Corporate Tax Avoidance and Justice

An institutions-based comparative approach

Thesis in partial fulfillment of the requirements of the MA degree in Philosophy and Economics

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[…] but in this world nothing can be said to be certain, except death and taxes.
–Benjamin Franklin, [1789] (Franklin, 1817, p.266)

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1. Introduction

On November 13th, 1789, Benjamin Franklin wrote a letter to Jean-Baptiste Le Roy, in which he expressed his great faith in the permanency of the newly established constitution, but added the caveat that: "nothing in this world is certain except death and taxes" (Franklin, 1817, p. 266). However, it seems that even this shot list of certainties was excessive, for though indeed no way to avoid death has yet been discovered, paying taxes is, for some, far from unavoidable these days.

Different from that of Benjamin Franklin, the world we live in today is at an advanced stage of economic globalization, meaning that our time is characterized by an increasingly deep and far-reaching international integration of markets in goods, services and capital (Garrett, 2000; Gilpin & Gilpin, 2001; McGrew, 2014). Seen as a process, economic globalization must be understood as a profound qualitative shift in the organization and dynamics of the world economy. Driven by changes in communication and transportation technology, and accelerated by the removal of trade barriers and capital controls from the 1980's onwards, the international mobility of both goods and services, but especially capital, was greatly enhanced (Furceri & Loungani, 2015; Ostry et al., 2016; Palan et al., 2013). Cumulative patterns and networks of such cross-border economic activities have, over time, dissolved the separation of the world into discrete national economic units, such that the world increasingly operates as a singular system (Gilpin & Gilpin, 2001; Sayer, 2000).

In some areas, such as trade, this structural shift has led to the establishment of global political institutions (i.e. the World Trade Organization) charged with the regulation of specific parts of the global economic system. One area in which such transnational institutions have not been established, however, but where the effects of economic globalization are no less profound, is that of corporate income taxation. It seems no coincidence that the rise in the number of so called "tax havens" and the increase in the amount of capital that flows through them set off precisely at the time that capital controls were relaxed in the 1980's (Soros, 2015; Zucman, 2015). Where capital crosses borders with great ease, the power to tax still remains firmly bound to the nation state (Rixen, 2008; Tanzi & Zee, 2000). This general absence of international cooperation in taxation is thought to be grounded in the conviction that the power to tax is one, if not the, central attribute of sovereignty (Rixen, 2008, p. 5). We are thus confronted with a status quo that is characterized by the collision of global economic

integration and (a desire to hold on to) national fiscal sovereignty (Ruggie, 1982, 2002; Sassen, 1996). Right now every sovereign state has the sovereign right to tax whatever income is reported within its jurisdiction - whether it is income from capital (i.e. interest, dividends, royalties, etc.) or from labor (i.e. wages) – at whatever rate it wants to, in order to raise the revenue required to finance its operations.[1] And these state operations do not solely involve levying taxes, which means that taxation itself is not only an important right of the nation sate, but that it is also essential for the state's ability to execute or protect several of its other sovereign rights (i.e. the military protection of its territory). However, this sovereign right of nation states to tax income *reported* within their borders is a right established in a time before globalization boosted the mobility of capital (Feld et al., 2013). And it is precisely this convergence of economic globalization and the failure to cooperate on taxation internationally that leaves governments struggling to capture the elusive taxes of corporations operating in more than one country. High capital mobility enables corporations to shift their capital income (profits) to low tax countries (usually revered to as tax havens) from the high tax countries where value is usually created, leaving the latter with an eroding tax base (Bourguignon, 2016; Rixen, 2008; Sassen, 1996; Zucman, 2015). This is a practice that is usually revered to as *tax avoidance*, and it is the subject of this thesis.

