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From the Tax Base Erosion to the Tax Sovereignty Shifting from States to OECD/ Inclusive Framework

De la erosión de la base imponible al paso de la soberanía fiscal de los Estados al marco inclusivo de la OCDE

Da erosão da base tributária à transferência da soberania fiscal dos Estados para a OCDE/Quadro Inclusivo

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Summary

Base erosion and profit shifting (BEPS) by multinational companies is a growing global concern. This practice deprives countries of tax revenue, distorts competition, and challenges tax sovereignty. International initiatives such as the OECD BEPS Action Plan seek to address these problems through coordinated actions between countries and international organizations. This essay critically examines the impact of said Plan on the concept of fiscal sovereignty of individual States and the displacement of said power towards international organizations. Its starting point is that States must preserve fiscal sovereignty, since it is fundamental for democracy, based on the consent of citizens to pay taxes to transparent and auditable governments. In contrast, the shift of fiscal sovereignty to international organizations raises concerns about its effects on democratic principles. The author advocates a balanced approach to addressing global fiscal problems, respecting fiscal sovereignty and democratic values. From this perspective, the solution to these problems, instead of focusing exclusively on increasing global coordination, could imply that States renew social contracts with their citizens, achieving a balance between state coercion and the freedom of taxpayers to link with other jurisdictions.

Keywords: BEPS, Erosion of the Tax Base, Profit Transfer, Fiscal Sovereignty, OECD, International Coordination, Democratic Legitimacy, Social Contract, Global Taxes, Fiscal Equity.

Resumen

La erosión de la base imponible y el desplazamiento de beneficios fiscales (BEPS) por parte de las empresas multinacionales es una preocupación mundial creciente. Esta práctica priva a los países de ingresos fiscales, distorsiona la competencia y desafía la soberanía fiscal. Iniciativas internacionales como el Plan de Acción BEPS de la OCDE buscan abordar estos problemas mediante acciones coordinadas entre países y organizaciones internacionales. Este ensayo examina críticamente el impacto de dicho plan en el concepto de soberanía fiscal de los Estados individuales y el desplazamiento de dicho poder hacia las organizaciones internacionales. Su punto de partida es que los Estados deben conservar la soberanía fiscal, ya que es fundamental para la democracia, basada en el consentimiento de los ciudadanos al pago de impuestos a gobiernos transparentes y fiscalizables. Por el contrario, el desplazamiento de la soberanía fiscal a organizaciones internacionales plantea preocupaciones sobre sus efectos en los principios democráticos. El autor aboga por un enfoque equilibrado para abordar los problemas fiscales globales, respetando la soberanía fiscal y los valores democráticos. Bajo esta perspectiva, la solución a dichos problemas, en lugar de concentrarse exclusivamente en una cada vez mayor coordinación global, podría implicar que los Estados renueven los contratos

sociales con sus ciudadanos, logrando un equilibrio entre la coerción estatal y la libertad de los contribuyentes para vincularse con otras jurisdicciones.

Palabras clave: BEPS, erosión de la base imponible, transferencia de beneficios, soberanía fiscal, OCDE, coordinación internacional, legitimidad democrática, contrato social, impuestos globales, equidad fiscal.

Resumo

A erosão da base tributável e a transferência de lucros (BEPS) por parte das empresas multinacionais é uma preocupação global crescente. Esta prática priva os países de receitas fiscais, distorce a concorrência e desafia a soberania fiscal. Iniciativas internacionais como o Plano de Acção BEPS da OCDE procuram resolver estes problemas através de acções coordenadas entre países e organizações internacionais. Este ensaio examina criticamente o impacto do referido Plano no conceito de soberania fiscal dos Estados individuais e no deslocamento desse poder para organizações internacionais. O seu ponto de partida é que os Estados devem preservar a soberania fiscal, uma vez que é fundamental para a democracia, baseada no consentimento dos cidadãos em pagar impostos a governos transparentes e auditáveis. Em contraste, a transferência da soberania fiscal para organizações internacionais levanta preocupações sobre os seus efeitos sobre os princípios democráticos. O autor defende uma abordagem equilibrada para resolver os problemas fiscais globais, respeitando a soberania fiscal e os valores democráticos. Nesta perspectiva, a solução para estes problemas, em vez de se concentrar exclusivamente no aumento da coordenação global, poderia implicar que os Estados renovem os contratos sociais com os seus cidadãos, alcançando um equilíbrio entre a coerção estatal e a liberdade dos contribuintes de se ligarem a outras jurisdições.

