Three principles for a new global contract on tax

By:

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About a decade ago, I wrote that tax policy creates and reflects the social contract between individuals as mediated through the nation-state and that this idea gives rise to the intuitively appealing yet ultimately flawed idea of tax sovereignty. Flawed, because the economic interdependence of virtually all states creates an inescapable second-order contract, which economic and geo-political dominance has allowed some states to shape to their consistent advantage. This observation remains valid today, but there is some reason to believe that a growing number of countries are prepared to reject global tax norms and institutions forged without their meaningful input. The COVID-19 pandemic forms part of the shifting sands of acceptance of the old ways of doing things; another is the frustration of relatively affluent countries with the order they themselves helped create, as prominently on display in the area of digital services taxation. We seem to be at a pivotal moment for a re-evaluation of who gets to make tax policy, and who gets to say what is reasonable and fair when it comes to tax norms and institutions with global distributive

implications.

Since the core element of a social contract is the institutional structure it employs to mediate relationships, this is, in particular, a time for reflection on the past governance decisions that got us to where we are today, a recalibration, and systemic change. I would argue that an acceptable social contract depends on good governance, and good governance requires that the institutions we use and the global tax norms we create must be representative, transparent, and sustainable. The way we do global tax policy today effectively excludes many countries, even though it formally includes them; it obscures geo-political power even as it gestures toward transparency, and it pays little more than lip service to sustainability. I explore these three governance failures and discuss some ways to counter them in the immediate term.

Representativeness

If we were to do better at achieving the substantive inclusion of all countries in global tax governance, I believe we would see this representativeness reflected in the issues that come to the forefront of international tax policy mandate-setting. In particular, taxation in the extractive industries sector and the prospects for formulary apportionment would get the detailed attention that nonroutine profits attributable to marketing intangibles are currently receiving. I do not know if the effort would produce better solutions for extractive industries, or whether formulary apportionment would prove to be the solution to taxing multinationals as proponents of this policy thrust anticipate. But the sophistication of our understanding of these phenomena would be exponentially higher than it is today if a globally representative body with the resources of the OECD set the global agenda to the immediate and urgent study of these things, and that more sophisticated understanding would contribute to better problem solving going forward.

Representativeness is crucial to global tax policy-making because it ensures that ongoing issues of all countries will be at the centre of mandate-setting, which starts at the ministerial level, carries through to all of the committees that bring all countries together to undertake the substantive work on the mandate, and then returns to ministerial-level approval.

The United Nations is representative of all nations, so it is no surprise that there are so many calls for the UN committee of experts to be elevated to an intergovernmental agency. The countries that reject these calls are members of the OECD. The OECD is not representative of all nations. It is a club with 37 members with high standards for admission. The OECD says that the Inclusive Framework does the work of representativeness for OECD work on tax policy. However, there is a significant gulf between the task of setting mandates and that of agreeing to a consensus position on a mandate of someone else's choosing. The Inclusive Framework is a body to implement. It is not a body to mandate, organize, design, study, or draft. The work of the OECD Secretariat is not designed or directed by the Inclusive Framework. It is designed and directed by the OECD member states.

For the Inclusive Framework to be truly representative, it would probably need its Secretariat and its working parties. It is not clear why such a body should exist as is—sitting awkwardly under the OECD Council—when the United Nations already includes all Inclusive Framework countries as full-fledged members. There is no substantive reason why the coordinating infrastructure in place at the United Nations should have been ignored while the OECD Secretariat created and directed a nascent organization. The good news is, since the Inclusive Framework is still an under-theorized and imperfect institution, its work could be easily moved over to the United Nations where it can become a fully representative body.

This is not just a matter of bureaucratic complaint; it has a direct impact on what gets worked on when it comes to international tax. If the Inclusive Framework was truly representative of all of its members, I believe we would expect the main issues of relevance to developing countries to be at the front and centre of everything the OECD does, including in the taxation of consumer-facing and highly digitalized firms. These issues are already front and centre at the United Nations, which is representative. If it is not politically feasible in the short term to move the Inclusive Framework out from under the OECD Council, then at a minimum the OECD should be convening a working party on governance, staffed with governance experts from the non-OECD members of the Inclusive Framework. I predict such a working party would conclude that full representativeness would require a change in institutional venue. It is only to

be hoped that the OECD would heed the advice of its working party in such a case.

Transparency

Second, if we were to do better at achieving transparency in global tax governance, I predict we would see this reflected in the feedback loop between analysis and policy-making. In particular, outside experts would be able to review data currently collected by the OECD, replicate and test the assumptions underlying OECD economic analysis, and apply diverse policy perspectives to the issues studied. To enable this kind of collaborative analysis that enriches everyone's understanding requires procedural structures to allow data access for researchers that still protects confidential information, as happens within domestic legal systems.

For governance institutions to be effective, they must be transparent, not only about their hierarchical decision-making structures but also about how they develop their policy prescriptions. The way experts gather and use data to form global tax policy is particularly important in light of how the OECD Secretariat has taken the lead in producing policy on the strength of its own internal data gathering and analysis, especially in the digitalization work. For example, while proposals of the United States and the United Kingdom formed the basis for the OECD Secretariat's proposed consensus on taxing highly digitalized firms, a preliminary proposal submitted by the G-24 was excised without discussion. When questioned, the explanation given was that the Secretariat—not a working party, and not the Inclusive Framework but the Secretariat itself—determined that there was no global consensus to build upon on the G-24 proposal and that key countries had backed away from the proposal. That answer only demonstrates the obscurity involved in policy development at the OECD. Instead of allaying concerns, it highlights why governance transparency is so important to those who are not privy to the discussion yet will certainly be affected by it.