1.1. Tax Avoidance and Justice

First, it is important to underscore the distinction between tax *avoidance* and tax *evasion*. The essential difference between the two is that latter is illegal, while the former takes place within the confines of fiscal law (Dietsch, 2011; Palan et al., 2013; Zucman, 2015). In general, tax avoidance involves multinational corporations exploiting of the loopholes and lacunas of the system described above. Using all kinds of artificial constructions they are able to legally move their profits across international borders enabling them to make use of the beneficial tax regimes on offer in other countries (Creedy & Gemmell, 2011; Dietsch, 2011; Palan et al., 2013; T. Rixen, 2008; Zucman, 2015). Tax evasion on the other hand usually involves the shifting of wealth, of either corporations or wealthy individuals, into so called secrecy jurisdictions (like Switzerland) that enable them to hide it from the tax authorities in their countries of residence (Zucman, 2015). With tax evasion it is thus not the case that, say, a Dutch person with money in a Swiss bank

[1] There are of course also several sources other than income on which the state can levy taxes (i.e. estate taxes, consumption taxes). I this thesis however I focus on the taxation of income, more specifically the taxation of multinational corporations' capital income: profits.

account is legally exempt from paying taxes over that money (they are still Dutch), but rather that due to Switzerland's bank secrecy laws the Dutch government has no information about whether and how much taxes it should levy.

This thesis will engage with *tax avoidance by multinationals*, which thus entails corporations that are incorporated in more than one country, using precisely this imbalance between economic globalization and national fiscal sovereignty to reduce their tax bills as far as possible. It is important to emphasize that indeed those companies that engage in aggressive tax planning usually defend their actions by arguing that they do, in fact, meet all their tax obligations under fiscal law (Atkinson, 2015). Tax avoidance is not illegal. However, this thesis will build on the perspective that there doesn't necessarily exist agreement between law and morality (Shavell, 2002; Taylor, 1968). More specifically, it will provide a normative assessment of the structure that enables this practice from the idea that, though tax avoidance does not go against (the letter of) the law, this does not mean that it is morally acceptable or just. When in 2012 the British Public Accounts Committee questioned Google, Amazon and Starbucks about their tax avoidance strategies, chairwoman Margret Hodge referred to the complex web of accounting strategies these companies were (and are) using to shift their profits out of the UK, as not as being against the law but rather as being cynical and "unjust." "We are not accusing you of being illegal" she added, " we are accusing you of being immoral" (Ebrahimi, 2012).

I sympathize with this statement made by chairwoman Hodge, and I agree in a more general sense with the committee's claim that something unjust is going on, making corporate tax avoidance an issue of social justice. However, in this thesis I will take a different approach to the subject at hand. That is, rather than submitting the behavior of big corporations like Google or Amazon to a normative evaluation, I will put the international corporate income tax system itself in the dock. My normative analysis will be one of the international political economic and fiscal framework, rather than the behaviors and duties of firms. I will thus not engage with theories of corporate social responsibility, which argue that firms have a duty towards society of which paying taxes in the country where your economic activities take place is an important part (Christensen & Murphy, 2004; Sikka, 2010). Rather I will grant Milton Friedman's famous dictum – also often used by firms as a reply to accusations of social irresponsibility and immorality (Atkinson, 2015) – that the only social responsibility firms have is to their shareholders (Friedman, 2002, p. 133). So, rather than claiming that firms

have certain duties, the violation of which constitutes an immoral act, I hold that firms have but one obligation: to maximize shareholder value. Trying to aggressively avoid taxation is, in that respect, a valid strategy for a company trying to fulfill this obligation to its shareholders. Any injustices that follow from it are, therefor, to be attributed to the institutional framework that is supposed to curb a company's attempt to achieve this goal. In other words, *any injustices that follow from tax avoidance are interpreted as resulting from the existing institutions of international corporate income taxation rather than from the behavior of individual firms.* And it are also these institutions that must be adjusted if their effects are found to be immoral or unjust (Atkinson, 2015, p. 204; Sen, 2011).

