are useful. The more successful reforms are, the more resilient they will be. And the whole aim of taking an egalitarian, impure welfarist approach is that the reforms outlined here benefit *all* parties. Therefore, if the reforms have done their job, all parties are incentivized to sign up, and the reforms are more resilient. Egalitarianism encourages broad buy-in by seeking to benefit everyone.

Even if the reforms put forward here seem unrealistic, a step must be taken to make these kinds of reforms realistic. The reforms put forward here offer a halfway house or middle ground, allowing countries to buy in individually and for progress to happen gradually. It is not suggested here that this should be done all at once. The reforms need to be implemented slowly to see how they work, allowing for a period of experimentation. This is analogous to putting out a beta version of the reforms.

7. Conclusion

While these, like any reforms, are difficult to achieve in practice if the aim is to achieve a more equitable global economy, they are a necessary step. This paper offers a possible, ideal solution for consideration for how to tax MNEs appropriately. The middle ground offered here seeks to be an exciting and helpful way to improve the current global tax system and how the global economy works. Such reforms should usefully take an egalitarian, impure welfarist approach to benefit everyone. This has the dual effect of making the reforms fairer and more resilient. The philosophies of egalitarianism and impure welfarism can help further improve the excellent reforms of the OECD. Appropriate taxation of MNEs by home states is necessary for creating a fairer world.

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