It seems to have been lost on some experts that data analysis is not policy. Instead, undertaking data analysis is a means of providing one kind of information to policy-makers that they must assess (including in

methodological terms) and combine with other types of social and political information in order to produce proposals which then require further refinement through successive rounds of implementation and analysis. A policy that is designed on the strength of data analysis that uses proprietary data and confidential methodologies cannot be replicated or reviewed by outsiders, thus eliminating the increased understanding that can only arise when ideas are tested with diverse perspectives.

Connecting transparency to inclusivity, the OECD's main claim to fame has always been its expertise. For international tax to develop coherently, the experts need to work on the things that are of utmost importance to all countries around the world, and not exclusively on the matters that most agitate the most geo-politically dominant powers of the day. It is not clear how the Inclusive Framework can achieve competence without its Secretariat dedicated to serving Inclusive Framework working parties.

Related to this is the general lack of transparency surrounding the cooperation being undertaken by the platform for collaboration on tax. Even if, in contradiction to the view laid out above, the OECD is the right place to undertake policy analysis and the OECD Secretariat is the right body to develop global tax policy proposals, it is far from clear how the other members of the platform for collaboration on tax are fully participating in the project with their own core competencies. It is not evident for instance, whether and how the OECD shares its work on developing its proposal and formula for reallocating the profits of highly digitalized and consumer-facing firms. It is not clear whether and to what extent the Platform is activated to provide analytical assistance to countries that are meant to be using tools designed and drafted by the OECD Secretariat to figure out the possible impact of its proposal for their own countries. Without help, accomplishing this task on the OECD's deadline would have been difficult or impossible for many countries even before COVID. Now it seems practically impossible.

With more governance transparency about who is making what kinds of decisions about what to study, how to study it, and how to develop policy with what can be gleaned from the available data, it would be feasible to determine whether the Inclusive Framework truly is representative as the metaphor of

equal footing insists. Without it, there is and will always be suspicion on the part of outside observers that it is the 37 member countries of the OECD or even a small subset of these countries, that decide what policy matters the OECD will tackle, what consensus is to be formed, and how it is to be implemented.

Transparency in governance will be key to building trust in any institution that seeks to create and deploy a new global consensus on tax. If it is to be the Inclusive Framework, there needs to be far more information about the workings of that body and its interaction with the governance structure of the OECD itself. The fact that succession to OECD membership is a lengthy and difficult process unsuccessfully sought by many countries indicates that there must be something about the value of membership in the OECD that is missing in the Inclusive Framework.

Sustainability

Finally, a sustainable global tax governance system would create more substantial linkages between global tax policy-making and the UN's work on Agenda 2030 (the Sustainable Development Goals) by prioritizing the interdisciplinary study of the value created by externalizing costs associated with social and environmental risks. Currently, Platform members primarily characterize the link between tax and sustainability as one of mobilizing domestic revenue to fund core fiscal spending. A more profound linkage could be forged through collaboration among researchers who study the true social and environmental costs of extraction, production, consumption, and disposal with the policy-makers who advocate for the allocation of tax according to value creation and business activity.

With deeper collaboration between policy-makers and such researchers, whose work spans a range of scientific fields, it would be possible to re-examine some of the hidden fiscal incentives for unsustainable business practices. Some of these fiscal incentives are embedded in the core structural components of the tax system, including antiquated source and residence designations which have allowed value that is associated with social and environmental destruction to be instead assigned to intellectual property located in low tax regimes and

jurisdictions. Other incentives are more visible in the web of tax deductions, exemptions and credits designed to attract cross-border trade and investment at virtually any cost, including environmental degradation and lack of social protection for workers. The current pandemic has highlighted how important the latter is; coming events connected to climate change will further demonstrate the mistakes that have been made in valuation exercises to date.

A focus on sustainability will further establish whether the OECD is indeed capable of providing holistic leadership on taxation. The OECD is not focused on sustainability. Its focus is and always has been economic growth. As sustainability become of interest to a range of stakeholders, the OECD has wedged itself uncomfortably into an area that is obviously the province of the United Nations. The awkwardness of this position, combined with deficits in representativeness and transparency, undermine the OECD's position that it is the appropriate institution to oversee the next global compact on tax.

Conclusion

In a recent virtual presentation, I laid out the principles discussed above. I proposed three immediate term correctives, namely for incorporating externalized costs through existing transfer pricing rules, adopting a global excess profits tax (discussed at more length in this Afronomics tax symposium by co-author Tarcisio Magalhaes), and forming a tax governance working party at the OECD. But I cautioned that any substantive solutions need to be developed through representative institutions and processes; there is no room for experts from affluent countries to swoop in and tell less affluent countries what they ought to do to reform their tax systems. Instead, experts from wealthy countries need to take tax policy spillovers seriously and correct the systemic flaws in the international tax regime that make it hard for some countries to tax effectively. This is, in my view, crucial to forming an acceptable international social contract going forward.

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