Dynamism and democracy: essays on the fiscal social contract in a globalised world

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5 Contract theory as a guide to fairness in tax treaties■

Abstract

The current international tax system is based on bilateral treaties that generally favour taxation by the resident state rather than by the source state. Low-income countries that have signed those treaties do not necessarily benefit from them. That outcome is paradoxical because tax treaties can be seen as international analogues of contracts, which, in a well-functioning market, should be mutually beneficial. The reason for this paradox is threefold. First, a tax treaty improves conditions for bilateral investment, which puts pressure on third capital-importing nations to join the treaty network. Second, a country's need for investment worsens its bargaining position in treaty negotiations, especially against a 'cartel' of OECD countries aiming to disseminate OECD standards. Third, there may be imbalances in the treaty partners' capacity to oversee the treaty's tax-technical and economic consequences. Hence, three contracting problems may occur, namely, externalities, coercion and asymmetric information. We examine the solutions to these problems provided by contract theory and investigate whether those solutions can provide guidance in discussions of fair tax base distribution in bilateral treaties. In the two main (liberal and welfare consequentialist) approaches to contracting problems, we find no clear standards to deal with the interests of third parties or to determine whether a party's consent to an agreement is voluntary and informed. Several existing theories of justice in tax policy work analogously to either of these approaches. We show that these theories are equally unable to provide satisfactory normative criteria to guide the balancing act between national autonomy and international fairness in a context of bilateral tax treaties.

■ This chapter has been accepted for publication in IK Lindsay and B Mathew (eds), *Fairness in International Taxation* (Oxford, Hart Publishing, forthcoming): https://www.bloomsbury.com/us/fairness-in-international-taxation-9781509968077/. It was co-authored with Dirk Broekhuijsen and Henk Vording. To comply with the PhD regulations outlined by the Doctorate Board of the Faculty of Law at Leiden University, which require me to provide an overview of contributions to co-authored chapters, I declare the following. The idea to use insights from contract theory to analyse issues of fairness in the bilateral distribution of taxing rights was Dirk Broekhuijsen's. The design of an earlier version of the study was a common effort with equal input from all authors. Bastiaan van Ganzen designed the final version of the study. Section 5.1 was written by Bastiaan van Ganzen. Section 5.2 was drafted by all authors together but was finalised by Bastiaan van Ganzen. The first two paragraphs of section 5.3 ('The costs imposed (…) the first place.') were drafted by Dirk Broekhuijsen and Henk Vording and finalised by Bastiaan van Ganzen; the remainder of that section was written by Bastiaan van Ganzen. Sections 5.4 through 5.6 were written by Bastiaan van Ganzen, except one paragraph in section 5.5 ('Insofar those unreasonable (…) has come about.'), which was largely written by Henk Vording. Editing was done by Bastiaan van Ganzen. Bastiaan van Ganzen claims >70% authorship.

5.1 Introduction

Whereas most theories of international tax justice take a normative stance on the fairness of unilateral tax policy, the realm of international taxation is dominated by bilateral treaties. Those raise fairness issues of their own: to what extent do low-income countries as well as high-income countries benefit from tax treaties;[1] how does the relative negotiating power of those countries impact treaty content; are existing OECD treaty standards renegotiable; are countries under economic and/or political pressure to sign; do both countries oversee the treaty's consequences; and does the treaty generate spill-over effects on third countries? The answers to these questions have considerable implications for international tax justice and may possibly conflict with normative theories on unilateral tax policy.

A common element of the abovementioned issues is that they can be regarded as international analogues of three much-examined problems in the theory of contracts, namely: externalities, which are spill-over effects imposed on third parties that are not involved in the agreement; coercion, whereby voluntary consent to the agreement is negated by severely constrained choices; and information asymmetry, whereby one of the contracting parties is inadequately informed about the contents and consequences of the agreement. In this chapter, we aim to investigate whether and how those aspects of contract theory can provide guidance in discussions of fair tax base distribution. Our aim is not to draw an analogy between the law of contracts and international tax law, as they are incomparable in many respects.[2] Instead, we base our analysis on the *theory* of contracts, which provides the philosophical underpinning for the norms that guide the

1 Although the terms 'developing countries' and 'developed countries' are relatively common in the academic literature on this topic, this chapter will instead refer to 'low-income countries' and 'high-income countries', respectively. This choice avoids oversimplification of the complexities of socio-economic development into a singular definition based on Western-centric standards that might imply inferiority and that disregards global leadership in specific areas such as technology. Furthermore, an income-based categorisation is more relevant than a broad socio-economic indicator in the context of this chapter, which will emphasise that a country's need to attract foreign direct investment may force it to accept poor treaty conditions; that economically powerful nations are dominant in the tax policy community; and that there are imbalances in countries' domestic tax-technical expertise. These issues are relatively closely related to countries' economic development or power, for which gross national income per capita can be regarded as a proxy variable. The arguments in this chapter will mainly centre on countries' differences in economic development or power, rather than their absolute levels, such that 'high-income countries' and 'low-income countries' should be read as illustrative generalisations rather than given sets of nations. However, for a classification of countries by income, see World Bank, *World Bank income groups* (2024), retrieved 26 November 2024 from https://ourworldindata.org/grapher/world-bank-income-groups.

2 Y Brauner, 'The True Nature of Tax Treaties' (2020) 74 *Bulletin for International Taxation* 28; A Rasulov, 'Theorizing Treaties: The Consequences of the Contractual Analogy' in CJ Tams, A Tzanakopoulos and A Zimmermann (eds), *Research Handbook on the Law of Treaties* (Cheltenham, Edward Elgar, 2014).

conduct of two autonomous parties entering into agreements. The contract analogy seems appropriate, as several theories of international tax justice compare the sovereignty of nation states to the concept of individual freedom as used in liberal political theory.[3] The axiom 'one's freedom ends where another's begins' then applies analogously to national sovereignty. The regulation of those conflicting spheres of individual freedom is the basis of contract law in our liberal democratic order.

This chapter is structured as follows. In section 5.2, we highlight several issues of fairness raised by bilateral tax treaties. As shown in recent studies, low-income countries do not necessarily benefit from treaties, but they feel pressure to sign and may be forced to accept poor treaty conditions. This has to do with competition for foreign direct investment (FDI), the dominance of the OECD Model in the tax policy community, and imbalances in countries' tax-technical expertise. We then use insights from contract theory to analyse those issues. Starting with externalities in section 5.3, we argue that tax treaties have the potential to induce a 'race to the bottom' in treaty conditions accepted by low-income countries. This policy spill-over is comparable to that caused by unilateral tax competition. But whereas the tax fairness literature has proposed several standards aimed at reducing the negative spill-overs of unilateral tax policy while leaving room for national autonomy, we show that such standards fail when applied to bilateral tax treaties. We illustrate this using Dietsch and Rixen's Fiscal Policy Constraint. We argue that the only workable solution is to significantly reduce the normative weight attached to national tax policy autonomy. This negates the value of freedom of contract. With respect to coercion (section 5.4), contract theory appears equally unhelpful because the philosophical theories that underpin contract freedom are unable to provide a satisfactory criterion to determine whether a country has voluntarily consented to certain treaty conditions. We show that resultingly, existing remedies to imbalances in bargaining positions, including Christians and Van Apeldoorn's Equal Benefit Principle, may produce adverse outcomes. Only with respect to asymmetric information, which we examine in section 5.5, can contract theory provide some guidance. As a remedy to clear imbalances in knowledge and expertise, existing treaties could be interpreted in favour of the weaker party. However, when it comes to drafting new treaties, the question arises whether a country knows which treaty conditions are 'best', which makes it difficult to avoid value imperialism. Section 5.6 concludes.

5.2 Bilateral tax treaties and fairness

It might be assumed that tax treaties, like contracts, are entered into for mutual benefit – that is, there is a net benefit and both parties perceive to

3 eg P Dietsch, 'The State and Tax Competition: A Normative Perspective' in M O'Neill and S Orr (eds), *Taxation: Philosophical Perspectives* (Oxford, OUP, 2018), 214–15.

get a share in that benefit. For instance, a contracting state's citizens may experience more tax certainty and fewer fiscal obstacles when engaging in economic activities in the other state. The government or the national community at large may benefit when enhanced cross-border economic activities increase tax revenues, GDP, welfare, employment, and/or human and financial capital inflow.