Palavras-chave: BEPS, erosão da base tributária, transferência de lucros, soberania fiscal, OCDE, coordenação internacional, legitimidade democrática, contrato social, impostos globais, equidade fiscal.

I. Introduction

A. Background and context

Tax base erosion and profit shifting have been growing concerns of governments around the world. In an era of increasing globalization and digitalization, multinational enterprises have been able to exploit loopholes and use aggressive tax planning strategies to shift their profits to jurisdictions with lower tax rates, thus eroding the tax bases of other countries (OECD, 2013c). This practice not only deprives countries of much-needed tax revenues but also creates an uneven playing field for businesses, distorting competition and hindering

economic growth. Moreover, it undermines the principle of tax sovereignty, which is the ability of a country to establish and enforce its own tax laws (Deutsche Gesellschaft fur Internationale Zusammenarbeit, n. d.). However, the predominant reaction of the international community against this issue has been the establishment of international initiatives such as the Base Erosion and Profit Shifting (BEPS) Action Plan (Apeldoorn, 2016). The core of such initiatives is coordinated actions of the different countries and organizations to address the challenges arising from tax base erosion and profit shifting. Such a kind of coordination logically implies renouncing a portion of the sovereignty of every country involved in this initiative. Thus, it is not surprising that the main result of the BEPS Action Plan was the drafting and further signing of a Multilateral Instrument (MLI) which was the most efficient way to allow a multitude of countries to homogeneously and simultaneously amend their bilateral tax treaties to reshape the international tax landscape in such a way that impedes or prevents Multinational Enterprises (MNE) from further engaging in base erosion and profit shifting practices (OECD, 2013c). Paradoxically, the second phase of actions derived from the BEPS Plan (so-called BEPS 2.0) has shown more ambitious goals, since instead of proposing a new arsenal of instruments to, even more, reduce the room of MNEs to conduct base erosion and profit-shifting practices, it now pretends to reshape every domestic corporate income tax regime at a worldwide level, harmonizing their operation in an inaudible version that allows for a never-before seen fairer and more equitable distribution of tax burdens among countries. In fact, BEPS 2.0 is a two-pillar approach that pretends to address tax avoidance, ensure the coherence of international tax rules, and create a more transparent tax environment. The first pillar aims to reallocate taxing rights and profits to market jurisdictions where multinational companies operate, while the second pillar aims to ensure that income is taxed at an appropriate rate and has several complicated mechanisms to ensure this tax is paid (Leung, 2022). This giant global effort supposes, nevertheless, that all participating states abandon the idea of establishing unilateral measures to address the issues and adhere to global rules and guidelines set forth by the OECD and the Inclusive Framework. To this purpose, they have not only outlined a model of domestic rules (Model Global Anti-Base Erosion Rules), including Commentary, an Implementation Framework, and Administrative guidance, but also proposed the signing of a new multilateral instrument to facilitate implementation of the Subject to Tax Rule (STTR) in relevant bilateral treaties (KPMG's EU Tax Centre, 2021) As can be seen, this new initiative involves the development of a vast arsenal of model rules aimed at harmonizing national legislation in certain aspects, along with the use of a multilateral instrument once again to adapt the existing network of bilateral treaties to the terms of the new initiative.

B. Purpose and Objectives

The purpose of this essay is to examine the implications of the BEPS Action Plan on the notion of tax sovereignty and the redistribution of power to international organizations. The starting point of our reasoning is that individual States are the natural holders of tax

sovereignty and that it is advisable that this power remains allocated at this level, instead of being de facto shifted to international organizations or forums. The foregoing, since the acceptance by individuals of paying taxes to public bodies is one of pillars of the modern democracy and its justification directly derives from the notion that taxes are being collected and used by their own governments, which are accountable to their citizens.

