A multilateral tax treaty: designing an instrument to modernise international tax law

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5 In a less than perfect world: a realistic view on multilateral cooperation in international taxation

5.1 Introduction

Now that a normative view on multilateral cooperation in international tax law has been constructed in the previous chapter, let's examine what is actually feasible in the international tax arena.[1] The purpose of this chapter is to put the normative claims of the previous chapter in a practical perspective, drafting a 'realistic' or 'instrumental' view on international tax cooperation.

Suppose, e.g., that it is proposed that the PE concept is, in some way, broadened to include non-physical forms of local 'presence' (e.g., digital local presence). What will influence states to enter into either bilateral or multilateral tax relations on such a proposal? A state's decision to cooperate in either bilateral or multilateral relations reflects its rational perceptions of the economic gain of either course of action. These perceptions of gains typically have two dimensions: size and uncertainty. 'Size' reflects a state's perception of the gains to be had from cooperation with (an)other state(s); the larger the perceived gain (the 'size of the pie'), the more the negotiations will tend to focus on the distribution of the gain over participating states. 'Uncertainty' reflects a negotiating state's lack of knowledge on the future impact of alternative courses of action on its own position (whatever the 'size of the pie'). The larger this uncertainty, the less 'distributive' the negotiations will tend to be, as it incentivises states to agree on broadly acceptable, or 'central', substantive arrangements.

If the economic gains of cooperation are perceived to be large and certain, states will be inclined to distribute the gains in bilateral agreements. If gains are expected to be small and uncertain, states will tend to focus on general multilateral principles of cooperation rather than agreement on specific rules. In between these extreme positions, multilateral agreement is easier to achieve on matters of design and concept ('rules of the road'), than on specific rules which have obvious distributive implications on states' economic positions. As we will see, the commitments set out in the BEPS Convention generally fit into this pattern, at least to the extent that distributive issues are avoided. But

1 The chapter is largely based on D.M. Broekhuijsen and H. Vording, *The Multilateral Tax Instrument: How to Avoid a Stalemate on Distributional Issues?*, [2016] British Tax Review 39 (2016). The text has been partly rewritten and some sections have been added, deleted or moved to different sections of the book.

looking forward, this also means that binding multilateral agreement on rules that strike at the heart of tax competition and tax arbitrage is very unlikely. Indeed, from this chapter follows that achieving multilateral cooperation on rules of a formulary apportionment-type of nature (i.e., what are the baselines for dividing the tax pie? Sales, labour, or assets?) may be very problematic.

In this chapter, theory stemming from the field of international relations is used to construct an analytical framework for analysing international tax relations. In section 5.2, the assumption of the rational, self-interested, welfare-maximizing state is selected as the most useful point of departure for analysing states' 'behaviour' in concluding tax treaties. Some recent economic contributions to the tax treaties literature that generally fit this assumption will be discussed in section 5.3, explaining states' choices between bilateral and multilateral forms of cooperation in terms of distribution of economic gain. External (spill over) effects turn out to be an important challenge to that analysis. In section 5.4, the discussions turn to the impact of a multilateral agreement on bilateral tax treaty relations. The existence of a 'veil of uncertainty' is added, showing how negotiating states' decisions may be affected by uncertainty regarding the impact of (new) rules on their economic positions. The resulting analytical framework, summarised in section 5.4.3, is used to discuss the feasibility of a multilateral approach in regard of several potential tax policy changes, and to suggest a direction for a design strategy for a multilateral agreement for international taxation. Also, the mitigating effect of two procedural elements of multilateral cooperation – transparency and the number of participants – is considered in section 5.4.7. In the face of distributive conflict, inconsiderate action on such procedural elements can make matters worse. Procedural design choices in this regard therefore soften the risk of negotiation breakdown on widely acceptable compromises. Section 5.5 concludes.

5.2 Selecting the most promising international relations perspective for analysing international tax relations

Adding a multilateral agreement to the existing patchwork of bilateral treaties could qualify as a 'regime' change in international relations between states. An international regime is a set of principles, norms, rules and decision making procedures that guides states' actions in any specific field of international cooperation. Regimes must be distinguished from international agreements: the purpose of regimes is to facilitate agreements.[2] Applied to the field of

2 S.D. Krasner, *Structural Causes and Regime Consequences: Regimes as Intervening Variables*, in: International Regimes (S.D. Krasner ed., Cornell University Press 1983) at 186-187. He notes at 187: 'regime-governed behaviour must not be based solely on short-term calcula-

taxation, the regime's relevant principles could be, e.g., national tax sovereignty, an idea of states' 'fair shares' based on concepts like source and residence, a perception of the international tax environment as a competitive 'market' for foreign direct investment (FDI). The relevant norms can be found in the various MTCs, with the OECD MTC and its Commentary as the dominant one. The 'rules' are the terms of bilateral treaties. Moreover, decision-making procedures are predominantly national (tax administration and tax courts), and are added to by mutual agreement procedures. Regime change would imply that the set of decision-making procedures is expanded with a multilateral agreement that not only generates new norms but also new rules. It could also imply changes in underlying principles: a reduced role of national tax sovereignty, a changing perception of 'fair shares', and/or a more cooperative idea of the international tax environment.

Literature on international relations has developed along several lines, based on different and often competing views on states, politics and the role of academic analysis. Following Ring, three perspectives that seem particularly relevant to international taxation can be sorted out.[3] These three perspectives are used as pragmatic analytical tools: their purpose is to understand, explain and predict the very complex reality of cooperation by oversimplifying that reality.[4]

One is (neo)realism. In this perspective, states are rational self-interested actors in an anarchic world, sceptical to sacrifice their own self-interest to adhere to normative notions of 'ethical' conduct. It is about survival: leading notions of (neo)realism are power politics, groupism (i.e., states, clans, clubs, etc.), egoism and anarchy.[5] The keys to understanding the world from a realist view are the distribution of power in the system, and a state's relative position to others.[6] For international regimes to develop in such a world, dominant states have to take the lead. But given a 'survival of the fittest'-mentality, states may reject a regime that 'coordinates action and generates gains for all players if that regime allows another state to achieve relative gains'.[7] The inference would be that shifts in dominance could be regarded as triggering regime change. The existing regime, loosely based on the OECD consensus, may be seen as reflecting US dominance. The BRICS nations challenge this consensus

tions of interest. Since regimes encompass principles and norms, the utility function that is being maximized must embody some sense of general obligation'.

3 D.M. Ring, International Tax Relations: Theory and Implications, 60 Tax Law Review 83 (2007), offers an excellent overview of the international relations literature from the perspective of international taxation.

4 See on the role of political theory: D. Beach (2012), p. 9.

5 W.C. Wohlforth, *Realism*, in: The Oxford Handbook of International Relations (C. Reus-Smit and D. Snidal eds., OUP 2009) p. 132-133.

6 D. Beach (2012) p. 35.

7 D.M. Ring (2007) p. 102.

– and the relative weight of the EU in international taxation has a tendency to increase. Non-OECD members cooperate in the forum of the OECD because this at least provides them with the ability to voice their concerns. Given their weaker power positions, this is an opportunity they may not have been able to secure absent cooperation in the regime.[8]

A second perspective is 'neoliberal institutionalism' (not to be confused with the neoliberal policies associated with Thatcher and Raegan). Like (neo)realists, neoliberal institutionalists start from the analytical starting point that international cooperation takes place in an anarchical system in which states are the relevant actors, with the distribution of power and wealth as the most important factors defining state behaviour. States enter into cooperative regimes if there are gains to be had from cooperation. Yet, the core conception of neoliberal institutionalism is a 'market' idea of economic rationality: states can use cooperative regimes to overcome suboptimal outcomes caused by individualistic, uncoordinated behaviour,[9] provided that states have a common interest in cooperating.

The basis for this argument, set out by Keohane, is the analogy with the prisoners' dilemma. It runs thus: two prisoners are locked up for having committed a crime, and are questioned separately by the public prosecutor (the DA):

> 'Each prisoner knows that if neither confesses, the DA will only have sufficient evidence to convict them to misdemeanours, leading to thirty day prison terms for each. If both confess, however, they will each be sentenced to a year in the penitentiary. This prospect might seem to give both an incentive not to confess, except that the clever DA has promised that if either confesses while the other refuses, the confessor will not be prosecuted at all, while his recalcitrant partner is punished severely with a five-year sentence'.[10]

On the basis of narrow self-interest, prisoner A knows that he should confess, whatever his partner, prisoner B, does. If B refuses to confess, A's confession will let him go free. If B confesses, A's own confession will at least save him from the severe five year sentence. However, the walls between the two prison rooms prevent the prisoners from communicating, and there is only one game played. Therefore, both A and B's preferred course of action, if they are self-interested and rational individuals, is to confess, as they expect the other to do the same. They hence receive prison sentences that they could have avoided.

Keohane argues that many of the cooperative structures in international relations resemble prisoners' dilemmas. In that light, he argues, international

8 Id. at p. 104.
9 R.O. Keohane, *After Hegemony: Cooperation and Discord in the World Political Economy* (Princeton University Press 1984) Ch. 6. For a discussion: D. Beach (2012) p. 53-56.
10 R.O. Keohane (1984) p. 68-69.

regimes are of value to states: regimes can prevent market failure (i.e., prevent larger prison sentences for the prisoners) by taking care of communication (i.e., by making transparent the walls that separate the two prisoners from one another). Freed from these walls, the prisoners 'can learn about each other's intentions and actions, agree on standards of behaviour, and learn about the relationship between their actions and outcomes'.[11] By providing actors with information, by enabling states to make credible commitments, and by making long-term cooperative outcomes more beneficial than short-term defection,[12] regimes, in other words, prevent states from 'cheating'.

The prisoners' dilemma analogy teaches us that the neoliberal institutionalist's analysis focuses on the size and distribution of the *absolute* rather than *relative* gains of cooperation,[13] and on transaction costs, which are also related to the number of participating states. Moreover, in extending the prisoners' dilemma to international relations, neoliberal institutionalists are concerned with *durable* cooperation, as is often the case in economically interdependent relationships between states. Provided that states have a common, albeit conflicting, interest on an issue, regimes are helpful.[14] So, cooperation could be opted for to deal with 'club' goods (such as joint defence or free trade) where non-participants can be excluded from the benefits of cooperation. But even with public goods (such as reduction of pollution) where exclusion is more difficult, cooperation is possible, provided that disagreements are not impossible to deal with through bargaining. Within a regime, for instance, initially uncooperative states can be compensated by means of side-payments. Also, linkages can be created among issues.[15] Applied to the area of international taxation, the feasibility of a shift from the existing international tax regime to a more committing multilateral regime must be analysed by comparing net gains or losses for each participating state. Assuming that states maximize national welfare, the impact of alternative regimes on national GDPs is a relevant measure.

A third perspective is constructivism. This approach centres on the ways in which our views on international relations are framed by (implicit) principles and by the analytical tools used.[16] The approach is driven by the role of beliefs and ideas in conceptualising issues of international cooperation. As

11 L.L. Martin, *The Political Economy of International Cooperation*, in: Global Public Goods: International Cooperation in the 21st Century (I. Kaul, I. Grunberg and M.A. Stern eds., OUP 1999) p. 55.
12 D. Beach (2012) p. 54-55.
13 (Neo)realists are interested in the *relative* gains of cooperation: How do I fare in relation to my competitors? See e.g. R. Jarvis, *Realism, Neoliberalism, and Cooperation: Understanding the Debate*, 24 International Security 42 (1999).
14 R.O. Keohane (1984), p. 97.
15 Id. at p. 90.
16 D. Beach (2012) p. 57-61; I. Hurd, *Constructivism*, in: The Oxford Handbook of International Relations (C. Reus-Smit and D. Snidal eds., OUP 2009).