The assumption that bilateral tax treaties are beneficial for both parties was first challenged fifty years ago by Irish, who argued that treaties 'shift substantial amounts of income tax revenues to which developing countries have a strong legitimate and equitable claim from their treasuries to those of developed countries', which 'creates the anomaly of aid in reverse – from poor to rich countries'.[4] This is why Dagan calls the prospect that double tax relief will benefit all parties involved by facilitating free trade and generating allocative efficiencies, the 'tax treaties myth'.[5] Nowadays, it is broadly accepted that low- or middle-income countries do not necessarily, or even usually, obtain benefits from concluding tax treaties.[6]

For instance, Leduc and Michielse note that, for those countries, potential tax treaty gains break down into: (1) a positive impact on FDI inflows; (2) supporting tax administration functions; and (3) enhancing international relations. In reviewing these gains, they find little indication of success. Moreover, with respect to the first point, they argue that even if source-country tax incentives stimulate FDI and/or generate positive economic spill-overs that increase human and financial capital, 'the optimal policy would seemingly be to adopt this reduction unilaterally under domestic statutes (by legislating moderate-to-low statutory withholding tax rates, for example).'[7] As Hearson notes, high-income countries' tax systems already offer relief for taxes paid in source countries routinely, such that 'the most significant effect of a [bilateral tax treaty] between a developed and a developing country is to shift the burden of doing so from the former to the latter'[8] – which is indeed the key finding of Dagan's 2000 article.[9]

With respect to the second point mentioned by Leduc and Michielse, we would underscore that technical tax assistance offered by high-income countries (or by the OECD) to lower-income countries can be, and is, supplied independent of any tax treaty context. Additionally, one wonders whether the recent tendency to add anti-avoidance rules to bilateral tax

4 CR Irish, 'International double taxation agreements and income taxation at source' (1974) 23 *International and Comparative Law Quarterly* 292.

5 T Dagan, 'The Tax Treaties Myth' (2000) 32 *JILP* 939.

6 Overview in M Hearson, *Imposing Standards: The North-South Dimension to Global Tax Politics* (Ithaka, Cornell University Press, 2021).

7 S Leduc and G Michielse, 'Are Tax Treaties Worth It for Developing Countries' in R de Mooij, A Klemm and V Perry (eds), *Corporate Income Taxes under Pressure: Why Reform Is Needed and How It Could Be Designed* (Washington DC, IMF, 2021) 143.

8 M Hearson, 'When Do Developing Countries Negotiate Away Their Corporate Tax Base?' (2018) 30 *Journal of International Development* 233, 236.

9 Dagan (n 5).

treaties (such as principle purpose tests) has much practical relevance to low- and middle-income countries.[10] In sum, as the IMF put it in 2014, low- or middle-income countries 'would be well-advised to sign treaties only with considerable caution'.[11] One is left wondering why those countries have signed so many treaties with high-income nations over the last decades.[12] We argue that the answer is twofold: it boils down to the external effects of third countries' tax treaties, and to existing inequality between treaty partners.

Like contracts, tax treaties have the potential to generate both internal and external (or: spill-over) effects. The internal effect of a treaty is the immediate impact on the treaty partners' tax revenues (through the channels of tax base allocation and withholding tax rate reduction) and on their investment stocks.[13] Following the abovementioned interpretation of tax treaties 'shifting the costs of relief to developing countries', the tax revenue effect may tend to be zero-sum – the gain to one treaty partner is a loss to the other. The internal effect on FDI must be distinguished from substitution of FDI between alternative foreign states. For instance, when a country-A/B treaty leads to +100 investment from A to B, and -60 investment from A to the rest of the world, the internal effect of the treaty from A's perspective is +40, and the external or spill-over effect is -60.[14] This implies that A and B have created a benefit (to be distributed between them) at the expense of the rest of the world. That this spill-over effect should occur, follows from two plausible efficiency assumptions: the worldwide allocation of investments will equalise expected after-tax returns to capital; and a new A/B tax treaty increases the expected after-tax return to capital for bilateral A/B investments. The effect becomes bigger when residents of third countries can get access to the treaty, for instance by locating a letterbox company in country A that notionally holds the interests of a third-country investor in country B.

Even though B's neighbouring (low- or middle-income) countries would be able to attract investments through unilateral tax policy, any loss in FDI from country-A investors that they experience as a result of the A/B

10 Illustratively, few low-income countries have signed the MLI agreement which implements the 2017 BEPS Action Plan. A likely reason is a lack of administrative capacity: International Monetary Fund, 'International Corporate Tax Reform' (2023) IMF Policy Paper 2023/001, 18.

11 International Monetary Fund, 'Spillovers in International Corporate Taxation' (2014) IMF Policy Paper, 24.

12 This growth is neatly documented by Leduc and Michielse (n 7) 133–38.

13 Strictly speaking, this is an external effect. It is not the governments of both countries that adapt their investment choices, but their residents. Only the subsequent effect on both states' tax revenues is truly internal. We ignore this for simplicity.

14 Again, this is a simplification, as FDI responses do not equal welfare effects.

treaty should make them more willing to conclude a treaty with A as well.[15] Such external effects should be divergent in size across countries and might be small in many cases, for instance when treaty partners have limited economic ties, or because non-tax factors overshadow taxation in affecting returns to investment. However, the effects should be large in at least some cases, for instance when a treaty partner has a particularly large outward FDI stock or performs a hub function in international tax planning.

If the demand for joining country A's treaty network is large enough, it may well be that countries must be prepared to pay an entrance fee in the form of unattractive treaty conditions. This is the negative side of the network effect of tax treaties as discussed by Dagan.[16] This spill-over might be especially burdensome for low- and middle-income countries with relatively small domestic tax bases. Corporate income tax revenues from FDI often comprise a relatively large share of their tax revenues,[17] which increases the need to participate in treaty networks, at least to stimulate development in the short run. Thus, external effects and existing inequality intersect here.

Those factors constrain not only the freedom of low-income countries whether or not to conclude treaties, but also those countries' ability to decide upon treaty content. To begin with, participating in the treaty network only makes sense if a country first adopts the rules underlying income taxation, in order to be able to comply with common international tax principles. Hence, as Avi-Yonah notes, 'the process of integration into the world economy forces change'.[18] Moreover, as stressed by Brauner, the existing treaty network is dominated by 'the OECD, its Model, its negotiators' network, and the availability advantage of its work'.[19] Hearson observes the role of a specialized tax community of tax professionals and civil servants

15 Ring emphasises that investment is indeed a key reason why tax treaties appeal to low-income countries. She explains that 'the comfort that [tax treaties] provide to the new investor (…) can be both concrete and intangible. On the concrete side, treaties facilitate the intersection of two countries' tax system and provide a framework for resolving conflict. On the intangible side, treaties can signal to investors that a country is part of the "international" system and one can be comfortable pursuing business and investments there. Many emerging market countries believe that a treaty is an important indicator to potential investors about the status and reliability of the nation – i.e. you need to have a treaty to be perceived as a plausible and viable investment destination': D Ring, 'International Tax Relations: Theory and Implications' (2007) 60 *Tax Law Review* 83.

16 T Dagan, 'Tax Treaties as a Network Product' (2015) 41 *Brooklyn Journal of International Law* 1081. Generally, network effects are positive externalities. The point here is that low- and middle-income countries participate in this network without apparently obtaining much of the positive effects.

17 R de Mooij, T Matheson and R Schatan, 'International Corporate Tax Spillovers and Redistributive Policies in Developing Countries' in BJ Clements and others (eds), *Inequality and Fiscal Policy* (Washington DC, IMF, 2015).

18 RS Avi-Yonah, 'Tax Competition, Tax Arbitrage and the International Tax Regime' (2007) 61 *Bulletin for International Taxation* 130.