The counterpoint of this granting of power to States for imposing taxes is precisely the faculty of individuals to demand from their government's accountability and transparency in the use of those tax revenues, and ultimately to remove and replace them if they do not satisfactorily comply with their duties in that respect. This notion is commonly summarized under the motto of "no taxation without representation" used by the American colonists during the Revolutionary War (Walczak, 2018). Conversely, the implementation of the actions drawn by the OECD-Inclusive Forum under the framework of BEPS implies to shift of tax sovereignty away from individuals, impeding them from exercising effective control on the exercise of the taxation powers. As a result, the BEPS Action Plan raises concerns regarding its potential to undermine the modern concept of tax sovereignty with all of the negative effects —either intended or unintended— that this diminish of this power may have on modern societies. To this respect, this work intends to highlight the need for a balanced approach in addressing the challenges of tax base erosion and profit shifting, taking into consideration the importance of tax sovereignty and democratic principles.

II. Understanding Tax Base Erosion

Tax base erosion refers to the reduction in the taxable income of a country resulting from multiple reductions of a company's tax base through the use of legal tax planning strategies that exploit gaps and inconsistencies in tax laws. These strategies are often used by multinational companies to shift profits from high-tax jurisdictions to low-tax jurisdictions, resulting in a reduction of tax revenue for the high-tax jurisdiction (Dyreng & Hanlon, 2019).

Tax revenue depends on tax rates and the tax base. While tax rates in every country are under the control of the respective governments, the tax base is endogenous and can change as tax rates change. In the simplest model of a closed economy, an increase in the corporate tax rate reduces the return on capital and thus the incentive to invest. Output or economic activity will therefore be lower.

Things are more complicated when economies are open and there is capital mobility. A decrease in a country's tax rate not only increases its economic activity but also attracts activity from other countries. In an open economy, differences in tax rates can affect reported profits not only through their effect on actual activity but also through the mere shifting of profits on paper. There are various ways of shifting profits, such as allocating common expenses between different subsidiaries of the same multinational or financing new subsidiaries in high-tax countries with debt rather than equity (Hines & Rice, 1994).

The manipulation of transfer prices in cross-border intra-company deliveries of goods and services is also a relevant concern. Incentives for profit shifting depend primarily on the difference in corporate tax rates between countries and the system that countries of residence use to avoid double taxation (Bartelsman & Beetsma, 2000).

Base erosion techniques have been studied and documented by various domestic and international organizations around the world. Some of these techniques include transfer pricing, earnings stripping, and the use of tax havens. The concept of base erosion is a major concern for many countries, and there have been various efforts to address this issue, currently the most prominent in the OECD's Action Plan on Base Erosion and Profit Shifting (BEPS) (Wells & Lowell, 2013).

III. Understanding Tax Sovereignty

Tax sovereignty refers to the power of a state to create and enforce its own tax laws within its borders. It is a fundamental aspect of state sovereignty (Ring, 2022).

Tax sovereignty allows states to determine their own tax policies and to collect taxes from individuals and businesses operating within their borders. The ability to control tax policy enables a state to meet its functional duties and support its two important democratic norms – democratic accountability and democratic legitimacy (Dagan, 2022).

In the current world political order, the sovereign state stands as more than a nation with internal control and external independence regarding people, territory, and government (i. e. the possessor of a series of rights to exclude and control), but it is also the locus of a duty and an obligation to protect and promote the welfare of its citizens. Sovereign responsibilities now accompany those sovereign rights (Ring, 2022). The sovereign state stands as the primary decision-maker in matters of taxation within its jurisdiction. Obviously, states do not exercise unimpeded control over tax policy choices, since they are influenced and constrained by the political economy within their own domestic system (e.g., pressure from powerful taxpayers) and by the need to account for the implications of their tax rules globally (e.g., will the state's new tax be deemed a creditable foreign tax by other countries) (Ring, 2022). Tax sovereignty is not a "good" in and of itself. Rather, it is a tool to achieve important missions of the democratic sovereign state: (1) the continued operation and existence of a functioning government (predicated on revenue and sustainable fiscal policy) and, (2) the accountability and legitimacy underpinning that democratic state (Ring, 2022). The authority of the state originates in its constituents, as they combine their independent capacities to coauthor a regime that promotes their collective will in ways that would not have been possible individually. But the authority of the state demands justice. One way of presenting this idea of sovereignty as a locus of collective self-determination is through the artifact of the social contract. Under the social contract, the people grant the state the exclusive power to coerce them and exchange part of their independence for membership in the polity. Taxes are the coercive instrument that