1.2. The Project

Institutions - also at the international level – are in the end a social construction and the result of political choices: we have created them, and we can also alter them. And if we can change institutions in a way that would make them more just then, at least ceteris paribus, it seems clear that we ought to do so (Pogge, 1992). This thesis will try to make both a normative (theoretical) and a constructive contribution towards such change.

The normative part of the thesis will contain the central argument of the thesis, namely that the current international corporate income tax system is unjust from a *comparative justice point of view*, and that it is thus possible to determine a step towards a more just system without first having to decide on what the 'right' theory of justice is (Sen, 2006, 2011). That is, it will show that the current international corporate income tax system has certain effects – namely an increase in domestic socio-economic inequality and the enabling of free riding on public goods - which can be characterized as unjust *independent of a single theory of justice.* This means that though there might be disagreement on what a perfectly just system would look like, there is still agreement possible regarding the claim that a system that doesn't have these effects is more just than one that does. This will be the thesis' main claim, and the exploration of the applicability of Amartya Sen's comparative approach to justice to an actual, topical issue in political economy will be it's main contribution.

More constructively, the thesis will then argue that there is in fact an alternative to the current international fiscal regime that can make make it, comparatively, more just than the system we have right now. More specifically it will introduce the idea of setting up a *unitary tax system with formula appointment* involving a global tax authority tasked with the establishment of a common consolidated tax base and distributing it between

countries on the bases of real economic activity (Atkinson, 2015; Keen & Konrad, 2014; Piketty, 2014; Rixen, 2008; Thomas Rixen, 2011).

1.3. The Argument

More formally then, the main argument in this thesis can be expressed like this:

> **Premise 1:** The current international corporate income tax system causes an increase in domestic socio-economic inequality and enables free riding on public goods. *Chapter two.*
>
> **Premise 2**: An international corporate income tax system that doesn't cause an increase in domestic socio-economic inequality and doesn't enable free riding on public goods is, ceteris paribus[2], comparatively more just than one that does. *Chapter three.*
> ---
> **Conclusion 1**: An international corporate income tax system that doesn't cause an increase in domestic socio-economic inequality and doesn't enable free riding on public goods is, ceteris paribus, comparatively more just than the current system of international corporate income taxation. *Chapter three.*
>
> **Premise 3:** A unitary international corporate income tax system with formula appointment doesn't cause an increase in domestic socio-economic inequality and doesn't enable free riding on public goods. *Chapter four.*
> ---
> **Conclusion 2:** a system of unitary taxation with formula appointment is, ceteris paribus, comparatively more just than the current system of international corporate income taxation. *Chapter four.*

1.4. The Structure: Chapter Summaries

Chapter two will be descriptive, first elaborating on the practice of tax avoidance itself and providing a basic answer to the question of what strategies companies employ to avoid taxes, and what enables them to do so. This will involve a discussion of profit shifting through intra-firm debt financing and transfer pricing, combined with a short discussion of incorporation requirements (concerning mailbox companies). Next I will

[2] There are of course many more effects to the current international corporate income tax system and any change made to it than can be discussed within the confines of this thesis. For that reason the argument I make involves a *ceteris paribus* clause. That is, what I actually argue is that an international corporate income tax system that doesn't cause a rise in socio-economic inequality and doesn't allow for free riding on public goods is more just than a system that does, assuming that all other things remain equal. That is, assuming it doesn't come at a cost to welfare or causes other more grave injustices. The plausibility of such a ceteris paribus clause being satisfied by an alternative arrangement is something that remains to be explored, however that doesn't take away from the normative validity of the argument.

turn to consequences. Here I will discuss the effects of tax avoidance on countries' fiscal sovereignty, the distribution of the tax burden, socio-economic inequality and on the provision and usage of public goods. More specifically and most importantly the chapter will conclude that: (1) the current international corporate income tax system causes an increase in socio-economic inequality by forcing both statutory and effective tax rates downwards, making domestic tax systems (at least effectively) regressive rather than progressive or proportional; and (2) the current international corporate income tax system enables corporations and their wealthy owners to free ride on public goods of which they are themselves often the most intensive consumers. The purpose of this chapter is to provide the factual statements about the world on which any defensible normative assessment must rely (Caney, 2006). Chapter two will thus establish the descriptive premise 1: *the current international corporate tax system causes an increase in domestic socio-economic inequality and enables free riding on public goods.*