19 Y Brauner, 'Tax Treaty Negotiations: Myth and Reality' (2021) University of Florida Levin College of Law Legal Studies Research Paper Series No. 22-15, 59.

that regards the OECD Model Treaty as a panacea whatever the outcome for low- and middle-income countries and that aims to disseminate OECD standards. He notes that experts from lower-income countries who 'want to be part of this (…) community [have] little room (…) to challenge such a long-standing consensus, even where it exhibits a strong bias against them.'[20] In a recent survey of tax treaty negotiations, Brauner argues that '[t]his imbalance is completely unaccounted for by the current tax treaty interpretation canon', and he draws an analogy with the 'dilemma (…) which exists under contract law when it comes to interpretation of unbalanced contracts.'[21] We would add that the (partial) absence of voluntary consent and the constrained choices that low-income countries face resemble the situation that the theory of contracts calls 'coercion'.[22] Indeed, in an empirical investigation of treaty content using regression models, Oei finds evidence for the hypothesis 'that treaty negotiation outcomes predominantly reflect the power and preferences of the more powerful developed country signatory, resulting in treaties unfavorable to developing countries': the outcomes show that treaties signed with more populous, as well as with more 'tax attractive' OECD countries tend to be less favourable for low-income nations.[23]

What also plays a role is that low-income countries often have limited resources available for treaty negotiations and international tax policy. Tax treaties are formulated in tax-technical language and have complex economic consequences such as changes in FDI and strategic tax planning behaviour. When treaty partners have unequal access to the expertise required to oversee the treaty's consequences, this can be regarded as a contracting failure caused by asymmetric information. Of course, a country can hire outside expertise to partially alleviate information asymmetries, but as mentioned above, it will be dependent on experts who generally aim to disseminate OECD standards. Hence, the problem of information asymmetry intersects with the abovementioned problem of 'coerced' contracts.

A similar intersection occurs in the use of the OECD model convention as a standard-form contract. In contract theory, standard-form contracts are usually regarded as a subset of information asymmetry problems because they are drafted by a single party before negotiations start, implying a take-it-or-leave-it situation, and generally signal an imbalance in power, knowledge and expertise among the contracting parties. Brauner, while rejecting the contractual analogy in itself, compares these attributes to the current practice of tax treaty negotiations.[24] Arguably, the repeated use

20 Hearson (n 6) 6.

21 Brauner (n 19) 59, although he rejects the contractual analogy in itself: Brauner (n 2).

22 We discuss the precise definition of coercion in section 4.

23 S Oei, *Disentangling Power and Preferences in Tax Treaty Negotiations: Analyzing Tax Treaties between Developing and OECD Countries Using Multilevel Modeling* (2024) Duke Law School Public Law & Legal Theory Series No. 2024-47, retrieved 27 November 2024 from https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4904333.

24 Brauner, (n 19) 59.

of the OECD model tax convention does make treaties easier to draft and negotiate, which actually alleviates problems of information asymmetry. However, the more parties rely on an OECD-based standard form, the less freedom they have to challenge the OECD consensus.

In sum, the fairness issues raised by bilateral tax treaties boil down to international analogues of market failures and contracting problems which relate to externalities, coercion, and asymmetric information – and intersections between them. We will examine the theory behind those respective problems in the next three sections.

5.3 Externalities

The costs imposed on, and benefits enjoyed by third parties are not usually taken into account by contracting parties, and are hence neither part of their reasons to conclude a contract nor of the mutual entitlements and obligations that follow from that contract. These externalities, therefore, constitute a 'social' cost or benefit – they may lead to both inefficient contracting and inefficient non-contracting, such that freedom of contract may not lead to net welfare improvements, let alone Pareto optimality.[25] Contract law is one of the government's instruments to reduce externalities.

Civil contract law does so by protecting good morals and public order (*boni mores*) though the doctrine of prohibited contracts.[26] As Smits notes, 'underlying (…) violation of (…) *boni mores* (…) lies not only the wider interest of society in general, but often also the wish to protect people who are not a party to the contract'.[27] Likewise, English common law takes into account the illegality of contracting contrary to public policy, a concept that is considered not very far removed from its civil-law counterparts.[28] Yet, neither civil law nor common law currently observes a clear-cut concept of externalities, and both define the 'third party' narrowly.[29] One reason is that the concept of 'public policy' generally refers to the national realm only, such that third parties in foreign countries are rarely taken into account.[30] Contract theory that seeks to expand the regulation of external effects is of an exploratory and normative, rather than of a descriptive nature. Relevant theories depart from notions such as 'ethical consumerism' and 'corporate

25 RH Coase, 'The Problem of Social Cost' (1960) 3 *Journal of Law and Economics* 1.
26 Eg article 138 BGB, Germany; article 3:40 BW, Netherlands.
27 JM Smits, 'The Expanding Circle of Contract Law' (2016) 27 *Stellenbosch Law Review* 227, 232.
28 V van den Brink, 'De rechtshandeling in strijd met de goede zeden' (PhD thesis, University of Amsterdam, 2002); C Mak, *Fundamental Rights in European Contract Law* (Alphen aan den Rijn, Wolters Kluwer, 2008) 32–33.
29 Smits (n 27) 232.
30 Smits (n 27) 233.

social responsibility'.[31] Most of those concepts are vague because the underlying reason for, and method of dealing with externalities depends greatly on one's philosophical justification of the freedom of contract. The liberal and welfare consequentialist perspectives that provide two common underpinnings of contract freedom[32] are conceptually incommensurable, and neither provides a clear standard to judge externalities in the first place.

From a liberal or libertarian perspective, one could view freedom of contract as a prerequisite for individual autonomy, which should be promoted as a good in itself. Consequently, externalities are problematic because they harm the autonomy of other individuals. As almost all human conduct affects others, the definition of justifiable versus inappropriate harms requires decisions about the right level of state intervention and the design of balancing tests for conflicting individual rights.[33] As illustrated elsewhere in this chapter, these decisions inevitably rely on assumptions, political choices or moral values that go beyond the sole pursuit of 'autonomy'.

From a contrasting, consequentialist perspective, freedom of contract would be instrumental to some other goal. A much-explored goal is welfare maximisation, to which freedom of contract should contribute as parties enter into contracts for mutual benefit.[34] A classic example is a factory polluting a river and giving fisheries downstream a compensation that outweighs their damages. All parties experience a Pareto welfare improvement, despite the fisheries losing some autonomy. When transaction costs prevent resource allocation via contracting, the initial distribution of property rights is crucial: can the factory use the river freely, or should it negotiate with the fisheries before polluting it? Negotiations with two hundred individual fisheries (or, in international taxation, countries) are perhaps too burdensome. In those cases, choices about the initial set of property rights will affect welfare. In making these choices, governments must make assumptions about transaction costs and economic outcomes. The chosen set of rights will curb at least one party's autonomy, based on no other moral standard than those assumptions.

Of course, under consequentialism, freedom of contract could be instrumental to any other goal, such as resource equality or justice – whatever their definition. But the further those goals deviate from the mutual benefit

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31 JM Smits, 'Enforcing Corporate Social Responsibility Codes Under Private Law: On the Disciplining Power of Legal Doctrine' (2017) 24 *Indiana Journal of Global Legal Studies* 99.

32 See eg Nozick's idea of contract as just acquisition, based on libertarian freedom: R Nozick, *Anarchy, State and Utopia* (New York, Basic Books, 1974); Coase's analysis of the efficiency of contracts, rooted in welfare economics: Coase (n 25).

33 MJ Trebilcock, *The Limits of Freedom of Contract*, 2nd edn (Cambridge MA, Harvard University Press, 1998) 61–64.

34 For an exploration of the distinction between welfare economics, utilitarianism and other forms of welfare consequentialism, see ER Morey, 'What are the ethics of welfare economics? And, are welfare economists utilitarians?' (2018) 65 *International Review of Economics* 201.

for the two contracting parties, the more complex the law of contracts will become. For instance, it would be infeasible to serve egalitarian purposes by judging externalities on a case-by-case basis depending on the respective resource endowments of contracting parties and third parties. Instead of burdening parties who contract with poor people, society as a whole takes on redistributive duties through the tax-and-transfer system.[35] We will revert to this issue later, but note here that case-by-case decisions generally will not make the rules that guide externalities any less arbitrary.

