The Shift Toward a Distribution-Based Tax Framework in a Post-Pandemic World

By:

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Global tax policy discourse has long focused on deontological consensus, namely around theories of tax nexus based on source and residence. But the past decade is witnessing a shift to consequentialism, which focuses on the distributional outcomes resulting from various tax policy design choices. The turn to consequentialism creates a need for normative guidance that prevailing tax theory does not provide. Distribution-based approaches require a normative principle that integrates distributive justice considerations in a way that the predominant normative framework does not. If taxing rights are to be allocated based on distributional consequences, broader attention to the role of international tax in perpetuating or reducing international inequality is warranted.

Defining the normative principles for this new social contract for tax requires us to reconsider the normative principles that have defined international tax

relations to date. In particular, traditional tax theory generally holds that countries should be entitled to tax income generated in their territories or arising from the resources they control. This view can be broadly defined as origin-based. It relies on some version of the principle of origin: tax entitlement should be allocated to countries based on their relative contribution to the generation of income. Discussions in tax policy circles about value creation, user participation, and alignment of taxing rights with economic activity do not deviate from this general normative view. However, recent tax developments seem to suggest a gradual shift from a purely origin-based to a distribution-based approach. Policymakers are increasingly focusing on the actual distributional outcomes to various countries resulting from alternative reform proposals. And concerns about the distributional impacts of a potential global tax compact will likely intensify due to the urgent need for revenue to respond to the global pandemic's economic impacts.

The move toward a distribution-based approach to allocating taxing rights partially arises from the sharp disagreement between countries about the current division of the international tax base. As a result, policy discussions have increasingly relied on economic impact assessments to consider alternative reform proposals. A case in point is the OECD's plan to reallocate taxing rights to countries with substantial consumer markets to prevent them from moving forward with unilateral plans to tax digital businesses on the basis of consumer or user location. Under the label 'new taxing right,' this new allocation would be determined by a fixed percentage that will rely on some form of political agreement rather than on any clear economic rationale. And the OECD's efforts to show how its proposal will impact different countries illustrate that distributional considerations play a key role in reforming the allocation of taxing rights.

This is significant because the international tax regime has historically disfavoured less developed countries. From the standpoint of normative legitimacy, tax policy decisions have been made by the most powerful economies with minimal participation of developing countries. From a distributive justice point of view, the current system strikingly harms less affluent countries. First, it allows for tax avoidance practices that take a significant toll on poorer countries. Second, the existing bilateral tax regime

inevitably favours more powerful nations, leaving weaker states susceptible to power imbalances in treaty negotiation.

A promising normative approach embraced in other areas of international law is differentiation. The differential approach submits that countries should have differentiated rights and obligations based on their varying levels of development needs and capabilities. It recognizes that formally equal treatment can secure equality only among parties at a similar economic level, and thus calls for differentiated treatment to correct existing inequalities. Differential treatment is also seen as a way to foster cooperation and facilitate the effective implementation of international norms while ensuring the sustainable development of poorer countries.

Applied to international tax, the differential approach requires that the distribution of the international tax base improve rather than worsen global poverty and inequality. This can be accomplished in different ways.

One potential solution would be to allocate taxing rights between countries based on, among other factors, their levels of economic development, so that the poorer the country, the more taxing rights it retains. Although this may sound radical, well-respected economists Peggy and Richard Musgrave made a similar proposal almost five decades ago, arguing for a differentiated tax rate schedule based on countries' relative per capita income. Likewise, in climate change discussions, the idea of differentiated commitments based on each country's relative capabilities has been widely agreed. In forthcoming work, I explore some of the normative and practical implications of a differential approach for the allocation of taxing rights.

Discussions about fairness in allocating taxing rights are often met with skepticism. Some would argue that any agreement on normative principles is based on self-interest and that more affluent countries would hardly accept a normative framework that might significantly disfavour them. Three relatively recent developments, however, warrant a broader normative discussion. First, initiatives such as the United Nations' Sustainable Development Goals (SDGs), the OECD's Task Force on Tax and Development, and the inter-agency Platform for Collaboration on Tax are evidence that the international community is at

least to some degree motivated by a concern to address global poverty and inequality. Second, meaningful consideration of international justice may be needed to secure the cooperation of lower-income countries in undertaking obligations required for a coordinated effort to address the present international tax challenges. Third, platforms such as the BEPS Inclusive Framework—where developing countries purportedly have the opportunity to voice their needs, interests and concerns on an equal footing—will only be genuinely inclusive if these countries are empowered to bring forward a framework that shifts the balance toward a more equitable division of taxing rights.

The global pandemic makes this discussion even more urgent. Inequality will likely worsen across the world due to governments' depressed ability to spend on social protection. But the situation is drastically more difficult for lower-income countries. Whereas stronger economies pile up debt to combat the economic impacts of COVID-19, fragile ones do not have that option because creditors refuse to roll over their loans at times of crisis. Additionally, developing countries are seeing a fall in prices of commodities, removal of foreign investment, and limited international financial support. One consequence is that hundreds of thousands of people each day, notably in countries across Africa and the Middle East, are expected to die from hunger in the absence of urgent funding.

As global inequality is expected to worsen due to the pandemic, efforts to improve tax revenues to lower-income countries are critical. The relatively higher impact of the present recession on the global poor is one more reason for greater attention to normative demands for a more equitable distribution of the international tax base. And as the international tax community presently reviews the existing rules for allocating taxing rights due to the challenges arising from the digitalization of the economy, this is the time to consider a differential approach to international taxation that reduces rather than worsen international inequality.

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