Ring says, in the constructivist view, (1) states' interests are contingent on their understanding of the world because these interests are not a given; (2) states rely on experts due to the technical nature of many of the international issues and (3) some degree of intersubjective, shared understandings about the subject at hand are required before states can engage in cooperation.[17] Hence, constructivists depart from fundamentally different assumptions than neoliberal institutionalists and (neo)realists do.[18] Neoliberal institutionalists and (neo)realists, with their 'consequentialist' focus on material factors (i.e., costs and benefits), treat identities and interests as exogenous and given. Just like economic analysis does not explain the origin and constitutive rules of the market itself, neoliberal institutionalist and neorealist analysis, which are imported from economics,[19] tell us little about the social order or 'structure' that defines who actors are and what they want. Constructivists, on the other hand, *are* interested in the origins and significance of these identities and interests. So, while material factors are important, ideas and values matter too. In the words of Wendt: constructivists accept 'that the structures of human association are determined primarily by shared ideas rather than material forces, and that the identities and interests of purposive actors are constructed by these shared ideas rather than given by nature'.[20]

Given that specific identities of specific states may shape their interests, this may also help explain international outcomes. Examples are numerous. Finnemore for instance uses constructivist analysis to explain why states have intervened to provide humanitarian relief in countries and areas of negligible geostrategic and/or economic interest.[21] Sikkink argues that 'values' explain the emergence of human rights after the Second World War in Europe and the United States.[22] Peter Haas uses constructivist theory for an institutional account of gradual accommodation of governments to environmental problems via social learning.[23] And applied to the field of international taxation, Webb

17 D.M. Ring (2007) p. 110-112.

18 The two logics are distinguished as 'the logic of consequences' and 'the logic of appropriateness' by J.G. March and J.P. Olsen, *The Institutional Dynamics of International Political Orders*, 52 International Organization 943 (1998).

19 J.G. Ruggie, *What Makes the World Hang Together? Neo-Utilitarianism and the Social Constructivist Challenge*, 52 International Organization 855 (1998) p. 871-872.

20 A. Wendt, *Social Theory of International Politics* (Cambridge University Press 1999), p. 1.

21 M. Finnemore, *Constructing Norms of Humanitarian Intervention*, in: The Culture of National Security: Norms and Identity in World Politics (P.J. Katzenstein ed., Columbia University Press 1996).

22 K. Sikkink, *The Power of Principled Ideas: Human Rights Policies in the United States and Western Europe*, in: Ideas and Foreign Policy (J. Goldstein and R. Keohane eds., Cornell University Press 1993).

23 P.M. Haas, *Epistemic Communities, Constructivism, and International Environmental Politics* (Routledge 2015). See for an overview of important constructivist contributions: E. Adler, *Constructivism in International Relations: Sources, Contributions, and Debates*, in: Handbook of International Relations (W. Carlsnaes, T. Risse and B. Simmons eds., SAGE 2nd ed. 2013).

uses constructivist insights to show how norms of 'liberal economic ideology' as well as fiscal sovereignty helped shape the debate on harmful tax competition.[24] Constructivism thus emphasises the role of social debate in international taxation, which may relate to (re)defining the boundary between 'acceptable' and 'unacceptable' tax incentives and tax planning behaviour, as well as to an emerging concept of 'fair shares'. Regime change would come about as a result of gradually changing views on the interests at stake in international taxation: from preventing double taxation to combating tax avoidance.

As this brief outline shows, each of these three perspectives may have relevance in understanding the prospects of multilateralism in international tax law. This chapter will, however, focus on the neoliberal institutionalist tradition, for several reasons. Firstly, institutional neoliberalism is arguably better at explaining issues related to political economy, such as trade, than neorealist models, which are better at explaining security-related issues, particularly between powerful states.[25] In fact, most literature in the field of tax cooperation and coordination fits in the neoliberal institutionalist tradition, as it employs a model of self-interested players in a 'game' played in a world characterised by high levels of economic interdependence. Ring, for instance, shows that the neoliberal institutionalist tradition more accurately reflects the experience of the double taxation regime than realist models of regime formation do.[26] Generally speaking, her argument is that the neoliberal institutionalist model is best fit to the idea that tax treaty relationships are entered into by governments because they enhance durable trade relationships (i.e., they encourage investment). Realist models cannot, for instance, convincingly explain why developing countries, in their relations with other developing countries, participate in bilateral tax treaties patterned on a model that favours residence taxation.[27] To be sure, there is literature that explores the relevance of leadership in the making of the international tax order – usually with the US as the 'Stackelberg' leader.[28] This literature suggests, for

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24 M. Webb, *Defining the Boundaries of Legitimate State Practice: Norms, Transnational Actors and the OECD's Project on Harmful Tax Competition*, 11 Review of International Political Economy 787 (2004).

25 D. Beach (2012) p. 31-61. Nevertheless, realists will of course claim that all important foreign policy issues are, in the end, related to security. And institutionalists will argue that their models are relevant for security issues too, as they are about providing information (misperceptions, simply put, may lead to war). See id. at p. 31-61.

26 D.M. Ring (2007) p. 147.

27 Id. at p. 128-129. See further on this (the footnotes in) section 5.3.4.

28 R.H. Gordon, *Can Capital Income Taxes Survive in Open Economies?*, 47 The Journal of Finance 1159 (1992); R. Altshuler and R. Altshuler and T.J. Goodspeed, *Follow the Leader? Evidence on European and US Tax Competition*, 43 Public Finance Review 485 (2015). Stackelberg leadership (named after the German economist Heinrich von Stackelberg) is a specific game with two unequal participants, in which the smaller participant adapts to the choices made

example, that states can play the 'tax game' cooperatively, when a large capital exporting state unilaterally adopts the full residence principle. Under the umbrella of that principle, smaller states will have no incentive to reduce their source state tax rates. From this line of reasoning follows that the chances of achieving multilateral agreement will depend on the participation of large players (which is plausible enough without taking recourse to game theory).

Secondly, the constructivist approach can, for the purposes of analysing international tax relations, best be seen as complementary to the neoliberal institutionalist one.[29] As Ring notes, constructivism:

> 'proposes a model of how states may come to adopt new positions and how purveyors of knowledge can under certain circumstances shape the direction of new policy. Despite a major role of cognitivists [that is, constructivists] as sceptics and critics, cognitive theories frequently are understood (even by advocates) as being 'complementary' to realism and neoliberalism'.[30]

Indeed, the reality of international tax affairs is most comfortably reflected when assuming that major decisions in international tax are fundamentally constrained by egocentrism and economic rationality.[31] Bilateral tax agreements are entered into by states, first and foremost, for their economic gains.[32] Consequently, state decisions to alter tax relationships are likely to be constrained by the extent to which such decisions increase/decrease such gains. This is in keeping with neoliberal institutionalism. Yet, this does not mean that 'ideas' and 'values' play no role in international tax, even if, in a multilateral negotiation, protecting national economic interests is a more likely determinant of state behaviour than 'achieving tax fairness'. Since the launch of the BEPS Project, the idea of achieving a 'fair' international tax system has clearly become of relevance to international outcomes, and, as such, the emerging idea of 'tax fairness' has most likely been the catalyst that has spurred

by the stronger one.

29 I. Hurd (2009) sec. 3.2.

30 D.M. Ring (2007) p. 112.

31 Four methods to integrate the constructivist with the rationalist perspective can generally be identified: competition (both are checked against reality and one is excluded for being inferior/unclear); by distinguishing 'domains of application' (e.g., differentiating high stake decisions from low stake ones); by sequencing (each approach depends on the other temporally) and by incorporation (one theory can be logically derived from the other). See: J.G. March and J.P. Olsen (1998) p. 952-953. See also: J. Jupille, J.A. Caporaso and J.T. Checkel, *Integrating Institutions: Rationalism, Constructivism, and the Study of the European Union*, 36 Comparative Political Studies 7 (2003) p. 19-24. In this book, see also Ch. 6, I use a sequential approach, problematizing state preferences rather than taking them as fixed and given.

32 See e.g. A. Pickering, *Why Negotiate Tax Treaties*, in: Papers on Selected Topics in Negotiation of Tax Treaties for Developing Countries (A. Trepelkov, H. Tonino and D. Halka eds., UN 2014).

cooperation on the BEPS Project.[33] If public opinion will indeed continue to ask for 'fairer' or more effective taxation of international capital flows, the constructivist perspective to international tax relations may prove of relevance to refine neoliberal institutionalist explanations of international tax cooperation.[34] State preferences in international taxation, are, in other words, unlikely to be fixed and given. They may, over time, and spurred on by normative forces related to 'tax fairness', be subject to (modest) change. How such change occurs and can be facilitated, is however the subject of Chapter 6.

By focusing on the neoliberal institutionalist interpretation of states' 'behaviour' in concluding tax treaties, one implicitly accepts a number of assumptions. A recent review of literature on 'rational design' of international cooperative regimes[35] lists four assumptions that fit in with the (neo)liberal institutionalist approach to treaty negotiations. These are: (1) rationality: states develop cooperative regimes to serve their interests; (2) the expected gains are sufficiently large to enhance cooperation; (3) establishing forms of cooperation is costly; (4) states are risk-averse, i.e., they try to reduce the eventuality of outcomes which negatively impact their future positions.

Under these assumptions, it is not necessary to presume that states' behaviour in concluding tax treaties is unboundedly rational. The intuitions underlying tax treaty negotiations (reduction of both tax frontiers and avoidance options) may be plausible enough and may mean that the requirements of assumptions (1) and (2) are met. But the fundamental question: 'what do states gain by concluding tax treaties?' has only recently been explored empirically;[36] and it may be assumed that states conclude tax treaties under conditions of uncertainty regarding the size (and their own share) of economic gains – which means that assumption 4 is critical. 'Rationality', in other words, does not mean access to full information, or the ability to calculate perfectly. Rationality is 'bounded'.[37] And indeed, in the upcoming discussion, the

33 See I. Grinberg, *The New International Tax Diplomacy*, 104 Georgetown Law Journal 1137 (2016) p. 1169.

34 Likewise, D.M. Ring (2007) p. 148, argues that 'neoliberalist regime theory alone cannot adequately account for the double taxation regime. The 'epistemically informed bargaining' model [which includes constructivist theory] more fully captures the factors crucial to regime formation. (…) its sustained importance in the process is powerfully demonstrated over the decades'.

35 B. Koremenos, *Loosening the Ties That Bind: A Learning Model of Agreement Flexibility*, 55 International Organization 289 (2001), at 781-782.

36 A. Lejour, *The Foreign Investment Effects of Tax Treaties* (2013) CPB Netherlands Bureau for Economic Policy Analysis: CPB Discussion Paper 265 finds that the level of a state's participation in the tax treaty network has a significant positive impact on its FDI stock, while noting that previous empirical studies found little (or even a negative) effect.

37 The concept of 'bounded rationality' stems from the work of Herbert Simon, e.g. H. Simon, *The Sciences of the Artificial*, (MIT Press 1981).

potential impact of uncertainty on the feasibility of a multilateral tax deal plays an important role.