In sum, neither a deontological commitment to individual freedom, nor a consequentialist approach is able to provide a clear-cut solution to externalities without invoking external values or standards.[36] In the remainder of this section, we draw a parallel between these perspectives and existing theories of international tax justice. In international taxation, spill-overs stem from divergent tax rates, overlapping tax jurisdiction, dissimilar tax base definitions, special regimes to attract non-residents, and anti-abuse rules to deter residents from using attractive features of other tax systems. They may lead to cross-border relocation of taxpayers, FDI, and paper profits, which in turn induces competitive tax rate setting by governments.[37] Because this competition is mainly aimed at attracting mobile capital and rich individuals, countries' tax burdens shift from capital towards labour, and the progressivity of tax systems declines.[38] Thus, spill-overs reduce the range of policy options that states can realistically pursue, and hence undermine their fiscal self-determination or sovereignty,[39] which can be regarded as the international analogue of individual autonomy.[40] Additionally, spill-overs widen the difference in fiscal autonomy between countries, as low-income nations face a particularly salient trade-off between attracting taxpayers and FDI on the one hand, and raising domestic revenues in a way that matches democratic preferences on the other. As noted by De Mooij, Matheson and Schatan, corporate income tax revenues from FDI comprise a relatively large share of those countries' tax mixes.[41] Furthermore, low-income countries are particularly vulnerable to policy spill-overs caused by tax havens, because they have limited administrative capacity to tackle base erosion and profit shifting (BEPS) strategies.[42]

35 Trebilcock (n 33) 98–101.

36 There are also perspectives that are neither consequentialist nor deontologically committed to the promotion of autonomy, eg virtue ethics. As those are virtually unexplored in theories of international tax justice, we do not consider them in this chapter.

37 P Genschel and P Schwarz, 'Tax competition: a literature review' (2011) 9 *Socio-economic review* 339.

38 eg S Ganghof, *The Politics of Income Taxation* (Colchester, ECPR Press, 2006); B van Ganzen, 'Determinants of top personal income tax rates in 19 OECD countries, 1981–2018' (2023) 43 *Journal of Public Policy* 401.

39 P Dietsch and T Rixen, 'Tax Competition and Global Background Justice' (2014) 22 *The Journal of Political Philosophy* 150, 156.

40 Dietsch (n 3).

41 de Mooij, Matheson and Schatan (n 17) 177.

42 Ibid.

In the existing tax fairness literature, the normative implications of those spill-overs have given rise to concepts like 'sovereign duty' (Christians)[43] and 'fiscal policy constraint' (Dietsch and Rixen),[44] centred on the idea that states should not pursue unilateral tax policies that are aimed at damaging other states' taxing rights. Like the abovementioned perspectives on the freedom of contract, the underlying theories of international tax fairness differ in the normative weight they assign to autonomy (that is, national sovereignty) and in the extent to which they make taxation instrumental to some external goal. For instance, Risse and Meyer assert that '[a]ny state should design its fiscal policy to advance justice, both domestic and global'.[45] From their perspective, it is in principle irrelevant whether tax competition reduces countries' range of realistic tax policy options; what matters is whether it disables countries to meet basic duties of justice towards their citizens. Governments should refrain from implementing policies with such a detrimental effect on other countries, or they should compensate those countries via international redistribution.[46] By contrast, Dietsch and Rixen argue that unilateral tax policy should not be made instrumental to international redistribution by biasing the normative enquiry into tax policy spill-overs.[47] For that normative enquiry, they propose a fiscal policy constraint (FPC) that proscribes policies which are both strategically motivated and negatively affect the aggregate fiscal autonomy of states. The ban on strategic policies would allow countries to pursue non-strategic policies that match the preferences of their electorates, even if those preferences include low taxes that incidentally attract foreign tax base. Those local preferences are key in realising justice, as national communities have different conceptions of what justice entails. Because part of today's injustice boils down to existing inequality between countries, with some nations lacking the resources to be fiscally autonomous in the first place, Dietsch and Rixen acknowledge that redistributive duties may co-exist beside the FPC – but those duties constitute a separate normative issue.[48] Risse and Meyer, however, find the approach too procedural and want to 'determine the range of permissible tax regimes first, by appealing to substantive principles of global justice' – only within that range can countries follow their democratic preferences.[49]

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43 A Christians, 'Sovereignty, Taxation and Social Contract' (2009) 18 *Minn J Intl L* 99.

44 Dietsch and Rixen (n 39).

45 M Risse and M Meyer, 'Tax Competition and Global Interdependence' (2019) 27 *The Journal of Political Philosophy* 480, 492.

46 Resultingly, a competitive tax policy that attract tax base from poor countries may give rise to redistributive duties. Additionally, in extreme cases, poor countries would be allowed to become tax havens for paper profits of taxpayers from rich countries, insofar those rich countries fail to meet international redistributive duties.

47 Dietsch and Rixen (n 39) 166. See also P Dietsch and T Rixen, 'Debate: In Defence of Fiscal Autonomy: A Reply to Risse and Meyer' (2019) 27 *The Journal of Political Philosophy* 499.

48 See text to n 47.

49 Risse and Meyer (n 45) 495.

The arguments in this debate are conceptually incommensurable because they are based on different normative premises, namely a deontological attachment to autonomy versus a consequentialist view in which international tax law is instrumental to justice. This will turn out relevant in the remainder of this section, where we use those respective views to normatively assess the spill-overs of tax treaties (that is, increased bilateral investment at the expense of the rest of the world). We will pay particular attention to the autonomy-based position, exemplified by Dietsch and Rixen's stance on unilateral tax policy.[50] This position appears the most intuitively appealing and the least controversial, because the scope of its normative enquiry (asking whether a tax policy harms other countries' autonomy) is narrower than a pursuit of 'global justice'.[51] Relatedly, its focus on autonomy seems the most compatible to the freedom of contract, and hence to countries' existing freedom to conclude tax treaties.[52]

The starting question in this assessment is whether the spill-overs of bilateral tax treaties are normatively different from the situation in which two countries change their tax policies unilaterally. If not, no further analysis would be required. We see a key difference with respect to democratic decision-making. Unilaterally, the application of Dietsch and Rixen's FPC is feasible under the simplifying assumption that governments act in accordance with their citizens' preferences,[53] and provided that one is able to distinguish those preferences from strategic intentions. To identify those intentions, one should ask whether a country would still implement a policy if the resulting 'benefits (…) in terms of attracting tax base from abroad did not exist'.[54] If it would, the policy is motivated by local preferences; if it would not, the policy is strategically motivated, and thus illegitimate insofar it reduces countries' aggregate fiscal autonomy. It is difficult to answer this question in a bilateral setting, which lacks a single decision-making authority. Treaties are products of complex games of negotiation in which the respective treaty partners have strategic intentions vis-à-vis each other. Those individual intentions exist beside any unified strategic intentions vis-à-vis third countries. And as illustrated by numerous treaty interpretation disputes, it is questionable anyway whether both countries will ever speak

50 Dietsch and Rixen themselves limit the application of the FPC to the national level. Regarding tax base distribution, they 'endorse unitary taxation with formulary apportionment': Dietsch and Rixen (n 39) 152. Thus, our application of the FPC on the international level is a theoretical exercise rather than a critique of the FPC.

51 According to Dietsch and Rixen, this protection of national autonomy should be acceptable even to moral cosmopolitans. It indirectly serves the interests of all individuals worldwide because nation states are more democratic and better able to match policies to local preferences than a world government: Dietsch and Rixen (n 39) 172–75.

52 As discussed above, freedom of contract can also be compatible with consequentialist views, but those tend to be welfare consequentialist and not, like Risse and Meyer's approach, 'justice' consequentialist.