Chapter three provides a normative assessment, from a comparative justice perspective, of the effects that were identified in chapter two. More specifically this means that I will show how these effects can be characterized as unjust *without* the reduction of multiple, and potentially conflicting, principles of justice to one solitary survivor, guillotining all the other evaluative criteria, which is not a prerequisite for getting useful and robust conclusions on what should be done (Sen, 2011, p. 4). Though various theories of justice have a claim to being 'the right one,' we do not have to decide on that discussion in order to know that a certain action would in fact be a step towards greater justice. As competing theories of justice I take the theory introduced by John Rawls in his 1971 *A Theory of Justice* and the one introduced by Robert Nozick in his 1974 *Anarchy, State and Utopia.* What I show is that both theories can agree that an international corporate income tax system that does not cause the effects identified in chapter two would be *more just* than one that does, even though Rawls and Nozick would certainly not be able to agree on what a perfectly just arrangement would entail. So, rather than trying to show what would be a perfectly just institutional arrangement for the taxation of the income of multinational corporations, I focus on the removal of manifest injustice from the world that we live in from the idea that, if a theory of justice is to guide reasoned choice of policies, strategies or institutions, then the identification of fully just social arrangements is neither necessary nor sufficient (Sen, 2011, p. 15). Chapter three will thus establish premise 2: *An international corporate income tax system that doesn't cause an increase in domestic socio-economic inequality and doesn't enable free riding on public goods is, ceteris*

paribus, comparatively more just than one that does, and deduce conclusion 1, which holds that: *An international corporate income tax system that doesn't cause an increase in domestic socio-economic inequality and doesn't enable free riding on public goods is, ceteris paribus, comparatively more just than the current system of international corporate income taxation.*

Chapter four will then follow up on this conclusion by introducing an example of a system that can in fact mitigate the causation of the effects identified in chapter two, namely a system of *unitary taxation with formula appointment.* Chapter four will thus establish premise 3 that: *A unitary international corporate income tax system with formula appointment doesn't cause an increase in domestic socio-economic inequality and doesn't enable free riding on public goods.* From this premise, and conclusion 1, chapter four will thus deduce conclusion 2, which holds that: *a system of unitary taxation with formula appointment is, ceteris paribus, comparatively more just than the current system of international corporate income taxation.* That is, without claiming that this alternative is in fact the best, or most just, system of international corporate income taxation, this chapter mainly intends to show that there do exist measures that can, ceteris paribus, bring about an increase in justice. The claim is thus not that justice necessarily requires the establishment of this system specifically, but rather that there are feasible alternative arrangements that can meet the demands of justice identified in this thesis.

2. The International Corporate Income Tax System.

This chapter will consist of two parts. The first part (section 2.1 – 2.2.2) will describe some of the basic characteristics of the international corporate income tax system that exists today, and how corporations that operate across borders can exploit it to avoid paying taxes. The second part (from section 2.3 onwards) will discuss some of the effects that result from this arrangement and establish premise 1: *The current international corporate income tax system causes an increase in domestic socio-economic inequality and enables free riding on public goods.*

2.1 The International Corporate Income Tax System: Characteristics.

As mentioned already in the introduction, the current international corporate income tax framework is defined by the interplay between economic globalization and nation-based fiscal sovereignty. In spite of the rapid development of a global economy there is no comprehensive international architecture for taxation comparable to that which, for example, regulates trade (Feld et al., 2013; Hay, 2014; IMF, 2014; OECD, 2014; Rixen, 2008; Zucman, 2014, 2015). The globalization of the economy came, in the case of taxation, without the globalization of politics involving the development of international tax institutions and the (partial) transfer of tax sovereignty from the national to the international level (Hay, 2014). Current arrangements for the taxation of multinational's capital income instead evolved over the past century or so, without any explicit coordination (IMF, 2014, p. 9).