Finally, the analysis starts from the idea that states are the key actors in the international area. In this regard, the neoliberal institutionalist perspective presumes states to have fixed rather than dynamic interests,[38] and to function like 'black boxes', in which the influence of domestic politics and pressure groups on international cooperation is marginalised.[39]

5.3 The neoliberal institutionalist view on bilateral tax relations

5.3.1 Introduction

The arguments recently developed by Rixen,[40] and by Thompson and Verdier[41] function as good neoliberal institutionalist starting points to explain the choice of states to enter either in bilateral or multilateral tax agreements. But it should be noted that both contributions are best understood as addressing negotiations on withholding tax rates. Issues of double income taxation can be resolved unilaterally: from any state's perspective, it is optimal to offer either a foreign tax credit or full exemption to its resident investors[42] (even when tax treaties will still be useful to coordinate source rules, the definition of residency, exchange of information, etc.). The mutual reduction of withholding taxes, on the other hand, is a game that includes important distributional issues in terms of treaty partners' tax revenues.

5.3.2 Bilateralism as a response to asymmetric interests

Rixen presents the tax treaty negotiation game as focused on withholding taxes. He does argue, however, that bilateral tax treaties are settled upon by states because they provide a better solution for reducing double taxation than when a state offers unilateral relief for foreign taxation of residents. That is, he believes, because a reduction of tax levied at source reduces the cost of relief. It would seem that this reasoning is based on a very specific assumption: that withholding taxes are creditable under home state tax rules. Under exemption

38 But see the discussion in Ch. 6 and above.

39 This means that the role of domestic politics on state behaviour is not accounted for. See for the influence of domestic politics on (neo)liberal theory R.D. Putnam (1988).

40 T. Rixen (2010).

41 A. Thompson and D. Verdier, *Multilateralism, Bilateralism, and Regime Design*, 58 International Studies Quarterly 15 (2014).

42 A. Easson, *Do We Still Need Tax Treaties*, 54 Bulletin for International Taxation 619 (2000); T. Dagan, *The Tax Treaties Myth*, 32 New York University Journal of International Law and Politics 939 (2000).

systems, this is not typically the case (as the foreign income is exempted, the tax burdens on that income are ignored).

But he does not need that assumption: his basic argument is that states have asymmetric (source or residence) interests in setting withholding tax rates. For each bilateral negotiation, a state has a (net) source or residence interest. Net importers (of capital, labour, etc.) favour taxation at source. Alternatively, net export states want to protect their resident investors' interests and thus seek to lower taxation at source. However, in reality, states have interests that differ from one interstate relationship to another, as economic flows between states are not reciprocal. As Rixen points out:

> '[B]eing a net exporter or net importer is a relational attribute that can vary with respect to different countries. Country A could have source interests in relation to country B, if A is a net capital importer from B. At the same time, A might have residence interests in relation to country C, exporting capital to C. In relation to country D, there might not be any distributive conflict, if capital flows between A and D are symmetric'.[43]

Rixen therefore rationalises the dominance of bilateral agreements in the tax field as a coordination game driven by distributive concerns. He argues that a full multilateral approach (as in the 'old' idea of a multilateral treaty) would only be needed when bilateral treaties had sizeable external effects. He believes that this is not the case. The only justification for a multilateral initiative is reduction of transaction costs by disseminating information and shared practices in the form of a model convention that provides a focal point for bilateral negotiations. This, of course, neatly describes the status quo.

It should be added that there is a dynamic side to the distributive concerns that drive bilateral coordination. When states set withholding taxes optimally, by implication they must have taken into account the impact of relevant tax base elasticities to maximize overall welfare. Reducing those tax rates in bilateral treaties will cause market responses in terms of mobility and economic growth, and have an impact on overall welfare as well. Assuming (as the neoliberal tradition does) that states enter a contract because of some net advantage, it follows that state A will be prepared to reduce its withholding tax rates (and accept a loss in tax revenue) vis-à-vis state B, if and only if it expects a gain that exceeds the tax revenue loss. The same applies to state B's position. The contracting parties' games may therefore be more complicated than assumed by the simple term 'distribution' – there will usually be a longer-term positive sum to be distributed, depending on expected market responses.

43 T. Rixen (2010), p. 597.

5.3.3 Bilateralism as a means to maximise membership surplus

Thompson and Verdier offer a slightly different approach – or at least, different analytical tools. They argue that the driving force behind concluding treaties is 'membership surplus': the gains that each party draws from participation (the concept is, probably, not very different from Rixen's distributive gains). Bilateral approaches allow for tailor-made negotiation on the distribution of the surplus. Multilateral treaties save on negotiation costs, but are feasible only if the membership surplus can be distributed with sufficient precision. Their conclusion is that multilateralism is most attractive when (a) transaction costs for the bilateral alternative are high while (b) the membership surplus of cooperation is low. The latter may mean that members' costs of complying with the treaty are low and/or that externalities for non-participants are high (i.e., much of the gains of an agreement would leak away to non-participants). Vice-versa, bilateralism is most attractive when (a) the transaction costs of a bilateral deal are low while (b) the membership surplus of cooperation is high (i.e., parties are able to exclude non-participants from the benefits of their agreement).

The point made by Thompson and Verdier can be illustrated by an example, to show that their approach is able to explain the institutional setup of withholding tax reductions. Assume for simplicity that the only issue in concluding tax treaties was the rate of national withholding taxes on dividends. Now states A and B can create 'membership surplus' by concluding a bilateral treaty reducing those tax rates. Their expected gains in national welfare depend on the existing stocks of investment by A in B, and by B in A (which determine the initial loss in withholding tax revenue) and by expected changes in future flows of those investments (which predict gains in national welfare). As withholding taxes are typically inefficient disincentives to FDI, it may be expected that mutual reduction of such taxes is a positive sum game. That is, there is membership surplus to be divided. And the division of the surplus is typically determined by negotiating tax rate reductions. The outcome may well be that state A reduces its withholding tax rate to 15%, while state B is prepared to settle for 5%. The reason may be that state A has a higher statutory rate to start with; that it has much higher stocks of 'state B' investments than vice versa; or that it expects a smaller inflow of new investments (hence, smaller gains) compared to state B's expectations.

As to the transaction costs of forging bilateral treaties to reduce withholding taxes, these can safely be assumed to be relatively low. Unlike for instance negotiations on human rights which require agreement on more principled ('constitutional') matters that surpass deep ideological rifts,[44] reduction of withholding taxes is simply a matter of money. It is in essence a reciprocal

44 E.g., M. Craven, *Legal Differentiation and the Concept of the Human Rights Treaty in International Law*, 11 European Journal of International Law 489 (2000).

exchange of commitments ('I reduce my tax rate if you reduce yours'). Moreover, the OECD MTC and Commentary have further reduced transaction costs by providing focal points for negotiations and by creating a high degree of uniformity in the interpretation and application of bilateral tax treaties based on the OECD MTC. Indeed, most existing bilateral tax treaties are based on the OECD MTC; and the Commentaries are widely used in their interpretation.[45]

Now compare this, still following Thompson and Verdier, with the alternative states A and B have of concluding a multilateral treaty with states C–Z. Assume that this treaty fixes the withholding tax rate on dividends at 10% for all participants. The 'membership surplus' will still be positive. It will also be much larger than the surplus of the bilateral A-B treaty, as the entire world is now involved. But the relevant benchmark is rather the joint surplus of *all* bilateral A – Z treaties. Then obviously, the positions of many states will be harmed by the inflexibility of the 10% tax rate. Considering their stocks of FDI and their expectations of future investment flows, states will actually prefer a zero rate in some bilateral relations while preferring 15% in other cases. Their acceptance of a general 10% rate implies a sacrifice – and if the sacrifice is too big compared to the gains of increased FDI, a state will not participate in the multilateral treaty and rather prefer bilateral solutions.

5.3.4 The substance of tax treaties: distributive issues and 'rules of the road'

Ultimately, the analysis by Thompson and Verdier leads to the same conclusion as Rixen's: a bilateral setting allows states to optimally benefit from negotiating a reduction of withholding taxes. In Rixen's case, the reason is asymmetry in investment relations; with Thompson & Verdier, the reason may also be differences in (initial) tax rates and in tax revenue requirements that reflect differences in underlying attitudes towards the role of government in the national economy.

It must be stressed that both analyses apply specifically to the setting of withholding tax rates and treat bilateral and multilateral agreements as alternative approaches. Of course, tax treaties typically do much more than reducing withholding tax rates. For one thing, they define concepts, such as resident, dividend, etc. – concepts that can be labelled 'rules of the road'.

The typical prisoners' dilemma game (see section 5.2) is based on the assumption that there is just one Pareto-optimal outcome, which can only be obtained when parties are able to commit credibly to cooperation. But there are games with more than one Pareto-optimal outcome. Brennan and Buchanan label these 'rules of the road',[46] as they literally include the driving left/right

45 M. Lang, et al. (2012).
46 G. Brennan and J. M. Buchanan, The Reason of Rules, Cambridge University Press 1985.

choice. The classic example: two cars arrive at an intersection simultaneously.[47] One car, a Volkswagen, is northbound. The other car, a Volvo, is eastbound. There are two ways for them to cross the intersection safely: either the Volvo goes first, or the Volkswagen does. But: neither of the two car drivers wants to wait. There are two possible solution rules. A first option is a coordination rule that is based on the specific characteristics of either of the two actors. For instance, such a rule could hold: all Volvos drive on and all Volkswagens wait. As the *same* actor will always get the outcome he prefers, such a coordination rule is likely to have distributional implications, which makes cooperative solutions hard to achieve. Another option is that the actors adopt a rule in which the context determines who gets his most preferred outcome. Ideally, such a 'fairness' rule would ensure that all actors get their preferred outcome half the time. Both 'right gives way' and 'right has precedence' meet this requirement: sometimes, the Volvo comes from the right, sometimes the Volkswagen. Once an equilibrium is set, no driver would gain from deviating from the preferred outcome, as he would only hurt himself.[48]

More generally, one can think of the choice of technical standards, units of measurement, and a forum language for international communication.[49] When first making the choice, states will prefer one option over another. But as soon as an international consensus starts to emerge, individual states have little incentive to defect.[50] On the contrary: changing 'rules of the road' (that is, changing 'right gives way' to 'left gives way') is costly. Once a specific 'rule of the road' is agreed upon and in force, a change to an alternative rule will have economic implications.

To some extent, choosing common definitions will even have network effects. As the number of states that apply a common concept or standard increases, so does the incentive for other states to join in.[51] This could then explain that the OECD has never had a concern to increase the amount of participating states when formulating its soft standards, even though these have also influenced non-members.[52] The concepts of the OECD MTC have

47 A.A. Stein, *Why Nations Cooperate: Circumstance and Choice in International Relations* (Cornell University Press 1990) p. 38. This been called a 'dilemma of common aversions and divergent interests' by Stein, which occurs when actors do not prefer the same outcome, but do agree that there is one outcome they want to avoid at all costs.

48 L.L. Martin, *Interests, Power, and Multilateralism*, 46 International Organization 765 (1992) at 775.

49 As Rixen notes, the OECD MTC can also be considered to provide 'constructed focal points', which is a concept that was introduced by G. Garrett and B. Weingast, *Ideas, Interests, and Institutions: Constructing the EC's Internal Market*, in: Ideas and Foreign Policy (J. Goldstein and R. Keohane eds., Cornell University Press 1993). See further sec. 6.3.3.

50 A car driver could of course threaten to defect, but this is not cheating: it is a public attempt to force the other actors to accept different equilibrium outcomes. A.A. Stein (1990) p. 42.