the state uses to pay for the collective goods and services it provides. This power to coerce the people for the people is inherently constrained. This is why we demand that good taxes should be both efficient and equitable (Dagan, 2022). In summary, if the social contract is supposed to have been created by and for the people, it must serve their mutual interests and treat each of them with equal concern and respect. With that idea as a backdrop, the objectives of fiscal sovereignty and its basic limitations become more intelligible (Dagan, 2022). The economic basis of the social contract relies on the following understanding of the process of tax collection: we, the people, entrust the state with the exclusive power to coerce us to pay for its services and to make a collective decision about the goods and services to be publicly provided and the level of taxes to be levied. Ideally, the state should provide public goods efficiently, i.e., the benefits it provides should outweigh its costs, making it worthwhile to engage in the social contract (Dagan, 2022). The inherent limitations of this coercive power granted to the State consist in its obligation to treat all co-authors with equal respect and concern. Indeed, coercion is only justified under a first condition, namely that the State treats all citizens as equal, as subjects of law. And the second implies that the care accorded to citizens should translate — unless one adheres to extreme libertarianism — into some degree of redistributive justice (Dagan, 2022). The counterpart of these limitations of sovereign power are the duties and obligations that derive for citizens from their membership in the respective political community. This is because, as Dagan points out, the social contract not only determines the duty to pay taxes and the responsibility of the state to act fairly but also assumes the group that is subject to such rights and duties (Dagan, 2022). Members of the political community are not merely users of the public goods and services provided by the state under a coercive regime. They are also parties to the social contract, and, thus, co-authors of its regime. As such, they enjoy unique privileges and have special duties. They have a voice — at least ideally — to determine the level of tax as well as the kinds and level of public goods the state offers (Dagan, 2022).

IV. OECD and its BEPS iniciatives

One of the motivations for the BEPS project is to address the negative effects of tax competition. According to the OECD, one of the main concerns about tax competition is that it poses a threat in terms of tax sovereignty and tax revenues (OECD, 2013a). More specifically, it may hamper the ability to raise sufficient revenue and secure the redistributive goals desired by the countries' population (OECD, 1998). This is in large part attributable to aggressive tax planning by MNEs facilitated by states attempting to increase their taxable base by attracting the accounting profits of MNEs and FDI (OECD, 2015). As a result, one important aim of the BEPS project is to support 'the effective fiscal sovereignty of countries over the design of their tax systems' (OECD, 2014, p. 14; Apeldoorn, 2016). At this point, the OECD suggests that the main way to address this problem is through

the application of the principle of economic allegiance. Accordingly, the principle is reflected in the BEPS project, which aims to "better align rights to tax with economic activity" (OECD, 2013b, p.18; OECD, 2013a, p.11) by ensuring that corporations do not shift accounting profits to low tax jurisdictions and so artificially separate the profit from the economic activities that generated it (Apeldoorn, 2016).

As Apeldoorn points out, the principle of economic allegiance aims to curb "virtual" tax competition, where MNEs shift profits from high-tax countries to low or zero-tax jurisdictions. This principle asserts that the tax base, such as corporate profits, should be allocated to the countries where the economic activities generating those profits actually occur. This approach allows states to tax profits that were previously moved abroad (Apeldoorn, 2016). However, it does not prevent "real" tax competition to attract Foreign Direct Investment (FDI). While it allocates the tax base, it leaves the determination of tax rates to sovereign legislatures. Under this scenario, states still have an interest in reducing tax rates on the mobile tax base allocated to them under economic allegiance, especially when they seek to attract FDI for economic growth or expertise. The OECD acknowledges that competition for FDI through low or no taxation is not inherently problematic (Apeldoorn, 2016). Real tax competition is likely to persist, limiting states' fiscal self-determination and their ability to determine budget size and engage in redistribution. Consequently, it can be argued that the BEPS 1.0 initiative falled short in safeguarding states' fiscal self-determination, one of its primary objectives (Apeldoorn, 2016). This implies the need for at least some regulation of tax rates that states set for the tax base allocated to them by the principle of economic allegiance (Devereux & Vella, 2014). Considering this weakness of the BEPS project, the OECD continued to develop a second version of BEPS, which included in the so-called Pillar 2, the introduction of a global minimum tax, probably inspired by the reasoning of some supporters of the principle of economic allegiance. Dietsch argues that this concern may be addressed by introducing a second principle, the fiscal policy constraint, that limits the freedom of states to compete by lowering tax rates on the tax base that is allocated to them by the principle of economic allegiance (Dietsch, 2015).