53 Dietsch and Rixen (n 39) 153.

54 Dietsch and Rixen (n 39) 164.

with one voice regarding their intent behind the treaty. Thus, should one focus on the treaty partners' individual intentions; on some aggregation of their individual intentions; or only on their unified intentions vis-à-vis third countries, if observable? Another issue is that treaties are packages of multiple provisions, of which some may be strategically intended and some not: should one look at those specific provisions or only at the total package? Without spelling out all possible combinations of these options, we will highlight some difficulties.

First, focussing on the treaty partners' individual intentions behind the treaty as a whole, one would have to separate the prospect of increased inward investment from other potential benefits (such as double tax relief for domestic residents investing abroad, or tax-technical assistance). If at least one of both countries would not have signed the treaty were it not for the prospect of more FDI, the treaty would not be legitimate under the FPC – at least, if the treaty reduces aggregate fiscal autonomy. Most low-income countries sign treaties to attract FDI, so they will be under particular scrutiny of the FPC – or any normative standard that judges externalities based on a distinction between democratic preferences and strategic intentions.

Matters are different when looking at countries' individual intentions behind specific treaty provisions. A typical low-income country that expects inward investment would prefer high withholding taxes as an easy source of revenue, but will generally be forced to accept a low rate due to the 'market power' of high-income countries. Can one still argue, then, that its intentions are strategic? Furthermore, as the FPC is centred on 'attracting tax base from abroad', it focusses on this low-income country's intentions and disregards preferences of capital-exporting (high-income) countries. Those preferences probably include low withholding taxes, which exert large externalities. Thus, paradoxically, it would be relatively lenient toward 'harmful' treaties. The latter problem can be solved by expanding the FPC's notion of 'strategically attracting tax base' such that it also includes tax base attracted by the treaty partner. The underlying argument would be that capital-rich nations should reasonably know that stimulating capital export is inseparable from creating a capital import elsewhere.

However, this does not help when two capital-rich, high-income nations agree on a 0 per cent withholding tax rate, neither as a competitive policy to attract tax base, nor to stimulate capital export, but simply because they believe that withholding taxes are unnecessary distortions to the allocation of investments. Indeed, the view that corporate income taxes would suffice to tax investments at source has long been prevalent in the OECD. In this case, as highlighted in the previous section, not levying withholding taxes on bilateral investment flows might exert substantial externalities on low-income countries, but the FPC must allow it, because it clearly matches both high-income countries' democratic preferences.[55] Similar situations could

55 Compare a unilateral 0% CIT rate: that would be prohibited under the FPC, because it is unlikely to be a non-strategic, democratically preferred policy.

arise with other treaty provisions, such as particular distributions of taxing rights on active and passive income.

The only solution here would be to adopt an even broader conception of the FPC, under which we consider it strategic that tax treaties discriminate between countries by giving only taxpayers in the partner country access to certain benefits (such as lower withholding tax rates). Both treaty partners should reasonably know that their investment conditions resultingly improve at the expense of the rest of the world, and that could be regarded as 'strategically attracting tax base'. This implies that all treaties are strategic and that they should be banned insofar they reduce aggregate fiscal autonomy. Under the view that treaties reduce aggregate fiscal autonomy by nature, they should indeed be banned, and only a purely multilateral tax system would suffice. Under the view that they only do so when they include provisions that generate clear externalities, such as 0 per cent withholding tax rates, we would need world-wide minimum standards regarding those provisions. The downside would be a significant reduction in fiscal autonomy for countries that genuinely believe in low withholding taxes. An additional problem is that national autonomy encompasses more than fiscal autonomy alone. Countries may well conclude tax treaties to achieve non-fiscal ends, such as strengthening their international relationships. Under the expanded application of the FPC, this form of autonomy would be subordinated to fiscal autonomy. From a liberal point of view, it is debatable whether this approach would protect countries' aggregate autonomy.[56]

Alternatively, when not expanding the FPC's application, one would have to accept that this standard is unable to prevent the externalities of several treaties, mostly those between rich countries. To what extent is that problematic? From the liberal perspective that underpins the FPC, the answer depends on whether those externalities violate countries' autonomy, because that is where the freedom of contract of the two treaty partners ends. Again, the key issue is whether countries genuinely believe that withholding taxes are unnecessary in the presence of adequate source-country corporate taxation. In that view, the loss of autonomy boils down to the existence of corporate tax competition, the reliance of low-income countries on corporate tax revenues from FDI, and the limited administrative capacity of those countries to tackle BEPS strategies.[57] The primary solution would be to curb corporate tax competition; the unilateral FPC would do that job and no further action would be required.[58] We consider this solution problematic for the very same reason why the FPC aims to protect national autonomy, namely the existence of value pluralism about the content of a just tax policy. This pluralism not only encompasses the issue of tax rate setting, but also the relative importance of goals like capital import neutral-

56 We thank a reviewer for the latter point.

57 See de Mooij, Matheson and Schatan (n 17).

58 Adhering to an affirmative conception of national autonomy, rich countries might also have to provide technical tax assistance and perhaps even financial transfers, but these things would be normatively separate from the enquiry into corporate tax spill-overs: see text to n 48.

ity, revenue-raising capacity, administrability and simplicity. Withholding taxes are comparatively easy to administer and could be a rich revenue source for low-income countries, but they conflict with the efficiency- and neutrality-based OECD vision.[59] The problem is that visions pro and contra withholding taxes cannot coexist because of the externalities caused by tax treaties. Even though low-income countries might be happy to receive technical tax assistance, they must involuntarily set low withholding tax rates and introduce complex anti-avoidance legislation to prop up their corporate tax systems. Thus, freedom of contract under the FPC is unable to protect national autonomy by accommodating value pluralism.

This means that we are left with 'autonomy-defying' theories of tax justice if we want to curb the externalities of tax treaties. For instance, we could eliminate the distinction between strategic and non-strategic policies from the FPC and solely aim to prohibit treaties which reduce other countries' fiscal autonomy. We are then left with a consequentialist, global standard that rules out all negative externalities without attaching any weight to local preferences. That would cause a significant and arbitrary upward bias in tax rates. Of course, consequentialism can also make tax treaties instrumental to other goals, such as 'justice'. To make this goal feasible, justice could for instance be equated with 'ensuring that all countries can meet basic duties of justice towards their citizens'; we then arrive at Risse and Meyer's standpoint. With respect to contract theory, the main lesson from this analysis is that freedom of contract offers little guidance as to the protection of non-parties' interests.

5.4 Coercion

The problem thus remains that low- and middle-income countries are unfree in their choices whether or not to conclude tax treaties, and unfree in deciding upon treaty content with high-income countries. This may result in poor treaty conditions, and it negates a key assumption behind contract freedom, namely that parties enter into agreements voluntarily. Of course, even in an ideal-type free market, all contracts are based on constrained choices, because individuals' incomes are limited and most goods are scarce. To define 'coercion', the theory of contracts must identify the point at which parties' choices become so constrained that their consent to an agreement should be considered involuntary.[60]

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59 For an examination of the goals of efficiency and neutrality, see P Hongler, *Justice in International Tax Law* (Amsterdam, IBFD, 2019).

60 Authors use different words to describe this situation. Stewart, for instance, argues that 'coercion' and 'duress' 'refer to situations where α threatens to violate β's rights; situations where there is no such threat but the proposal is nonetheless improper are normally cases of exploitation or unconscionability': H Stewart, 'A Formal Approach to Contractual Duress' (1997) 47 *The University of Toronto Law Journal* 175, 185. We use 'coercion' for both situations throughout this chapter.

Section 5.3 has covered one only cause of constrained choices in the context of bilateral tax treaties: the external effects of neighbouring countries' unfavourable treaties, making the country in question relatively unattractive for FDI unless it joins this network. These externalities must be distinguished from the situation in which a capital-poor nation needs to give up taxing rights anyway in order to become attractive. That problem is not specific to tax treaties, but it may affect treaty outcomes when countries are 'coerced' to accept unfavourable treaty conditions because they lack attractive alternatives. Although it is difficult in practice to distinguish coercion from externalities as the main cause of an unfavourable treaty outcome, it is important to analyse both issues separately, because the issue of unfreedom caused by unequal bargaining positions would remain even when some multilateral effort would deal with externalities.