51 L.L. Martin (1992) p. 777.

52 Non-members have voluntarily taken up the OECD's standards in their tax conventions – between themselves too, see the introduction to M. Lang, et al. (2012).

'provide[d] benefits that the market has failed to provide – coordination of the tax rules between nations'.[53]

But it should be kept in mind that the first stage of the process ('we need a definition of residency, but which one?') may be a sensitive one as divergent interests may be at stake.[54] Nevertheless, when looking at tax treaty practice, it is evident that multilateralism has been strongest in the field of concepts. There is simply no point in renegotiating concepts like 'dividend' in every bilateral treaty relation.

5.3.5 Introducing external effects

The previous section has shown that the reduction of withholding tax rates through bilateral tax treaties can be adequately explained by Rixen's and Thompson and Verdier's work. However, these analyses do not take into account external effects (spill-overs), which are indeed at the core of international tax law's collective action problems (i.e., the BEPS Project). These effects

53 D.M. Ring (2007) p. 128. As to the contents of the treaties between OECD and Non-OECD states, research in the field of bilateral investment treaties, which countries use to compete for capital as well, suggests that source countries (called 'host' countries in the respective literature) compete with other hosts, and therefore cannot demand changes to the core provisions of BITs used by 'home' (resident) countries. Z. Elkins, A.T. Guzman and B. Simmons, *Competing for Capital: The Diffusion of Bilateral Investment Treaties, 1960-2000*, 60 International Organization 811 (2006). However, this may also be explained by a neorealist (state power-oriented) view. For a neorealist view, reference can be made to Krasner. In an article on the international distribution of the spectrums of telecommunication, he notes that in a distribution, the problem is not 'how to get to the Pareto frontier' (i.e., both state A and B have an incentive to enter into a bilateral treaty) 'but which point along the frontier will be chosen' (i.e., how the distribution between A and B works out). The exercise of state power is important in this regard: it may be used to dictate the rules of the game. It is a matter of who moves first. First movers can dictate the outcome of the distribution, 'provided that the other player is convinced that the first player's strategy is irrevocable'. S.D. Krasner, *Global Communications and National Power: Life on the Pareto Frontier*, 43 World Politics 336 (1991). So, non OECD-member countries have maybe had no option but to accept OECD standards in bilateral tax treaty negotiations between them and OECD members, even though this meant that they had to accept some component of coercion in doing so. As Ring notes, the fact that source (non-OECD member) states, absent direct access to the law-making activities of the OECD, worked through the UN to produce a draft more geared towards their interests, could be evidence of this. Participation 'inside the regime with the potential for some influence is preferential to sitting outside the regime entirely'. D.M. Ring (2007) p. 128. And indeed, a neorealist would argue in this regard that this is an example of how weaker states have used a regime to achieve a result slightly better than their initial power positions would have secured. Id. at p. 127-128.

54 It is not surprising that the OECD MTC is much less precise when it comes to concepts referring to factual situations, especially residency.

have been studied in BEPS Action 11; the overall estimate is that BEPS accounts for a worldwide reduction in corporate tax revenues of between 4 and 10%.[55]

It should be noted that much of this tax revenue loss cannot be dealt with by amending tax treaties. Especially differences in corporate income tax rates remain a major source of external effects (each state's tax rate choice depending on the choices made by others).

The spill-over effects of tax treaties are labelled 'network externalities': 'if country A, having a treaty with country B, signs a treaty with country C, it may in effect create a treaty between B and C'.[56] These externalities are created by some familiar traits of the international tax order, such as the concept of residence and the separate entity approach. Returning to the analyses of Rixen, and Thompson and Verdier: if two states conclude an agreement to reduce their withholding tax rates, a resident of a third state can get access to those reduced rates, depending on the residence criteria used by state A and/or state B. The size of this externality is significant though hard to calculate. One sign is that nearly 40% of worldwide FDI stocks is located in just ten countries representing 3% of worldwide GDP. Of these countries, the Netherlands, Switzerland and Belgium are the largest – and interestingly, 7 out of 10 are EU Member countries.[57] Another indication is that especially the tax revenue loss of developing countries may well run into the billions.[58]

The existence of sizeable external effects of bilateral tax treaty provisions reduces the rationale for concluding bilateral treaties – or, as a recent IMF paper summarizes in bold: 'considerable caution is needed in entering into any bilateral tax treaty'.[59] The only way to 'repair' the treaty network, the IMF suggests, is general adoption of Limitation on Benefits clauses (as suggested in OECD BEPS Action 6).[60]

The presence of external effects may also underscore the relevance of a multilateral approach in reducing externalities, which is what the BEPS Project is about. In contrast to the reduction of double taxation, the point is now to address collective action problems – public good issues – of which BEPS is the prime example.[61] 'Solving' BEPS requires wide or even global participation to be effective, while to any state, free riding (defecting) is an attractive option. E.g., for many states the adoption of limitation on benefits (LOB) clauses is

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55 OECD (2015), Measuring and Monitoring BEPS, Action 11 – 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.

56 IMF, *Spillovers in International Corporate Taxation* (2014) IMF Policy Paper, 9 May 2014 at 14, and further discussion at 25-28.

57 Id. at 6; OECD, *Measuring and Monitoring BEPS*, at 49 -51, offers comparable figures without specifying the states involved.

58 Id. at p. 27.

59 Id. at p. 27.

60 OECD, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6: 2015 Final Report* (2015), at 5.

61 On public goods and private goods in general: R. Comes and T. Sandler, *The Theory of Externalities, Public Goods, and Club Goods* (Cambridge University Press 1986).

typically a collective-decision-making problem. Addressing the collective action problems of international tax law might hence intuitively be better served by a multilateral agreement

5.4 THE NEOLIBERAL INSTITUTIONALIST VIEW ON MULTILATERAL TAX RELATIONS

5.4.1 The substance of a multilateral agreement for international taxation

A response to the externalities pointed out above would be to move from coordination (as in 5.3.2 and 5.3.3) to cooperation in the arena of international taxation, where common goals get precedence over national goals.

However, the gains of cooperation in the international tax area (the 'size of the pie') are not that clear. As we have seen, for a multilateral agreement to be viable, states must be able to foresee net benefits (the multilateral deal should be a 'positive sum game'). These benefits could be measured by means of the membership surplus. As set forth in 5.3.3, there are two sides to this surplus: it has to be significant, and it must be possible to limit free-riding.

There is indeed significant surplus to be gained by a multilateral treaty. This is also reflected in the BEPS Action plan. Indeed, one of its fundamental conceptions is that in order to *remain* sovereign in the international tax area, states must cooperate, as:

> 'Inaction in this area would likely result in some governments losing corporate tax revenue, the emergence of competing sets of international standards and the replacement of the current consensus-based framework by unilateral measures, which could lead to a global tax chaos'.[62]

Just how significant the surplus is, that is where uncertainty begins. As regards the BEPS Project, three types of uncertainties can be discerned. There are uncertainties about (1) the severity of BEPS activities; (2) the regional/ national impact of BEPS activities on revenues and on wealth in general and (3) the national economic implications of different policy responses in tackling BEPS. Especially the second and third sources of uncertainty might prove to be of relevance to signing a multilateral agreement, as these make the distributive implications of action (a multilateral agreement) and inaction (no multilateral agreement) hard to predict.

As regards (1); although there is abundant evidence of sizeable profit shifting, it remains difficult to distinguish 'acceptable' from unacceptable profit

62 OECD, *BEPS Action Plan (2013)* (2013) 10-11.

shifting behaviour,[63] the more so as the distinction itself is part of the BEPS Project. Consequently, it is difficult for states to estimate how much tax revenue they lose on BEPS behaviour (point 2). It is the explicit aim of BEPS Action 11 to improve the quality and availability of relevant data – but evidently, much work still needs to be done.

Moreover, even *if* the loss of tax revenue due to BEPS behaviour could be calculated, this figure would not directly inform us about the loss of welfare (for example: a low MNE tax burden must, in the end, benefit individuals, be it shareholders, employees or customers). Some caution is therefore warranted as regards the overall welfare benefits of tackling BEPS.[64] As to prevention of free-riding, much will depend on the substantive steps taken. If these steps do not include rules that strengthen the tie between the state where tax is paid and the taxpayer's 'economic reality', free-riding is a persistent threat to the goals of the BEPS Project. Anyway, the gains to be had from the BEPS Project may not, in themselves, be so evident that they could operate as a 'game changer'.

And as for point 3: assuming that a multilateral tax agreement allows for the rapid implementation of new or altered concepts in the tax treaties of all participating states, how can states be sure what the impact on their own position would be? And how would that affect their willingness to 'sign in'?

5.4.2 The veil of uncertainty

Literature on the impact of uncertainty on negotiations is fairly unanimous in its conclusions: when parties are uncertain how the choice between alternative rules will affect their own future positions, negotiations will tend to be successful in terms of establishing principles and concepts, rather than specific rules.

Evidently, there is John Rawls' veil of ignorance to start with. In his Theory of Justice,[65] he develops a contractarian approach to the construction of a

63 C. Fuest, et al., *Profit Shifting and "Agressive" Tax Planning by Multinational Firms: Issues and Options for Reform*, 5 World Tax Journal (2013); D. Dharmapala, *What Do We Know about Base Erosion and Profit Shifting? A Review of the Empirical Literature*, 35 Fiscal Studies 421 (2014) makes no such estimates but discusses the empirical evidence on MNE tax planning behaviour. A fairly low 'consensus' value seems to be in sight for the impact of changes in relative tax rates on MNEs tax planning activity. Dharmapala notes on p. 444 that 'in the more recent empirical literature, the estimated magnitude of BEPS is typically much smaller than that found in earlier studies'.

64 Remember that the official economic impact assessment of the CCCTB concluded that its adoption would not increase overall welfare in the EU. Cpb Netherlands for Economic Policy Analysis, *The Economic Effects of EU-Reforms in Corporate Income Tax Systems: Study for the European Commission Directorate General for Taxation and Customs Union* (2009) TAXUD/2007/DE/324.

65 J. Rawls, *A Theory of Justice* (Harvard University Press 1971).

fair constitution (i.e., the basic rules and institutions of a society). Rawls' conception of fairness is that an outcome is fair whenever the procedure generating that outcome was fair. Hence his veil of ignorance: to make sure that people make no judgements based on short-sighted self-interest, they should be deprived of information regarding their own positions under alternative constitutional rules and institutions. As a result, they will agree upon a constitution that is fair towards any member of society.

Ignorance is a strong assumption, and Brennan and Buchanan, in their *Reason of Rules*,[66] have coined the concept of a 'veil of uncertainty'. Their setting is comparable to Rawls': people participate in decision-making on the rules and institutions of their society-to-be. But even without assuming ignorance, participants will find it difficult to estimate the impact of general rules and principles on their own positions and economic interests in the future. They face an uncertainty which:

> 'serves the salutary function of making potential agreement more rather than less likely. Faced with genuine uncertainty about how his position will be affected by the operation of a particular rule, the individual is led by his self-interest calculus to concentrate on choice options that eliminate or minimize prospects for potentially disastrous results'.[67]

Here, the assumption of risk-aversion turns up again:[68] when faced with uncertainty, negotiators will try to avert outcomes that may be harmful to their future positions. And the result, as Brennan and Buchanan claim, is that each participant 'will tend to agree on arrangements that might be called 'fair' in the sense that patterns of outcomes generated under such arrangements will be broadly acceptable, regardless of where the participant might be located in such outcomes'. That is to say, the risk-averse participant will prefer a multilateral agreement that produces reasonable or 'centralized' outcomes for a broad range of future states-of-the-world.[69]

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66 G. Brennan and J.M. Buchanan, The Reason of Rules: Constitutional Political Economy, in: The Collected Works of James M. Buchanan (Liberty Fund 1985)..