However, even this revised proposal remains vulnerable to the charge that its implementation would fail to reliably guarantee or even increase justice in the realm of fiscal policy. Global tax justice requires that all states have equal or sufficient fiscal self-determination, but the principle of economic allegiance does not reliably do so. The principle of economic allegiance (which allocates tax jurisdiction in accordance with the economic activity of MNEs) is non-responsive to the distribution of fiscal self-determination between countries. The countries where MNEs conduct economic activities are not necessarily the countries that have low fiscal self-determination. Accordingly, the OECD's dependence on the principle of economic allegiance is misguided (Apeldoorn, 2016). In light of these criticisms, it is clear that the implementation of BEPS falls short in adequately protecting states' fiscal self-determination.

V. Tax Sovereignty Shift from States to OECD/ Inclusive Framework

But not only does the BEPS project fall short of protecting the fiscal self-determination (or rather sovereignty) of individual states, but since its launch in July 2013, tax academics, politicians and civil society groups have raised concerns about the legitimacy of the project on the decision-making process within the OECD/G20 or on the active participation and deliberation of citizens on it (Fung, 2017).

Following a typology suggested by J.E. Alvarez, alleged complaints of democratic deficits can be classified into three types: i.g. 1. 'vertical' (regarding the disconnect between international law-making and the democratic law-making process 'below' at the national level), 2. 'horizontal' (concerning the relations between international organisations and states and between states) and 3. 'ideological' (reflecting the dominant ideology of Western governmental elites). It should, however, be noted that certain democratic deficit complaints may rely on more than one type because, as Alvarez remarked, these three forms of critiques may converge in practice (J.E. Alvarez, quoted by Fung, 2017). For reasons of specialty, we will focus only on the alleged vertical deficits.

In this regard, three types of vertical complaints can be raised. First, that international law-making by international institutions is undemocratic because it does not meaningfully reproduce national processes of democratic governance and other structural components, such as electoral representation, checks and balances between the legislative, executive and judicial branches, transparency, accountability and deliberative participation. Second, that the nature of global governance makes it possible for decision-makers to adopt rules that do not have national support. Third, that the international legislative process does not respect the substantive rights associated with democratic governance, such as due process and other human rights. As is evident, criticisms of the OECD/G20 BEPS Project focused primarily on the first two types of vertical complaints (Fung, 2017). Although the G20 and the OECD are perfectly entitled to establish policy norms among their member countries, their aspiration to become 'the leader of the global economy and financial system' respectively 'a global standard setting body' is challenged by the absence of legitimate authority in the wider world.

Both the G20 and the OECD do not have the authority to impose binding tax rules or sanctions in the event of non-compliance. Most significantly, both the G20 and the OECD lack a parliament. Thus, since there is no international parliament subject to proportional representation of the peoples of the world, international law-makers lack the ties to democratically elected polities that legitimize law within democracies (Alvarez, quoted by Fung, 2017). This is one of the criticisms underlying the UN initiative to take an active role in the discussion of the proposals so far developed by the OECD. However, although the elevation of the issue to the UN sphere implies greater global representation, its character as an international body maintains several of the democratic deficits of international law. The BEPS project has been criticized mainly from the United States for being discussed