In most of the developed world today the corporate income[3] tax was invented at the time of the fist World War (Piketty, 2014; Zucman, 2014). Though the taxation of corporate income is rather straightforward in a closed economy, it becomes increasingly difficult when there exist firms that operate across borders: what should be done when several countries seek to tax the profits of the same company? Such a situation could lead to double taxation, which is not very attractive from an economic point of view. As an answer to this problem, the League of Nations decided in the 1920's on three principles that still "govern" international taxation today, and which have turned out to be highly questionable in light of the current context of economic globalization (IMF, 2014; Rixen,

[3] With corporate income I refer here to pre-tax profit, which is the financial benefit that is realized when the amount of revenue gained by a corporation exceeds the expenses and costs needed to sustain that activity (Creedy & Gemmell, 2011; OECD, 2009; Piketty, 2014; Zucman, 2014).

2008; Zucman, 2014). For the subject of this thesis two of those principles are especially important:

> *Source principle:* taxes on business profits are levied in the country where the profits are generated, where the source of the profits is located (Gravelle, 2009; IMF, 2014; OECD, 2014)
>
> *Arms length principle:* each entity (in different countries) must compute their profits separately. And, moreover, they must do so as if they were unrelated, which means that each entity must calculate its profits as if it were buying or selling at market price (IMF, 2014; OECD, 2009, 2013; Zucman, 2014)

The arm's length principle must be seen as an addition to the source principle, because for multinational corporations it can sometimes be quite hard to determine what the source country of it's profits is (IMF, 2014; Zucman, 2014). Say that there is a Canadian cigarette company (let's call it Canadian Cigarettes) that imports and distributes cigarettes produced by it's subsidiary in Turkey (which we'll call Turkey Tobacco). Now, if these two entities are viewed as one for tax purposes, it can be quite difficult to see where exactly the profits are created: they are not generated only by producing the cigarettes, nor only by importing and distributing them. So what the arm's length principle then dictates is that Canadian Cigarettes and Turkey Tobacco should be treated as separate entities, and calculate their profits independently, which are then taxed by the countries in which these profits are generated (read: reported) (so according to the source principle).

Now, just as these principles were agreed upon in the 1920's globalization receded, and what followed were about six decades of relative protectionism and economic nationalism (i.e. over that period foreign corporate profits accounted for only five percent of total corporate profits in the US, while that is up to nearly forty percent today) (Ruggie, 1982; Zucman, 2014). For that reason the problems that these principles brought with them did not become apparent until a only couple decades ago.

With the advent of the neoliberal regime and the Washington Consensus from the late 1970's came the far-reaching removal of trade barriers and capital controls (Hay, 2014; McGrew, 2014; Ostry et al., 2016; Piketty, 2014; Ruggie, 2002; Zucman, 2015). Together with several profound developments in both transport and communication technology, this caused a significant increase in the mobility of capital (Helleiner, 2014; McGrew, 2014; Piketty, 2014; Zucman, 2015). After over half a century of 'hibernation,' economic globalization came back at an unprecedented level, integrating much of the

world into a single economic system within which capital was virtually free to go wherever it wanted. And it came back with a vengeance, for it hardly seems like a coincidence that the significant rise in the number of tax havens from the 1980's onwards co-occurs precisely with the increased ability of capital to make the journey to these fiscal paradises (McGrew, 2014; Zucman, 2015). Multinationals could now, with great ease, transfer money and goods to their subsidiaries in foreign countries, which is exactly what they started doing as is evidenced by the fact that over half of all international trade today is made up out of trade within firms (McGrew, 2014). Multinational corporations started moving their capital income around within their corporate structures, enabling them to make use of, among many other things, the fiscal regimes in the different countries in which they were incorporated. Where tax regimes remained bound to national borders, corporations increasingly transcended them (Rixen, 2008; Sassen, 1996). On how exactly companies started moving capital across borders I will expand in the next section. It is important however to first emphasize an additional factor that is essential in the facilitation of these practices, namely so-called substance requirements (OECD, 2013).