67 Id. at Ch. 2 section VII, 19-23.

68 See B. Koremenos (2001) on the assumptions underlying rational design of international institutions.

69 The same argument has been used in other areas of international law too, see e.g. J. Goldstein and L.L. Martin, *Legalization, Trade Liberalization, and Domestic Politics: A Cautionary Note*, 54 International Organization 603 (2000) (precise rules and 'legalization' may be counterproductive to trade liberalization within the WTO, as legalization leads to more and better information about the distributional effects of proposed agreements, deterring the conclusion of cooperative deals) and O.R. Young, *The Politics of International Regime Formation: Managing Natural Resources and the Environment*, 43 International Organization 349-375 (1989) (in environmental distributive bargaining problems, a 'veil of uncertainty' may explain why actors have reached agreement in some environmental areas, such as in relation to arrangements governing the Mediterranean Basin and the transboundary flow of radioactive fallout, and not in areas of acid precipitation and biological diversity.

This line of reasoning can be applied to the position of states in negotiating rules for international taxation, i.e., in choosing between alternative basic rules and institutions in this field. As the impact of these alternatives on national GDP, FDI, tax revenues, etc., becomes more difficult to estimate, discussions will move away from quarrels over distribution, towards finding rules that can be considered 'fair'. Ring makes a similar observation; she notes that uncertainty will lead states to integrative rather than distributive bargaining.[70] That is to say: absent a clear and quantifiable goal in terms of economic gains, the focus of negotiations moves towards more general aims such as fair rules.

The conclusion follows that binding multilateral agreement will be more easily obtainable for general principles and concepts than for specific separate issues. E.g., a general reconsideration of the concept of treaty abuse will be easier to achieve than a rule against a specific form of abuse. Quoting Brennan and Buchanan once more:

> 'As an example, consider the position of a dairy farmer (...) He might strongly oppose a specific reduction in milk price supports, since such action will almost surely reduce his net wealth. At the same time, however, he might support a generalized rule that would eliminate political interference with any and all prices for services or goods. The effect of such a rule change or institutional reform on his own net wealth is less determinate in the latter case than in the former'.[71]

5.4.3 A synthesis: uncertainty on distributional issues

To sum up: when states face a choice between bilateral and multilateral approaches, they may prefer the bilateral instrument when there are economic benefits that the contracting parties can divide between them; they will be more inclined to multilateral agreement when the distributional aspect is absent or very uncertain ('rules of the road', see section 5.3.4). To make the point more clear, two types of tax policy changes can be distinguished.[72]

On one side of the spectrum there are policy options that generate clear economic benefits. These options involve the (re)distribution of the 'pie'. In the (generally not too likely) case that there are *obvious* winners and losers, reaching multilateral agreement will be difficult.[73] Support for this argument can be found in the founding period of the OECD MTC. As follows from Chap-

'Why is there a robust international regime for polar bears but not for other marine mammals such as walruses, sea lions, and sea otters?', id. at p. 350). See further section 7.11.2 and footnotes therein.

70 D.M. Ring (2007) p. 109.

71 G. Brennan and J.M. Buchanan (1985), Ch. 2 section VII, p. 34.

72 The same point is made by T. Rixen (2010), p. 601-603.

73 Grinberg reaches the same conclusion on the basis of an analysis of the OECD's work on CFC rules. See I. Grinberg (2016), p. 1170-1174.

ter 2, the efforts to conclude a multilateral treaty were dropped primarily due to disagreements on the formulation of a general principle to allocate tax jurisdiction, that is, source or residence, which determined obvious winners and losers for the allocation of tax jurisdiction over interests and dividends.[74] Bilateral agreements were needed to tailor the withholding tax rates to each reciprocal tax treaty relationship.

On the other side of the spectrum are hypothetical tax policy changes that provide completely new techniques or terminologies for solving a *new* problem. It may concern 'rules of the road' for taxing new economic phenomena, or an amendment of existing rules without obvious distributive aspects. In these cases, multilateral agreement can be reached more easily. Again, support for this argument can be found in the founding period of the OECD Model Tax Convention. Even when it proved impossible to reach multilateral agreement on the precedence of either residence or source states, concepts such as 'permanent establishment' and 'arm's length' were established multilaterally, as the definition of these notions had no *obvious* distributive aspects.[75] Likewise, little distributive concerns seemed to exist as regards the allocation of taxation on e.g., employment and pensions (see Chapter 2.2: it makes sense to, in principle, allocate these items to the residence state). What mattered was that states selected the same 'fair' standard and did not end up with different solutions on these matters. And indeed, the distributive 'rules of the road' set forth in later OECD MTCs are part of an 'international tax language'[76] and may even be called 'multilateral' in a strong sense, as they are recognised by practitioners all over the world. So, the element of 'uncertainty' may help explain the overlap between the Mexico and London draft models, set out in Table 1 of section 2.2.2.

5.4.4 Some illustrations: The feasibility of a multilateral approach in some tax policy changes

To illustrate the relevance of these observations, let's now turn to various examples of tax policy changes. Some may serve to understand and/or predict negotiation outcomes of a number of the proposals of the BEPS Project (e.g., those on treaty abuse and interest deductions). But the point is more far-reaching than that. Literature argues that the BEPS Project deals with the symptoms but not the causes of the malfunctioning of the international tax system. Indeed, the inadequacy of the BEPS outcomes to 'remedy' corporate

74 See Ch. 2. The taxation of interest and dividends prevented the adoption of a multilateral, uniform solution.
75 S. Picciotto (1992) p. 23.
76 K. Vogel (2000) at p. 616.

income taxation has been widely discussed,[77] and the Project has been criticised to 'fail to provide a coherent and comprehensive approach, and offer instead proposals for a patch-up of existing rules'.[78]

Assuming this is indeed the case, some of the examples below are therefore panoramic: what do the observations summarised in 5.4.3 tell us about international corporate taxation policy debates of the next decade? Each of the following cases may lead countries to reflect on their willingness to participate in a multilateral arrangement that they would not have chosen in a bilateral setting.

1. Limitation of Benefit (LOB) and Principle Purpose Test (PPT) rules.
Under current rules of international taxation, entities may get access to treaty benefits even when they do not perform a relevant economic function within the group. Stronger requirements (in terms of local economic activity) could well reduce treaty shopping in the economists' broad sense of that concept. How would states perceive their interests? This probably is a matter of many winners, a few losers. Presently, the Netherlands and Luxemburg together host 25% of worldwide FDI stock. Behind this figure are, of course, most if not all of the world's MNEs. But should it be multilaterally decided that 'withholding tax shopping' must end, the number of losers (including Switzerland and to some extent the UK), and their political weight should be manageable. A principled multilateral agreement on LOB clauses might hence work, provided that parties are given enough leeway for bilateral fine-tuning. LOB clauses create clear and obvious distributive conflicts.

A brighter outlook applies to the PPT rule, as the text indicates that it involves a 'rule of the road': the key terms are 'reasonable', 'principal purpose',

77 See e.g. M.P. Devereux and J. Vella, *Are We Heading towards a Corporate Tax System Fit for the 21st Century?*, 35 Fiscal Studies 449 (2014); Y. Brauner, *BEPS: An Interim Evaluation*, 6 World Tax Journal 10 (2014); R. Tomazela, *A Critical Evaluation of the OECD's BEPS Project*, 79 Tax Notes International 239 (2015). It also convincingly follows from M.F. De Wilde (2015a) and A.C.G.a.C. De Graaf, P. De Haan and M.F. De Wilde, *Fundamental Change in Countries' Corporate Tax Framework Needed to Properly Address BEPS*, 42 Intertax 306 (2014) and R.S. Avi-Yonah and H. Xu, *Global Taxation after the Crisis: Why BEPS and MAATM are Indadequate Responses, and What Can Be Done About It*, University of Michigan Public Law Research Paper No. 494 (2016), available at SSRN: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2716124 and Y. Brauner, *Treaties in the Aftermath of BEPS*, University of Floriday Levin COllege of FLaw Research Paper No. 16-18 (2016), available at SSRN: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2744712. Moreover, this is also the image that follows from the special edition on BEPS of *Weekblad Fiscaal Recht*, introduced by J. Vleggeert, *De implementatie van de BEPS-acties door Nederland: Kroonjuwelen versus "aggressieve tax planning indicators"*, WFR 2016/47.

78 BEPS Monitoring Group, Overall Evaluation of the G20/OECD Base Erosion and Profit Shifting (BEPS) Project, https://bepsmonitoringgroup.files.wordpress.com/2015/10/general-evaluation.pdf, p. 3.

and 'object and purpose'.[79] These generate uncertain outcomes, and an agreement along these lines is typically served by a multilateral approach. Evidently, it would be in the interest of residence states to reduce source states' incentives to broaden their tax jurisdiction (by procedural safeguards, i.e., dispute resolution and/or exchange of information commitments). But 'asymmetric interests' (each state is predominantly a source state in one bilateral relationship, and a residence state in another) suggest the presence of a 'veil of uncertainty', enhancing a multilateral approach. Indeed, countries have committed to including a minimum level of protection against treaty shopping in their treaties,[80] and the PPT is posed as one of the BEPS Convention's central commitments.[81]

2. *Transfer pricing guidelines and formulary apportionment*

The focus of Actions 8-10 of the BEPS Project lies on refining the arm's length standard which has developed into the 'rule of the road' for transactions between associated enterprises. Hence, it is likely that refining the standards will not be met with a lot of resistance in a multilateral negotiation, as they are of a technical nature and are cast in flexible, non-binding documents that provide governments with ways out. A different forecast however applies in relation to the more difficult issues for which binding formulary apportionment or unitary taxation-type of solutions might be unavoidable.[82] At the heart of BEPS lies the possibility to 'move' (hard-to-measure) intangibles out of the reach of a high-tax environment (particularly the United States) towards a low-tax state.[83] The establishment of baselines and allocation standards for a formulary approach (e.g., labour, assets, innovation), or in other words: the establishment of the size and the shares of the 'tax pie', inevitably involves a distributive problem that creates obvious (and foreseeable) winners and losers. Should e.g., innovation rather than labour be chosen as the formula's benchmark, the US would win and China and India would lose. This makes multilateral cooperation on formulary apportionment unlikely. It is therefore not surprising that the final BEPS reports lack formulary apportionment-type of solutions. Turning the point around: it may therefore be said that any rule that makes use of a formula to distribute tax among countries is politically unlikely. Hence, a Common Consolidated Corporate Tax Base (CCTB) may also prove to be politically very difficult to achieve.

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79 OECD, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6: 2015 Final Report* (2015) 55.

80 See the BEPS Convention and the discussion in Chapter 8; also: id. at at 10.

81 See Article 7 of the BEPS Convention, discussed in Chapter 8.

82 E.g. R.S. Avi-Yonah and I. Benshalom, *Formulary Apportionment: Myths and Prospects*, 3 World Tax Journal 371 (2011) p. 380 and M. Kobetsky, *The Case for Unitary Taxation of International Enterprises*, 62 Bulletin for International Taxation 201 (2008).