As with externalities, the various perspectives underpinning the theory of contracts have different approaches in defining 'coercion'. A welfare consequentialist approach would infer parties' voluntary consent from the contract increasing both parties' welfare. As Trebilcock notes, this approach begs the question, because contract theory assumes that transactions are welfare-improving for the reason that contractors close them voluntarily.[61] Even if one accepts the inverted line of reasoning, it seems morally problematic to look only at the welfare consequences of enforcing a contract, instead of the circumstances under which this contract was signed.[62] In the context of international tax law, such an approach would be unable to address the unfairness of poor treaty conditions due to countries' unequal bargaining positions, as long as low-income countries receive minor benefits from their treaties.

More generally, Stewart argues that all consequentialist theories are unsuited to evaluate voluntary consent, because they would override parties' autonomy to voluntarily enter into contracts if those contracts conflict with some external goal.[63] Thus, whereas a consequentialist solution seemed more appropriate for the problem of externalities, it appears more convincing to solve the problem of coercion by invoking some conception of autonomy. To this end, liberal or libertarian theories would distinguish voluntarily signed contracts from coerced contracts by asking whether a contracting party's offer expands or restricts the other party's set of meaningful options – that is, whether it increases or decreases that party's autonomy, respectively. But then we are back at the difficulty in defining a 'harm' to someone's autonomy. As explained in the previous section, liberalism must inevitably compose a list of rights and wrongs.

A negative conception of autonomy (that is, 'freedom from …'), would only rule out explicit threats and obstacles, disregarding countries' unequal bargaining positions. By contrast, the notion of positive freedom is more

61 Trebilcock, (n 33) 83–84.
62 Stewart, (n 60) 224, 226.
63 Stewart, (n 60) 182.

appealing in the context of coerced treaties, because it seems to capture the idea that states should be capable to freely choose between different options – or treaty content – available to them.[64] A nation's autonomy in this sense would mean its ability to sovereignly implement policies according to the democratic preferences of its citizens. This aggregate autonomy includes but is not limited to fiscal autonomy, which concerns the implementation of tax and redistributive policies according to national preferences.[65] Although a tax treaty restricts a country's set of tax policy options and may hence reduce fiscal autonomy, it is an exercise of, and ideally enhances 'aggregate' autonomy through increases in bilateral trade and tax base inflow and through the enhanced freedom of citizens to conduct cross-border activities. By contrast, if concluding a tax treaty is the only way for a capital-importing nation to attract enough FDI, and if this treaty's provisions are so unfavourable that they severely reduce fiscal autonomy, the treaty can be argued to reduce the country's set of meaningful options and thus be considered 'coerced'. Testing empirically whether a treaty increases or restricts a country's autonomy according to this definition closely resembles a welfare economic analysis. This analysis would still be unable to distinguish unfair treaties, because it remains unclear why a treaty partner would be obliged to give away more taxing rights once the treaty is marginally beneficial for the country in question.[66] In fact, maximising the capital-poor nation's taxing rights would harm the treaty partner's own autonomy according to the definition above.

For similar reasons, Trebilcock notes that autonomy-based approaches have no clear answer to cartelisation, whereby consumers face higher prices and a lower consumer surplus than under perfect market conditions, even though they face no explicit 'threat' from monopolistic producers. Arguably, the consumers who are priced out of the market face the largest decreases in autonomy, but theories of coercion focus on the voluntary consent of those who remain in the market. Autonomy-based approaches do not clarify why exactly it is problematic to overcharge those consumers. Introducing a right to be free of monopolistic conduct would be unhelpful. Illustratively, it seems unproblematic for a monopolistic seller of a rare stamp to extract the full consumer surplus of a collector who has an idiosyncratic preference for this particular stamp.[67] Incidentally, a welfare consequentialist approach would not be able to determine voluntary consent either, because overcharged consumers apparently find it beneficial to remain in the market.[68]

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64 See I Berlin, 'Two concepts of liberty' in I Berlin, *Four Essays On Liberty* (Oxford, OUP, 1969); A Sen, 'Equality of What?´ in S McMurrin (ed), *Tanner Lectures on Human Values, Volume 1* (Cambridge, CUP, 1980).

65 See Dietsch and Rixen (n 39) 152–153.

66 Incidentally, this autonomy-based approach again requires external normative standards, namely the variables that measure 'autonomy'. Hence, this test is not truly 'empirical': see Stewart (n 60) 214.

67 Trebilcock (n 33) 92.

68 Trebilcock (n 33) 93.

These insights can be applied analogously to the world of international tax, where the OECD is the dominant 'supplier' of treaty provisions and the self-proclaimed 'market leader in developing [tax] standards and guidelines'.[69] The OECD Model Convention is in fact so dominant that it also affects treaties between non-OECD countries, and its influence clearly trumps that of the alternative UN Model.[70] OECD countries together own 70% of worldwide outward FDI stocks,[71] such that a capital-poor nation that aims to attract investments by joining a tax treaty network needs to conclude treaties with multiple OECD countries – by definition, because one treaty is not a network. Although the OECD itself is not a cartel, each OECD country will find itself in a monopoly or oligopoly position vis-à-vis this capital-poor nation.

Morally, an unfavourable treaty outcome that would result from the OECD's monopoly position seems more problematic than the abovementioned example of asking a high price for a rare stamp. Unfortunately, Trebilcock's own approach is unhelpful here, because it focusses on 'situational monopolies (…) where (…) transaction-specific market power is exploited opportunistically to extract commitments in return for quid pro quos that have a zero or negative social value, or for quid pro quos, which, while socially positive, cannot in the normal competitive environment surrounding the type of transaction in question justify anything like the commitment extracted for them'.[72] A semantical problem is that the OECD's position is more accurately described as a *structural* monopoly, which Trebilcock proposes to remit to antitrust laws – and those laws do not exist in international taxation. Nevertheless, when using his criterion for situational monopolies, the question would be whether the 'price' paid by low-income countries in terms of treaty conditions is a competitive market price.[73] Barring the question how to define market prices in a tax treaty context, this seems to imply that low-income countries with less attractive investment opportunities should accept lower quid pro quos, that is, poorer treaty conditions. We find this problematic. It is questionable in the first place whether high-income countries can fully abdicate responsibility and point at international redistributive duties to alleviate unequal bargaining positions. But even when

69 OECD, 'The OECD's Current Tax Agenda' (2008) 74–75, as cited in A Christians, 'Taxation in a Time of Crisis: Policy Leadership from the OECD to the G20' (2010) 5 *Northwestern Journal of Law & Social Policy* 19. Illustrative is UNGA Res 77/244 (30 December 2022), '[n]oting also the work of the [OECD/G20] Inclusive Framework on [BEPS]' and '[recognizing] the timeliness and importance of strengthening international tax cooperation to make it fully inclusive (…)' – a call that seems directed at the OECD.

70 P Pistone, 'General Report' in M Lang and others (eds), *The Impact of the OECD and UN Model Conventions on Bilateral Tax Treaties* (Cambridge, CUP, 2014).

71 OECD, 'FDI stocks (indicator)' (2023). DOI: 10.1787/80eca1f9-en (accessed on 27 June 2023).

72 Trebilcock (n 33) 101.

73 This follows from the latter component of his criterion. We assume that treaties are socially positive as we exclude the issue of externalities from our analysis of coercion.

accepting that argument, one would use treaty outcomes as a standard to determine low-income countries' voluntary consent.[74] That seems to run into the same problem that welfare consequentialist theories face, namely that prices and voluntariness are simply two different things.