If, as a company, you want to move your capital between subsidiaries in different countries to make use of the beneficial tax regimes there, then, of course, first you need to actually have subsidiaries in those countries. In other words, you need to have a *presence,* in those countries, which makes you subject to their tax law. The requirements for such presence (i.e. for setting up a business) are currently more or less non-existent in virtually all countries (Zucman, 2015). That is, there are no demands for any kind of *economic substance* that incorporation needs to meet: *legal presence is sufficient for utilizing national tax regimes* (Creedy & Gemmell, 2011; OECD, 2009, 2013; Palan et al., 2013). The result of this situation has been an enormous rise in the number of so called 'mailbox companies' or 'special purpose entities'. Mailbox companies are business entities that have no employees and usually consist of no more than a small room with a computer, serving no other purpose than to provide the company with legal presence in a certain country, thereby enabling it to make use of the tax rules that are on offer there. This lack of substance requirements for companies that want to incorporate in a certain country and make use of its tax regime is an essential element in the system that facilitates corporate tax avoidance (Buettner et al., 2015; Creedy & Gemmell, 2011; Egger & Raff, 2014). Decisions on where a multinational will establish it's real economic activity (i.e. factories or research and development facilities) depend for the biggest part on factors

other than favorable tax regimes, such as a well-educated population, presence of natural resources, or a well-developed infrastructure (IMF, 2014; UNCTAD, 2015). If making use of Bermuda tax law required multinationals to have substantive economic activity in it's jurisdiction, this would make tax avoidance an expensive activity, since Bermuda lacks virtually all of the factors that are required for making such substantive economic activity work (Zucman, 2015). Lack of substance requirements enables multinationals to set up mailbox companies in low tax jurisdictions and make use of tax regimes there, while at the same time having their factories and research and development facilities in locations with, for example, a well-educated population and good infrastructure (which are usually high tax jurisdictions since these things are generally paid for precisely through tax revenue). Yes, multinationals will keep on using tax havens as long as this would maximize their profits. But if making use of a country's tax regime were to require substantial economic activity, it would become much less likely that moving into a tax haven will indeed have this maximizing effect (Dietsch & Rixen, 2014; Edwards & Keen, 1996; Keen & Konrad, 2014; Rixen, 2008). More on this will follow in chapter four.

Summarizing for now: we have a system in which countries independently decide on their tax regimes, and where companies can incorporate in different countries to make use of those tax regimes without having to attach any actual economic substance to that incorporation. Furthermore, multinationals can move capital between their various subsidiaries in different countries with great speed and relative ease. Finally this situation is governed by two principles: each subsidiary calculates and reports their own profits at an arm's length price and these profits are then taxed in the country where they are reported. How companies use this system to avoid paying taxes is something we turn to now.

2.2. Avoiding Taxes: How it Works

Tax avoidance by multinationals can take on several different forms and highly complex structures (Feld et al., 2013; Gravelle, 2009; Palan et al., 2013; Rixen, 2008; Slemrod & Wilson, 2009; Zucman, 2014). A complete exposition would be enough to fill several theses, which is why this section will only be able to give a somewhat basic account of the ways in which multinationals avoid paying taxes. The idea behind these basic strategies of avoiding taxes does, however, underlie also the most complex structures (Gravelle, 2009; OECD, 2013). So even though it may not encompass every detail, this

section will give an account of tax avoidance that is sufficiently characteristic of the problem to work with in the remainder of the thesis.