83 Y. Brauner, *What the BEPS*, 16 Florida Tax Review 55 (2014) at 96.

The same considerations might affect proposals on country-by-country (CbC) reporting, to the extent that they could be considered a step in the direction of formulary apportionment. Or to put it differently: considering the broad support for CbC-reporting rules, this must mean CbC is *not* perceived as a credible step towards formulary apportionment.[84]

3. *Interest deductions*

One of the strongest substantive recommendations of the BEPS Project is the general adoption of an earnings stripping rule.[85] It consists of two parts: a fixed ratio rule (with a bandwidth of 10-30% of earnings before interests, taxes, depreciation and amortization (EBITDA)) and a group ratio rule (that would allow additional deduction of third-party interest if interest payments of the worldwide group exceed the fixed ratio). This might be a 'veil of uncertainty' situation. Most, if not all, states will see their corporate tax bases broadened, though the effect will be more limited in states that already restrict interest deduction. There may be a negative impact on investments, as the cost of capital increases – but this impact typically gets smaller as more countries join in. The OECD proposal has much to going for it to make it the new 'rule of the road' for deductibility of interest.

What complicates the issue however is that Action 4 requires changes in domestic legislation. The explanatory statement to the 2015 final BEPS reports notes that countries have 'agreed a general policy direction' on the matter,[86] while the Action 4 Final Report announces a multilateral review process of implementation efforts and their impact on MNE behaviour.[87]

4. *'Digital presence'*

Now that international trade in goods and especially services can increasingly do without a traditional permanent establishment, pressure has developed to widen the definition of local 'presence' in the source state. The OECD has suggested some options (Action 1), though the Final Report makes no specific recommendations. This is understandable, as any proposal on this issue would raise a clear distributive conflict. Assume there would be a proposal to replace art. 5 MTC with a sales criterion (e.g., local sales create tax liability when exceeding a fixed threshold amount), how would states assess their own position? In this case, the answer is reasonably clear: the US would lose, the

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84 Instead, as I. Grinberg (2016) at p. 1167 notes, transparency and information reporting requirements are not 'facially distributional'.

85 OECD, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4: 2015 Final Report* (2015) OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. http://dx.doi.org/10.1787/9789264241176-en

86 OECD, *Developing a Multilateral Instrument to Modify Bilateral Tax Treaties, Action 15: 2015 Final Report* (2015)

87 OECD, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4: 2015 Final Report* (2015), 79-80.

rest of the world might well win (or expect to win). The role of tax havens as 'home state' to internet services is a (potential) game changer. And in the end, it would be hard to estimate what amount of tax money is involved (after all, Google and Microsoft do have PE's in Europe). The prediction would be: the level of uncertainty would not be enough to be able to hide a clear distributional conflict between the US and the rest of the world. The debate on 'digital presence' may lead nowhere.

5. Minimum withholding tax rates

The BEPS Project is not aimed at rearranging the international allocation of taxing rights. But the pressure by NGOs to consider the interests of developing countries could lead to a focus on minimum withholding tax rates. As a UN report recently observed:

> 'With the current international discussion about the need to ensure taxing rights over economic engagement in one's territory, and concern about profit shifting through 'off-shoring' intangible property (...) there is likely to be renewed interest in withholding taxes as an efficient, and relatively secure against avoidance, means of enforcing source State taxing rights'.[88]

Within the OECD arena, the philosophy has always been that withholding taxes are hurdles to international investment and should be reduced to, preferably, zero. But developing countries have different interests. For them, withholding taxes are much easier to handle with limited administrative capacity. Here again there's an obvious distributive issue, but one that can easily be politicised: it may be hijacked by public opinion. A multilateral tax agreement could provide for a targeted solution, e.g., inserting 10% minimum withholding tax rates in all treaties with qualifying developing countries.

6. Proposals for 'destination-based' corporate income tax systems

In international tax literature, some suggestions for a destination-based corporate income tax system have surfaced, which can be considered as the economist's answer for a 'fair'[89] and/or 'neutral'[90] corporate income tax

88 UN Economic and Social Council, Further Progress in Strengthening the Work of the Committee of Experts on International Cooperation in Tax Matters: Report of the Secretary-General, 8 May 2013.

89 M.F. De Wilde (2015a).

90 The 'neutrality' question deals with the design of a corporate income tax systems which create minimum distortion to the economic behaviour of corporate taxpayers. The most extensive argument is that of the Oxford Centre for Business Taxation. E.g. A. Auerbach and M.P. Devereux, *Consumption and Cash-flow Taxes in an International Setting*, Oxford University Centre for Business Taxation WP 13/11 (2013); M.P. Devereux and R. De La Feria, *Designing and Implementing a Destination-based corporate tax*, Oxford University Centre for Business Taxation WP 14/07 (2014); A. Auerbach and M.P. Devereux, *Cash Flow Taxes in an International Setting*, Said Business School RP 2015-3 (2015).

system. What unites these proposals is that a move towards a destination-based corporate income tax system requires a switch to a different proxy as the basis for establishing taxing claims:[91] the relevant proxy would be the location of certain transactions, such as sales in the destination state, rather than the location of production factors.

From the simple starting point of equality (and hence economic neutrality) as fairness,[92] De Wilde for instance proposes establishing an unlimited tax liability in each tax jurisdiction in which the taxpayer has a nexus (i.e., the economic activity).[93] Moreover, he suggests that the multinational itself should constitute the taxable entity,[94] its economic rents the taxable base,[95] and the tax base would be assigned to the market jurisdiction on the basis of a sales factor.[96] Double taxation would be avoided by a Dutch-style relief system, that could be positioned somewhere in the middle of the spectrum between a credit and an exemption system.[97] What would remain is a disparity between tax rates.

Allocating the tax base by means of a destination-based attribution key (sales) removes the current incentive to shift taxable profit across borders. Indeed, the most important argument to turn to a destination-based tax base is that the consumer is immobile: 'a tax based solely on the revenue generated in each market cannot be avoided by switching factors of production (and

91 M.P. Devereux and R. De La Feria (2014) p. 15.

92 M.F. De Wilde (2015a) p. 37, and also p. 52. 'The basic argument made is that the notion of fairness in corporate taxation is founded on the equality principle, conforming to the historically widely acknowledged notion of equal treatment before the law'.

93 De Wilde proposes a system in which worldwide tax liability is established in the country closest to the 'source' or 'nexus' of the income. This would cause a tax system to be internally coherent, as it is irrelevant where the taxpayer's place of residence is located. As long as the economic operator is subjected to an unlimited tax liability in the nexus state, cross-border economic operations are not taxed differently from internal economic operations. Would all countries apply this system, they would effectively tax their fraction of the worldwide income to which they are entitled. Id. at Ch. 3.

94 The advantage of a unitary taxation approach is that it counters the distortive effects caused by the separate entity approach. As De Wilde notes, the separate entity approach allows MNEs to influence taxation in different countries by choosing the place of incorporation (residence) and legal form. Id. at p. 164. Taxing the enterprise as a unity, on the other hand, installs neutrality of legal form in corporate taxation. It has the effect that a group of affiliated entities is treated as a single entity for corporate tax purposes. Moreover, it resolves market distortions caused by the different tax treatment of financing instruments, i.e., debt and equity, within groups of affiliated companies. See id. at Ch. 4.

95 Technically, this could be achieved by an allowance for corporate equity (ACE) as this system leads to a tax on economic rent. Id. at Ch. 5. An ACE allows a deduction for the opportunity cost of equity capital. As the remuneration for both debt and equity capital are tax deductible, only the provision of production factors is taken into consideration for tax purposes. It hence leads to a system that does not affect financing decisions. M.F. De Wilde, *'Sharing the Pie': Taxing Multinationals in a Global Market*, 43 Intertax 438 (2015) p. 443.

96 See M.F. De Wilde (2015a) Ch. 6.

97 Id. at Ch. 3.

trade flows) between countries'.[98] However, the switch from a source-based corporate income tax towards one in which the proxy for establishing tax claims is based on a sales factor would imply a switch from producing countries to consumption countries. This clearly introduces the problems identified under point 2. Individual action seems pointless, as a switch to a destination-based system by some countries and not by others would only result in significant double taxation and double non-taxation distortions.[99] Hence, despite its elegance, proposals for destination-based corporate income taxation are likely to remain, at least for the time being, as De Wilde phrases it, 'on the drawing board'.[100]

Summing up, rules that create obvious and foreseeable winners and losers in the international tax area, such as formulary apportionment-type of rules, are likely to be unfeasible in a multilateral setting. It is therefore not surprising that the OECD Final Reports and the BEPS Convention (see Chapter 8) avoid making proposals/rules with evident distributional impact, and make strong recommendations on typical 'rule of the road' issues, increasing the likelihood that a multilateral agreement for international taxation will gain widespread support.

5.4.5 Two rational design presumptions point towards using flexibility mechanisms

Thus far, it has been argued that the prospects of multilateral agreement depend on the absence of obvious economic gains (or losses) to be distributed over participating states, and/or on a high level of uncertainty regarding the size of those gains for participating states. Both considerations point into the direction of two 'standard' rational design hypotheses, based on the literature regarding the rational design of international agreements.[101]

98 A. Auerbach and M.P. Devereux (2013), p. 3.

99 R.J. Vann, *Policy Forum: The Policy Underpinnings of the BEPS Project: Preserving the International Corporate Income Tax?*, 62 Canadian Tax Journal 433 (2014).

100 M.F. De Wilde (2015a), p. 60.

101 These presumptions are based on some of the conjectures presented by B. Koremenos (2001). The total number of conjectures adds up to sixteen, and covers, i.e., membership (inclusive or restrictive), issue scope (limited or broad), centralization and flexibility. They have been empirically tested in B. Koremenos, *The Continent of International Law: Explaining Agreement Design* (Cambridge University Press 2016).

Presumption 1.
Actors have an incentive to design institutions with flexibility when they are faced with uncertainty about how the division of gains will work out in the future.[102]
By using flexibility arrangements, actors can 'insure' themselves against unanticipated negative consequences.[103] Moreover, more flexible arrangements can lead to a 'learning' process, in which states learn over the course of time about the costs and benefits of policy action, reducing uncertainties.[104] Such 'learning' agreements are not aimed at providing once-and-for all solutions, but are rather built to *manage* a problem in the future.

Presumption 2.
States may reduce distributional problems by adopting a more flexible agreement structure.[105]
For international tax, this flexibility is reflected in the fact that the reduction of double taxation is organized bilaterally. Hence, this hypothesis does nothing more but reflect the conclusions of section 5.3.2 and 5.3.3: bilateralism is favoured over multilateralism because it enables states to maximize the membership surplus.

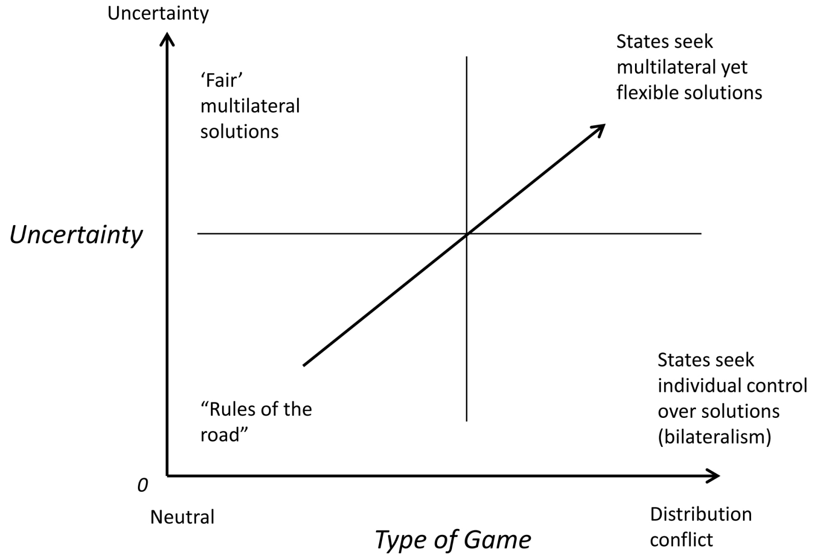

Figure 2: Design strategy: the argument

102 B. Koremenos (2001) 793.
103 B. Koremenos, Contracting around International Uncertainty, 99 American Political Science Review 549 (2005) 549.
104 B. Koremenos (2001).
105 Id. at 794.