We examine the issue of market prices in more detail using Gordley's approach, who aims to solve the problem of unequal bargaining positions by invoking a principle of equality in exchange.[75] According to Gordley, the value of performances exchanged in contracts should be equal, because self-interested parties should have no mutually redistributive intentions. Resultingly, when the value of performances exchanged is unequal, one can infer that one party is weaker than the other, and this should be a ground for contractual invalidation or revision.[76] We highlight this approach because it bears resemblance to Christians and Van Apeldoorn's Equal Benefit Principle for international tax law. That principle 'holds that having undertaken to cooperate with each other, states are entitled to equally share in the (net) benefits produced by such cooperation.'[77] These net gains discount for the gains a country would have had, had its inputs been put to use in a solely domestic situation (that is, for opportunity costs).[78] The argument recalls the Musgraves' proposed criterion of national neutrality of FDI.[79] A national community is only better off by engaging in FDI rather than domestic investment if the return to FDI exceeds the domestic return foregone, that is: the sum of (1) all private benefits and (2) the tax revenue foregone by reduced domestic investment. 'Equal benefit' then applies to the excess return.

To see the consequences of both approaches, consider the following example. High-income country A concludes treaties with low-income countries B and C, which both lack FDI. Profit margins on investments in B are high; those in C are low, for instance because C's natural resources are expensive to mine. In both countries, marginal returns to investments diminish with the aggregate amount of FDI. Barring tax revenues, each unit of investment would yield equal benefits for B and C in terms of positive domestic spill-overs from human and financial capital inflow, which both countries need. Investments in both countries would not be profitable without a tax treaty. As B and C have limited resources to tackle corporate tax BEPS strategies, both would prefer to levy withholding taxes on returns to investment income. Under the assumption that the worldwide allocation of investments equalises expected after-tax returns to capital, country-A investors will first invest in B, and once the marginal profitability of additional

74 See Stewart, (n 60) 230.
75 J Gordley, 'Equality in Exchange' (1981) 69 *California Law Review* 1587.
76 Gordley (n 75).
77 A Christians and L van Apeldoorn, *Tax Cooperation in an Unjust World* (Oxford, OUP, 2021) 12.
78 Christians and Van Apeldoorn (n 77) 14, 29.
79 RA Musgrave and PB Musgrave, *Public Finance in Theory and Practice* (New York, McGraw Hill, 1973).

investments has declined to the level that C offers, they will invest equally in both countries. Hence, B trumps C in the amount of FDI; in the total investment income earned by A's investors; and in the tax revenues on this income raised by A's government.

Like Trebilcock's approach, Gordley's principle of equality in exchange would prescribe that the value of what B offers A (investment income and resident-country tax revenues on this income) should equal the value of what A offers B (giving up taxing rights). As B's offer is rather attractive, so should the treaty conditions offered by A. By contrast, A would be allowed to force an unfavourable treaty upon C, because C has little to offer.

Under Christians and Van Apeldoorn's Equal Benefit Principle, all countries would first have to account for the domestic opportunity costs of their inputs. As gross benefits are a function of capital and labour, and B and C are fully dependent on foreign capital, we assume for the sake of simplicity that their domestic opportunity costs equal zero, such that their treaties' gross benefits equal net benefits. By contrast, gross returns on country-C investments earned by country-A investors are only marginally higher than those investors' opportunity costs, such that net returns approach zero.[80] If A taxes domestic and foreign investment income equally, A's net tax-revenue benefit also approaches zero.[81] Because nearly all net benefits produced by cooperation between A and C accrue to C, C would have share those benefits with A, for instance by giving up taxing rights in a treaty, or even through compensatory payments. When the net gains of cooperation are shared multilaterally, some of A's relatively high net benefit earned by investing in B would be redistributed to country C. That seems fair, but the problem remains that C would need to give up a large portion of its own net gains from FDI, simply because its domestic opportunity costs equal zero.

All of those outcomes, especially the latter, seem highly unfair. Invoking a less procedural and more substantive conception of fairness, one might at least want to give B and C equal amounts of taxing rights, or even argue that C deserves more taxing rights than B. Recall that there will be fewer investors in C, such that positive spill-overs from human and financial capital will be lower. Hence, C will be unable to reap substantial benefits from its natural resources. Withholding tax revenues might compensate this to some extent, while not necessarily reducing FDI or the income earned by country-A investors. This idea resembles the proposal of Infanti, who takes up the Musgraves' point that tax treaties could be used for tailor-made redistribution of taxing rights between rich and poor countries,[82] arguing

80 Net returns will not be negative, because otherwise the investors would have stayed home.

81 Incidentally, resident-country tax benefits do not affect this country's aggregate benefits anyway because they are paid by residents. Source-country taxation does make the source country better off at the expense of the resident country: Christians and Van Apeldoorn (n 77) 31.

82 RA Musgrave and PB Musgrave, 'Inter-nation equity' in RM Bird and JG Head (eds), *Modern Fiscal Issues: Essays in Honour of Carl S. Shoup* (Toronto, University of Toronto Press, 1972).

that such treaties can be made instruments for development aid.[83] That proposal remains at a considerable distance from current tax treaty practice; it is highly consequentialist, overriding high-income countries' voluntary consent to a treaty if that treaty runs counter to the goal of developing aid. However, this section has made clear that the procedural accounts of fairness that can be derived from contract theory also provide unsatisfactory solutions to inequalities in bargaining positions.

5.5 Asymmetric information

The question whether parties transact voluntarily is closely connected to the question whether they are adequately informed about the content and consequences of the agreements they enter into. Besides voluntary consent, informed consent is a key assumption in the theory of contracts.[84] Information imperfections may affect both parties (symmetric) or one party (asymmetric). As we have already noted, low-income countries often have limited resources for tax treaty negotiations, they might lack the expertise to deal with the tax-technical issues of treaties, and they are confronted with a model treaty and its commentary drafted by foreign, OECD-based experts. OECD countries generally do not face these problems. Therefore, this section will focus on asymmetric information imperfections.

Defining 'inadequate information' is perhaps even harder than defining 'coercion'. Unlike coercion, which can be regarded as simply befalling a contracting party, the adequacy or inadequacy of information is endogenous: it is a function of the (costly) effort that a party puts into acquiring additional information to better understand the content and consequences of the contracting options available.[85] Some nearly unanswerable questions arise: how much effort should a party reasonably put in acquiring additional information; how to deal with parties who have limited resources for their search; and what role should the better-informed party play?

From a liberal perspective, and invoking a positive conception of autonomy, one could argue that contracting parties should have sufficient resources for gathering information so that they are capable to make informed choices regarding the options available to them.[86] However, as with the issues of externalities and coercion, invoking some conception of autonomy does not answer the overarching question as to when someone is

83 A Infanti, 'Internation Equity and Human Development' in Y Brauner and M Stewart (eds), *Tax, Law and Development* (Cheltenham, Edward Elgar, 2013).

84 eg BH Bix, 'Contracts' in F Miller and A Wertheimer (eds), *The Ethics of Consent: Theory and Practice* (Oxford, OUP, 2009).

85 KL Scheppele, *Legal Secrets: Equality and Efficiency in the Common Law* (Chicago, University of Chicago Press, 1988) 25, as cited in Trebilcock (n 33) 102.

86 See n 64.

autonomous – in this case: how much information does 'informed consent' require?

Welfare consequentialist approaches have no clear answer either because they run into what Trebilcock calls the 'Paretian dilemma'.[87] On the one hand, if the relevant welfare-based criterion is that both parties feel better off when they sign a contract, there would be informed consent in nearly every case. On the other, if parties should experience ex-post at least the welfare improvement they expected ex-ante, every minor negative deviation from their expectations would negate informed consent, such that almost no contract would be upheld.

Recalling our previous observations on market prices, we would add that using treaty outcomes as a normative standard may be morally problematic and that even a marginal increase in either autonomy or welfare does not necessarily indicate that a contracting party had access to adequate information. For these reasons, we find Gordley's principle of equality in exchange, examined in the previous section, equally unsuited to determine informed consent as it is to determine voluntary consent.[88]

In the remainder of this section, we do not aim to provide a comprehensive theory of voluntary consent, but will instead discuss two types of information asymmetries that bear particular resemblance to the world of international tax law: standard-form contracts, and inequalities in resources for acquiring information.