by bureaucrats in Paris, behind closed doors, and not in the halls of national parliaments. Proponents of the BEPS project may argue that it is states, not individuals, who are part of the system of international law, and that states play the roles that individuals occupy in domestic society. In this view, the absence of individual citizens in the international decision-making process does not necessarily undermine the legitimacy of the BEPS Project, as long as they are represented by their elected government (Fung, 2017). But, on the other hand, and as we have previously pointed out, this distancing of the decisions from the base of citizens who will be affected by them, significantly reduces the transparency of their generation and prevents citizens from exercising adequate control over the actions of their representatives, since it is not they who participate in the discussion, but other delegates of the former, making the representativeness of these measures even more indirect and remote. Another commonly perceived democratic deficit is the possibility for unelected non-governmental organizations (NGOs) and special interest groups to bypass national parliaments by lobbying for certain policies at the international level and subsequently exert pressure on governments (Fung, 2017).

In this context, it can be argued that the BEPS project, especially considering the initiatives included in its second phase, namely Pillars 1 and 2, suffers from several of the vertical deficits mentioned earlier. This is because the decisions made, not only by the governments of the states that make up the Inclusive Framework but also by those related to OECD member states, have lacked the transparency and oversight typical of legislative activities in each participating country. Following this reasoning, it can even be said that the agreements reached probably do not have the majority support of the citizens of the respective states, considering that several of them have been agreed upon by representatives of governments that are on the verge of being replaced due to a lack of popular support, without the necessary checks and balances of other political sectors represented in parliament.

Furthermore, it may be argued the BEPS project also causes a real harm to its scope, as the activities undertaken by the OECD/G20 and their supporters under the framework known as the Inclusive Framework for the Implementation of BEPS result in an overlap of some of the fiscal competencies of these states.

Conclusions

As previously shown, the BEPS project, already in its first stage but with more prominence in the second, aims to address the issues of the current global tax order through coordinated action by a large majority of states, led by OECD and G-20 members, but to which many developing countries have also adhered under the framework of the Inclusive Framework forum. This coordination effort requires individual states to refrain from pursuing their own initiatives and yield to collective, or at least coordinated, action. This implies a proportional relinquishment of national tax sovereignty by each country involved in the BEPS project. However, like physical matter, a political power such as

tax sovereignty does not disappear by its renunciation by its natural holders (the States), but it is displaced to new holders since it needs to be exercised by someone to keep the tax cosmos in equilibrium. In this case, the displacement has occurred from state political powers or the para-political powers of international organizations or forums in charge of shaping this new global tax order. Thus, while the BEPS Action Plan seeks to combat tax base erosion and profit shifting, it also signifies —de facto— the shifting of tax sovereignty from individual countries to international organizations. In this regard, it is worth asking whether this transfer of sovereignty is legitimate in light of current international norms and, furthermore, at the national level in each of the countries involved. The answer appears to be clearly negative because neither international law norms recognize such a transfer, nor could domestic norms allow it. As constitutional law teaches, the attribution of sovereign power constitutes not only a right of the holder but also imposes a duty of action, so the sovereign cannot abstain from exercising its power. Similarly, it is worth asking whether this transfer of sovereignty from the public authorities of each individual state to representatives of international organizations seems to be a good way to solve globalization's problems in favor of citizens, changing membership in the domestic community for a kind of affiliation to a global community. In this regard, the answer also appears to be clearly negative, considering that such a transfer would entail losing the status of a citizen in a community where there is a relative closeness with representatives and, therefore, the right to have a voice and a vote, along with maintaining a degree of accountability over authorities, resulting in a more or less transparent regime. On the contrary, if fiscal sovereignty were transferred to international organizations, citizens' rights would be diluted in a large global community.

If the solution to the tax issues raised by globalization cannot and should not involve a weakening of the fiscal sovereignty of each state, what can the holders of sovereignty do to deal with these problems? The solution could consist of following what Dagan recommends: faced with globalization, States must re-establish their social contracts with their constituents. Such a renewed contract should allow its current and future members, mobile or immobile, to lead the kind of life that each would conform to behind the veil of ignorance. The new social contract would strike a balance between the coercive nature of the state and the freedom of taxpayers to choose to associate some aspects of their lives with other jurisdictions: between the contradictory, yet essential, goals of stability and freedom, which they need to prosper (Dagan, 2022).

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