5.4.6 What type of flexibility mechanisms?

Presumptions 1 and 2 hence will lead states to consider flexibility mechanisms when designing a multilateral agreement. The question then is: what *types* of flexibility mechanisms could be considered?

Generally speaking, literature on the rational design of international agreements distinguishes between three types of flexibility mechanisms: *transformative*, *adaptive* and *interpretative* flexibility.[106] *Transformative* flexibility allows the institution itself to be changed so that actors can respond as circumstances change; such mechanisms allow the development of substantive commitments over time. *Adaptive* flexibility allows actors to depart from institutional norms, for instance due to a change in domestic circumstances, whilst the institution itself remains in place. The goal of this type of flexibility is to isolate external shocks, whilst the broader institution is insulated from their impact. Examples of such rules are escape mechanisms and withdrawal clauses. Finally, *interpretative flexibility* has aspects of both other two types: it grants individual participants leeway in interpreting and applying agreed rules. The most common forms of this type of flexibility are the use of reservations, which ensure that states whose interests depart from the treaty's text are not forced to make an all-or-nothing choice, and the use of open norms or 'rules of the road'.[107] Nevertheless, the use of such norms is not without bounds: the more states are uncertain about the behaviour of others under such norms (does certain behaviour constitute cooperation or defection?), the more a need exists for information and dispute resolution mechanisms.[108] As Abbott and Snidal

106 See id. at 773; A. Thompson, Rational Design in Motion: Uncertainty and Flexibility in the Global Climate Regime, 16 European Journal of International Relations 269 (2010) at 270-271 (who first introduces 'interpretative' flexibility by the term 'means flexibility') and C. Marcoux, Institutional Flexibility in the Design of Multilateral Environmental Agreements, 26 Conflict Management and Peace Science 209 (2009). The latter two articles are about agreements in the area of the international environment. The agreements for the international environment are an ideal case for investigating uncertainty-flexibility designs, as political processes are transparent and outcomes distinct. As will be argued in Ch. 5, the problems underlying the environmental agreements are comparable to tackling BEPS. See on flexibility more in general: L.R. Helfer, *Flexibility in International Agreements*, in: Interdisciplinary Perspectives on International Law and International Relations (J.L. Dunoff and M.A. Pollack eds., Cambridge University Press 2012).

107 C. Marcoux (2009), p. 211-212.

108 J. Mccall Smith, *The Politics of Dispute Settlement Design: Explaining Legalism in Regional Trade Pacts*, 54 International Organization 137 (2000); B. Koremenos (2001) 'centralization increases with uncertainty about behaviour', p. 27-28 and B. Koremenos, *If Only Half of International Agreements Have Disputre Resolution Provisions, Which Half Needs Explaining?*, 36 Journal of Legal Studies 189 (2007).

say, delegation, that is the delegation of authority to e.g., courts,[109] may particularly be used to deal with incomplete contracting problems.[110]

Be that as it may, the underlying problem structure of a multilateral agreement for international taxation points in the direction of using *interpretative* and *transformative* flexibility mechanisms. Indeed, hypothesis 1 points in the direction of using 'rules of the road', which contain interpretative flexibility by allowing states to 'insure' themselves against uncertain future outcomes of a multilateral agreement. This enables states to create solutions as they go along. Additionally, a transformative flexibility design allows states to tackle completely new problems as they come up. This reflects the wish of the OECD to create an 'innovative approach to international tax matters, reflecting the rapidly evolving nature of the global economy'.[111] More importantly, as argued in the next chapter, it allows states to 'learn', that is, develop international rules over time. Once detailed commitments are under negotiation, presumption 2 points in the direction of a generous use of reservations. Reservations to multilateral norms create *inter se* (potentially bilateral) arrangements between parties within the multilateral regime, providing a flexible solution to the distribution problem. Although this strategy comes at the cost of uniformity and complexity, states individually remain in control over proposed solutions whilst not losing sight of the agreement's principal purpose (to amend the network of bilateral tax treaties and provide a level playing field).

5.4.7 Procedural elements of a multilateral agreement for international taxation

5.4.7.1 Participants

But especially in a multilateral agreement, the interests of states might be so different that negotiations could eventually end up in a choice between poor agreements (i.e., 'rules of the road' will not be further developed) and negotiation failure. Certainly, efforts should be made for the eventual universalisation of the regime, as is pointed out in Chapter 4. Moreover, there is an obvious logic to including more states in a multilateral agreement, as the current system's externalities can only be reduced when more (and the most economically relevant) states accept to sign a multilateral tax deal (see section 5.3.5). The point is that the membership parameter depends on the

109 K.W. Abbott, et al., *The Concept of Legalization*, 54 International Organization 401 (2000) p. 415.

110 K.W. Abbott and D. Snidal, *Hard and Soft Law in International Governance*, 54 International Organization 421-456 (2000) p. 433.

111 OECD, *BEPS Action Plan (2013)* (2013) p. 24.

amount and type of actors needed to resolve a problem. But rational design theory suggests that as numbers increase in a multilateral negotiation, this may lead to broader-deeper trade-offs.[112]

Indeed, the need for flexibility mechanisms will make negotiations far more complex and therefore, in terms of transaction costs, more expensive. Yet without such mechanisms, a step towards broader membership diffuses the influence of the individual state on law-making (this point is, essentially, a central argument of the discussions above), making such a state likely to renege. Moreover, tax rules are already of a very technical (and hence often complex) nature.[113] Indeed, as Ault says:

> 'The OECD has been most successful where it works to establish principles of sufficient specificity to be helpful in channelling policy formulation, but not principles so detailed as to be too restrictive of the ways in which the countries can implement them'.[114]

As Blum notes, 'the introduction of additional parties to treaty negotiations is hardly ever cost-free. It potentially increases barriers to efficient agreements and exacerbates problems of information asymmetry, strategic barriers, psychological barriers, and institutional constraints'.[115] Indeed, increased transaction costs 'may cause some states to remain outside an agreement even if their participation would increase the total surplus'.[116]

So, abruptly broadening state participation (e.g., by means of a switch to another established institution such as the United Nations) has the drawback that developed countries are likely to oppose such a move. During the Addis Ababa 2015 Financing for Development Conference, initiatives for an equal voice of developing countries in setting international tax policy, organised around the G77 and China, were blocked by developed states.[117] Would the

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112 B. Koremenos (2001) p. 785; G.W. Downs, D.M. Rocke and P.N. Barsoom, *Managing the Evolution of Multilateralism*, 52 International Organization 397 (1998). See also: G. Blum (2008) p. 351; A.T. Guzman, *How International Law Works: A Rational Choice Theory* (OUP 2008) p. 170-176.

113 This also explains that countries have negotiated, in limited numbers only, on the development of the OECD MTC. More participants would have made 'the model no longer a model', and would have reduced the quality of the output that the OECD sought to achieve. H.J. Ault, *The Role of the OECD Commentaries in the Interpretation of Tax Treaties*, in: Essays on International Taxation (H.H. Alpert and K. van Raad eds., Kluwer Law and Taxation 1993).

114 H.J. Ault (2008) p. 780.

115 G. Blum (2008) p. 351.

116 A.T. Guzman (2008) p. 171.

117 UN General Assembly, *Resolution adopted by the General Assembly on 27 July 2015: Addis Ababa Action Agenda of the Third International Conference on Financing for Development* (2015) UN A/RES/69/313, at para. 28 and 29, sets out that the financing for development initiative continues to work on the basis of already existing international consensus on international tax issues.

locus of decision-making and policy setting in international tax be moved to the more diverse-member forum of the United Nations *in one go*, the current control of developed nations over international tax matters would become far more diffused.

Hence, a quick expansion of countries involved in decision-making would probably come at the cost of reaching consensus, or even worse, might prevent rational states to renegotiate at all.[118] Consequently, to mitigate some of these risks, it may be wise, when starting off, to limit decision-making to the countries whose shared interests are greater than their differences, so that the road towards further agreement can be paved.[119] Also, decision-making can be slowly expanded over time to a wider and more diverse group of participants.[120] So, the neoliberal viewpoint leaves some leeway as regards broadening participation to more and more diverse groups of states.

It is unlikely that a procedurally fair system, such as the one set out in Chapter 4, will be immediately accepted. Nevertheless, there are indications that the OECD is working towards a system in line with such a system, i.e., that includes all of those interested. That the final BEPS package has been presented as a *fait accompli* to the rest of the world, causing some writers to question the Project's legitimacy,[121] seems a necessary compromise not to expand decision making too quickly. But it should be kept in mind that what needs to be worked towards to, is that the states participating in the ad hoc group or 'implementation framework' are ultimately given a real, tangible and equal influence on law-making taking place, i.e., on the adoption of the texts, setting of the agenda, etc.

118 B. Koremenos (2001) p. 794-795.

119 R.O. Keohane and J.S.J. Nye (1989) p. 294-295.

120 G.W. Downs, D.M. Rocke and P.N. Barsoom (1998) (admitting potential members sequentially over time based on their preferences for cooperation produces a multilateral organisation that will often be deeper at every stage than the cooperative structure that would have been obtained by an inclusive strategy). And: M.J. Gilligan, *Is There a Broader-Deeper Trade-off in International Multilateral Agreements?*, 58 International Organization 459 (2004) (a more diverse group of states may be allowed to set their tax policies at different levels).

121 See e.g. I.J. Mosquera Valderrama, *Legitimacy and the Making of International Tax Law: The Challenges of Multilateralism*, 7 World Tax Journal (2015), par. 7: 'The risk may exist that countries fail to reach consensus on the provisions of the multilateral agreement and that such agreement will have several reservations or opting out provisions by countries that may result in a lack of commitment to the provisions of the agreement by the OECD and the non-OECD countries', and C. Peters (2014), p. 342 'In the absence of appropriately institutionalized procedures, there is the fatal perception that the arguments and interests of the non-members are being heard, but that these do not find their way in the decisions that are being made'.