Standard form contracts have the reputation of expressing inequality: a large player selling the consumer a product on the basis of terms and conditions that take away all consumer rights. Consumers will not read standard form contracts and if they do, they will not understand their implications. Moreover, renegotiating standard form contracts may be very time-consuming and often even impossible: their existence implies a take-it-or-leave-it context. Tax treaty negotiations tend to produce standard form treaties, based on the OECD Model Tax Convention and the Commentaries on this model.[89] Standard form treaties may serve the useful purpose of reducing transaction costs – for instance, it would make little sense to renegotiate concepts like 'permanent establishment' and 'principal purpose' in every new treaty without acknowledging that such concepts have a tradition. Arguably, the repeated use of certain OECD standards makes treaty negotiations easier and can hence partially alleviate problems of information asymmetry. Nevertheless, the risk of a take-it-or-leave-it situation is evident, especially because there exist imbalances in power, knowledge and expertise between OECD and low-income countries, respectively.[90]

Trebilcock argues that the existence of take-it-or-leave-it contracts is not necessarily problematic, as long as there is 'a margin of informed,

87 Trebilcock (n 33) 103.
88 See text to n 76.
89 Brauner (n 2) 35–38; Pistone (n 70).
90 Brauner (n 19) 59.

sophisticated, and aggressive consumers', who discipline the market by either renegotiating contract terms or switching to suppliers who offer more favourable contracts.[91] But as explained in the previous section, the 'market' for tax treaties does not work this way. Joining a treaty network entails closing treaties with not one, but multiple countries, such that attractive, capital-rich treaty partners find themselves in a monopoly or oligopoly position vis-à-vis capital-importing nations. This position could enable them to dictate treaty content, as signalled by the dominance of the OECD Model Convention relative to the UN Model Convention.[92] The issue of asymmetric information thus intersects with the issue of coercion, which, as we have concluded, is difficult to solve by invoking contract theory.

In the current world of bilateral treaties, however, contract theory does offer one pragmatic solution, namely *contra proferendem* treaty interpretation – that is, interpretation of a standard form term against the party who supplied it.[93] This would prevent some of the adverse consequences of unclear treaty provisions for countries which are not acquainted with OECD interpretation traditions. An advantage of this approach is that it avoids the abovementioned discussions about voluntariness: one does not require the exact definition of 'informed consent' to observe that the party responsible for drafting a standard-form contract is in a relatively strong position. Still, as noted by Brauner, the OECD/non-OECD distinction does not always capture existing imbalances in power and expertise, even when a treaty is based on the OECD Model – think of a treaty between Slovenia and China.[94] Moreover, solutions in the phase of treaty interpretation only work when there is ex-post unclarity, and not when treaty provisions are clear but nevertheless unreasonable.

Insofar those unreasonable provisions result from information asymmetries, we should more closely look at the preceding negotiation process. As mentioned, a relevant issue is resource inequalities, manifested in countries' divergent levels of tax-technical expertise and hence their capacity to acquire relevant information for treaty negotiations. When a country lacks such expertise, it may for instance not be capable of foreseeing whether a treaty will intensify the use of BEPS strategies by taxpayers – especially when the treaty partner is a tax planning hub. A more concrete example of how a lack of expertise may lead to adverse consequences – albeit in a multilateral setting – is the concessions obtained by low-income countries in the negotiations on Pillar 2. One important gain was the recognition of a Qualifying Minimum Domestic Top-Up Tax (QMDTT). It allows source countries to tax the amount that would otherwise be due by the Ultimate Parent Entity under the Income Inclusion Rule (IIR). The QMDTT therefore reverses the precedence of the residence state as proposed in the original

91 Trebilcock (n 33) 120.
92 Pistone (n 70).
93 eg Principles of European Contract Law article 5:103.
94 Brauner (n 19) 61.

Pillar 2 design.[95] This is potentially a large success for low-income countries. However, low-income countries also obtained a second concession: a Substance-Based Income Exclusion (SBIE). Called 'carve-outs' in previous drafts of Pillar 2, the SBIE allows source states to have low or zero tax rates on profits from real investments (in the form of an imputed return to payroll and tangible assets which need not meet the 15 per cent test). On its own merits, the SBIE allows low-income countries to attract real investment on favourable tax conditions. But in fact, it may only reduce the amount of QMDTT that they can collect (as it is easier for qualifying taxpayers to meet the 15 per cent test when a substantial part of their profits is not taken into account).[96] One wonders how this surprising result has come about.

Two problems arise in dealing with bilateral information asymmetries resulting from resource inequalities. Perhaps the easiest of the two is a problem of definition: what level of resources do we consider adequate to acquire information? This problem is related to the overarching question explored above: how much information does 'informed consent' require? The latter question is nearly unanswerable, but a pragmatic solution could be to use some index of development or economic power (for instance GDP) as a proxy for a country's capability to acquire information. This avoids the need to draw a crude line to separate voluntary decisions from involuntary decisions; instead, the differential between the two respective treaty partners in terms of the particular proxy variable would indicate the extent to which the stronger/richer partner should take into account the interests of the weaker/poorer partner.

But then the second problem arises: how to do so? It is one thing to determine whether the poorer country knew which treaty provisions would have served its interests best, but once we conclude that it did not sufficiently know, it is quite another to determine what is in fact 'best'. To avoid undemocratic and imperialistic solutions, we could limit ourselves to relatively uncontroversial provisions, such as the right to levy withholding taxes – it is clearly best for low-income countries to retain that right, as the UN Model Convention expresses on behalf of those countries. However, more complex solutions involve more detailed political choices, and moreover, all treaty provisions that require considerable technical skill and specialised legal knowledge may be more problematic especially for understaffed tax administrations – hence, we run into the very problem that we tried to solve.[97] For example, provisions against treaty shopping can in principle help low-income countries to tackle withholding tax avoidance through shell companies, but may require considerable specialised effort

95 MP Devereux, J Vella and H Wardell-Burrus, 'Pillar 2: Rule order, incentives, and tax competition' (2022) Oxford University Centre for Business Taxation Policy Brief.

96 MP Devereux, J Paraknewitz and M Simmler, 'Empirical evidence on the global minimum tax: what is a critical mass and how large is the substance-based income exclusion?' (2023) 44 *Fiscal Studies* 9.

97 See International Monetary Fund (n 11).

– and not always with much success. Principle Purpose Tests and Limitations on Benefits are 'rich countries'' inventions, developed for tax administrations with adequate experience in international taxation. It is doubtful whether multilateral solutions would be able to alleviate the remaining information asymmetries. At least, they might avoid value imperialism when countries have an equal voice in their design. But again, the downside would be a significant reduction in countries' autonomy to conclude treaties which best fit their circumstances.

5.6 Conclusion

This chapter has examined discussions on fair tax base distribution in bilateral tax treaties through the lens of contract theory. Contract theory appears useful to categorise what currently makes the international tax system unfair: fairness issues boil down to contracting problems of externalities, coercion, and asymmetric information. However, contract theory does not provide a solution for these problems that can be applied in a bilateral setting.

One reason is that neither of the two main philosophical theories that underpin contract freedom – liberalism and welfare consequentialism – is able to provide clear standards to deal with the interests of third parties, and to determine whether a party's consent to an agreement is voluntary and informed. Another reason is that in a tax treaty context, all three examined problems intersect, and in the end boil down to tax competition. For instance, one might try to solve information asymmetries by giving low-income countries tax-technical assistance to better understand the content and consequences of a treaty, but then the problem remains that this country is coerced into signing a treaty based on OECD standards, as a result of the powerful bargaining position of OECD countries. In turn, one could adjust the treaty's provisions to make it more favourable for the low-income country in question, but then the problem arises that its neighbouring countries might have signed less favourable treaties which better facilitate taxpayers' BEPS strategies, and hence attract more FDI.

These conclusions tentatively suggest that we should move toward a multilateral system based on global minimum standards for treaty content, or maybe even a true multilateral treaty. However, this solution would significantly reduce countries' autonomy (that is, contract freedom) to draft treaties that fit their particular circumstances. We have shown that theories of unilateral tax justice are unable to provide satisfactory normative criteria to guide the balancing act between national autonomy and foreign interests in a context of bilateral tax treaties. We hope that our analysis can serve as a starting point for further normative work on this issue.