5.4.7.2 Transparency

The neoliberal institutionalist view on international tax relations also provides some insights into whether negotiations and deliberations should be transparent in a broad sense, that is, to the public and to other actors. Following Finel and Lord, two 'logics' of transparency can be discerned: one positive and one negative.[122]

In a positive logic of transparency, transparency first of all increases the effectiveness of regimes by reliably projecting states' intentions. This can prevent conflicts from escalating.[123] Improving transparency is, by definition, a way to perfect markets. For instance, Keohane argued that international regimes may overcome market failure by helping to 'dissolve' the walls of the prisons in a classic prisoners' dilemma, as this improves information flows and decreases transaction costs.[124] More particular in relation to law-making, transparency ensures that 'rules of the road' are perceived as fair by all, in the sense that they can be scrutinised to incorporate all relevant interests. In this regard, as Keohane notes, 'outsiders' will be reluctant to make agreements with 'insiders', expecting that the resulting bargains are unfair. The problem is not one of insufficient information, but rather one of systematically biased patterns of information, which are recognized before any agreement is arrived at. 'Awareness that others have greater knowledge than oneself, and are therefore capable of manipulating a relationship or even engaging for successful deception and double-cross, is a barrier to making agreement', he says.[125] Secondly, transparency obviously promotes democratic values: the more citizens know about the actions of bureaucrats, the better they can hold them accountable. Indeed, a point of Chapter 4 in this regard, reiterated here, is that as tax law-making becomes more and more removed from its democratic basis of justification, and as international institutions gain greater authority to influence the lives of individuals, the direct influence of national legislatures on law-making is reduced. This underscores the need for transparent deliberations, which allows civil society to follow and influence law-making taking place.[126]

But transparency has its drawbacks too. Identifying these drawbacks does, however, require relaxing some of the presumptions of neoliberal institutionalism set forth in section 5.2. The point is that transparency is of little help to a negotiation when the public can 'measure' the bargaining

122 B. Finel and K. Lord, *The Surprising Logic of Transparency*, 43 International Studies Quarterly 315 (1999).
123 Id. at p. 319.
124 R.O. Keohane (1984); see also A.A. Stein (1990), Ch.3.
125 R.O. Keohane (1984) p. 93.
126 M. Donaldson and B. Kingsbury, *Power and the Public: The Nature and Effects of Formal Transparency Policies in Global Governance Institutions*, in: Transparency in International Law (A. Bianchi and A. Peters eds., Cambridge University Press 2013) p. 502-504.

success or failure of its representatives by means of a publicly known 'baseline' (such as the terms/equilibria of existing bilateral tax treaties). Such a baseline may be set, as we have seen in section 5.4.3, when departing from an existing bilateral tax treaty equilibrium cannot be concealed by a 'veil of uncertainty'.

A transparent negotiation may further complicate matters, as it provides an incentive for that party to 'posture', which relates to the effect that representatives become concerned with achieving bargaining success in the eyes of the electorate.[127] This concern then motivates representatives to adopt uncompromising positions during negotiations, so that they will not 'fail' in the eyes of the public. If the public indeed expects its representatives to pursue the national interests (i.e., increase or protect domestic welfare),[128] a public renegotiation can prevent parties from explore workable compromises, as negotiation efforts can be compared to publicly known baselines. In a closed-door environment, on the other hand, representatives can blame other states for the positions ultimately adopted.[129] In the event that the public can indeed 'measure' the success of a negotiation against publicly know tax treaty equilibria,[130] transparency may hence increase the risk of negotiation breakdown.

The point is that openness has obvious benefits, but has costs too. Transparency can however be achieved to varying degrees, as there are many techniques to enhance transparency without making *all* information immediately available.[131] For instance, decision-makers may provide a reasoned account on why an issue will not be discussed in public, placing the onus of proof

127 This has been argued by D. Stasavage, *Open-Door or Closed-Door? Transparency in Domestic and International Bargaining*, 58 International Organization 667 (2004).

128 T. Risse and M. Klein, *Deliberation in Negotiations*, 17 Journal of European Public Policy 708 (2010) argue that negotiations 'behind closed doors' are conductive to persuasion the more actors know about the preferences of audiences whose consent is required. Vice-versa, a transparent negotiation setting is conductive to persuasion the more that actors are uncertain about the preferences of audiences whose consent is required.

129 S.J. Barkin, *When Institutions can Hurt You: Transparency, Domestic Politics, and International Cooperation*, 52 International Politics 349 (2015). See also D. Stasavage (2004).

130 Put differently: transparency may work when the public does not expect representatives to pursue the maximization of domestic welfare, or when 'measuring' negotiation success is impossible because gains are uncertain.

131 See in this regard: R.O. Keohane and J.S.J. Nye (2002) p. 239: 'As experiments continue with governance and trisectoral networks, it will be important to develop more modest normative principles and practices to enhance transparency and accountability – not only of IGOs but of corporations and NGOs that constitute global governance today. For example, increased transparency advances accountability, but transparency need not be instantaneous or complete. Consider the delayed release of Federal Reserve Board hearings or the details of Supreme Court deliberations'. Similarly, L.R. Helfer, *Constitutional Analogies in the International Legal System*, 37 Loyola of Los Angeles Law Review 193 (2003) p. 231-237 shows that international law-makers make use of a wide range of transparency and accountability mechanisms, from soft to more radical.

on those that seek confidentiality.[132] Also, policy makers may set the time period after which the records of closed meetings are published: although deliberations may take place behind closed doors, policy makers may at least make sufficient information available so that the public can understand the law made by a body. Publishing the *traveaux préparatoires* online, including preparatory documents, could help in this regard.[133] Policy makers can also resort to intensifying public consultation.[134] Alternatively, they can invite NGOs to participate as observers at the meetings of treaty parties.[135] In this regard, as noted by Schermers and Blokker, the importance of NGOs in the work of international organisations has risen. Through their expertise, by mobilising public opinion and by linking 'the local and the global', international organisations have been able to close in on social reality.[136]

The OECD works on the basis of a compromise. It has clearly put a lot of effort in being as transparent as possible. For instance, the OECD is transparent about the tax rules drafted and the technical aspects of those rules, and has systemically heard the voice of the public through public discussion drafts. As Mosquera Valderrama points out in relation to the BEPS Project: the key documents, the draft actions, the discussion drafts, they have all been published on the OECD website. So, the first impression is that the OECD meets the criteria of transparency.[137] Yet, the OECD only publishes what it wishes to publish, and probably not without a reason. Insufficient information is available on how decisions by the OECD are *actually* made.[138] Although the OECD claims

132 A.E. Boyle and K. Mccall Smith, *Transparency in International Law-making*, in: Transparency in International Law (A. Bianchi and A. Peters eds., Cambridge University Press 2013) refer to the *Convention on Access to Information, Public Participation in Decision-Making and Access to Justice in Environmental Matters* (adopted 25 June 1998), 2161 UNTS 447 and the *Agreement for the Implementation of the Provisions of the United Nations Convention on the Law of the Sea of 10 December 1982 Relating to the Conservation and Management of Straddling Fish Stocks and Highly Migratory Fish Stocks* (adopted 4 August 1995), 2167 UNTS 88 in this regard, see p. 429-430.

133 A.E. Boyle and K. Mccall Smith (2013) p. 432.

134 N.M.A. Kreveld, *Consultatie bij fiscale wetgeving* (SDU 2016) develops a practical decision-model for domestic law-makers to decide to use a particular type of consultation method, given the varying aims and purposes of the inquiry.

135 A.E. Boyle and K. Mccall Smith (2013) p. 426, includes references to conventions in this regard at fn. 36.

136 H.G. Schermers and N.M. Blokker (2011) par. 188-189. But, see S. Charnovitz, *Nongovernmental Organizations and International Law*, 100 American Journal of International Law 348 (2006), p. 368, who says: 'of course, NGO participation does not necessarily improve the outputs from 1Os or multilateral negotiations. Consultation with NGOs takes time, which can exact a cost. Moreover, while inviting the NGOs in makes the entire process more transparent to the public, such transparency can lead to different results than would ensue if governments arrived at agreements behind closed doors'.

137 I.J. Mosquera Valderrama (2015) sec. 6.2.1.

138 There is no detailed information available about the collaborative processes by means of which the rules of the BEPS Action items were established. It is not possible to learn what arguments played a role and what did not, who has set the agenda, who made what

to be transparent, little is revealed abouthow the OECD has adopted the BEPS proposals, how nations actually have 'used' the OECD in this regard.[139] But this protects negotiations on obvious distributive issues from being politicized against widely known pre-existing baselines, e.g., set by existing terms of bilateral tax treaties.

So, the question of transparency is a dilemma. On the one hand, the neoliberal institutionalist view strongly suggests that transparency increases the efficiency of a regime. Moreover, it increases the accountability of international lawmakers. But there are risks too. If the adoption of a multilateral agreement is interpreted as a 'negotiation failure' by a state's public, for instance when a flagrant loss of domestic welfare cannot be concealed by a 'veil of uncertainty', transparency can undermine rather than facilitate negotiation outcomes, as it prevents negotiators from blaming them on others. Transparency should be treated with care. But given the wide variety of transparency mechanisms at the disposal of lawmakers, there is no reason not to consider transparency as the appropriate standard for, rather than the exception to, international lawmaking. Deviations from the standard, if necessary, can be justified and explained.

5.5 Conclusions

In predicting how negotiations will turn out for a multilateral agreement for international taxation, the neoliberal institutionalist insights from the work of Rixen and Thompson and Verdier are useful. These explain why the reduction of withholding taxes is organised bilaterally: this provides states with the instrument to maximize their membership surplus (in the terms of Thompson and Verdier) or their gains in an asymmetrical distribution conflict (as reasoned by Rixen).

This line of thought does however not fully account for externalities of the tax treaties network, such as those caused by BEPS. Internalising these external effects requires collective action. But before states will agree to a multilateral arrangement, they must be able to foresee some gains in multilateral cooperation compared to likely alternatives (such as further loss of corporate income tax revenues, or increasing reliance on unilateral rules to

decisions and who had what influence, to what extent consensus has been reached on a particular action item, e.g., why 'ad-hoc partial solutions' were chosen over the 'comprehensive and principled rethinking' of the challenges posed by BEPS. See in this regard the criticism of Y. Brauner (2014a). Mosquera Valderrama recognises that the deliberations taken place between states in the BEPS Project have not been published, which prevents any insights in how the interests of non-member countries were actually taken into account. I.J. Mosquera Valderrama (2015) sec. 6.2.1.

139 A. Christians, *Networks, Norms, and National Tax Policy*, 9 Washington University Global Studies Law Review 1 (2010) p. 15.

protect the national tax base). Although some distributive benefits/membership surplus might be gained through multilateral cooperation in relation to tax avoidance and tax competition, there is a great deal of uncertainty about how significant these gains are. In the face of uncertainty, the risk-averse state will tend to agree on 'centralised' or 'fair' multilateral arrangements, i.e., arrangements that may be expected to generate acceptable outcomes for a broad range of future states-of-the-world. Hence, as the impact of different policy options is more difficult to measure, discussions will move away from quarrels over distribution, in which states will seek individual control over decision making, towards finding principles and rules that can be considered 'fair'.

These two factors (the size of the gains to be distributed, and the level of uncertainty surrounding that size) provide us with an insight into the feasibility of different future policy actions, as well as the design of a multilateral agreement. The multilateral approach can be helpful in improving and reformulating 'rules of the road'. Remaining distribution problems and uncertainty concerns can be relaxed by flexible regime design options, such as reservations. Moreover, negotiation breakdown can be mitigated by only including like-minded parties in the deliberations, and by closing the doors of negotiations, so that compromises are not openly set off against publicly known baselines. Relaxing these procedural restrictions can be experimented with, however, as transparency can be realized in varying ways and to varying degrees, and inclusivity can be achieved gradually.

This does in no way guarantee success in the near or even remote future. Instead, this may mean that solving the fundamental problems underlying BEPS, e.g. replacing the arm's length standard with formulary apportionment-type of rules, may prove very difficult. But focusing on 'rules of the road' and avoiding issues with clear distributional impact increases the chances of a multilateral agreement for international taxation gaining widespread support.