The central thought behind avoiding taxes is the following: *report low profits in high tax jurisdictions and report high profits in low tax jurisdictions*. That is, tax avoidance is not about lowering tax rates as such, but rather it is about moving the profits you make as a company to those places it will be taxed less. This practice of moving taxable income between the different entities, in different countries, within a corporate group to reduce a multinational's tax bill is what is called *profit shifting* (Creedy & Gemmell, 2011; Feld et al., 2013; Gravelle, 2009; OECD, 2009, 2013). There are two main ways of shifting the profits of one corporate group entity to another: transfer pricing and intra group debt financing (Gravelle, 2009; IMF, 2014; OECD, 2013; Tanzi & Zee, 2000; Zucman, 2014). In order to set out these practices I will continue to refer to the fictitious corporate group of Canadian Cigarettes and add two more entities to its corporate structure: CC Holding BV in the Netherlands; and CI Finance Ltd in the Cayman Islands.

2.2.1. Intra-Firm Debt Financing

So what multinational companies aim to do is reduce their reported profits in high tax jurisdictions. This is different of course from *making* fewer profits in high tax countries. Companies do not intend to actually reduce their revenue; they merely seek to *move* these profits to low tax jurisdictions. Since profit consists of revenue minus expenses and costs, the route that companies often take in order to reduce their taxable income usually consists of artificially increasing the costs and expenses in high tax jurisdictions. One tool for doing this, is intra-firm debt financing (Buettner et al., 2015; Gravelle, 2009; Sikka, 2010; Tanzi & Zee, 2000).

Let's return to our fictitious company. Say that in a year Canadian Cigarettes makes one billion in pre-tax profits (taxable income) in Canada, and lets furthermore assume that the corporate income tax there is 35 percent. This means that over one billion in profits Canadian Cigarettes will have to pay 350 million dollars in taxes, which leaves the company with 650 million dollars in after-tax profits. Not bad of course, but Canadian Cigarettes wants to maximize its profits and there is a way to further do so. First of all Canadian Cigarettes sets up a subsidiary in the Cayman Islands, called CI Finance Ltd. Now CI Finance is no more than a mailbox: it only rents a small room in an office building in George Town, and it has no employees. Still, since the Cayman Islands have no substance requirements for setting up a subsidiary, CI Finance is legally

incorporated there and can thus make use of the favorable Cayman Islands tax regime, which, let's say, includes a 1 percent corporate income tax. As a next step, CI Finance Ltd. gives out a loan to its Canadian parent company, the interest rate of which it is more or less free to set. There are some constraints because of the arm's length principle, which means that if the interest rates greatly exceeds the market price of such a loan, tax authorities might become suspicious and may, in some cases, demand a correction towards the marker price (Gravelle, 2009). Now let's say that Canadian Cigarettes borrows a billion dollars from its subsidiary in the Cayman Islands, at an interest rate of 10 percent a year. This means that over that year, Canadian Cigarettes will have to pay CC Finance Ltd. 100 million dollars in interest. The loan will end up as a liability in Canada, and as an asset in the Cayman Islands. Furthermore the interest paid will end up on the expenses side of the corporate accounting balance in Canada and on the revenue side in the Cayman Islands. This means that Canadian Cigarettes will report a profit of 900 million to the Canadian tax authorities, and CC Finance will report 100 million in profits to the Cayman Islands tax authorities. The corporate tax rate in Canada being 35 percent means that Canadian Cigarettes will have to pay 315 million in taxes, leaving it with 585 million in after-tax profits. In the Cayman Islands, CC Finance Ltd. only has to pay 1 percent of its profits in corporate taxes, and so it is left with 99 million in after tax profits. This means that the Canadian Cigarette Corporation, as a whole, is now left with 684 million in after-tax profits. Without this artificial corporate structure enabling it to issue intra-firm loans and write off interest payments for the Canadian tax authorities, it was left with 650 million, which means that through this structure it has avoided having to pay 34 million in taxes.

It is important to note how these activities are made possible by the current international corporate income tax system that I have described above. First of all, we can clearly see the importance of lacking substance requirements. If it were the case that Canadian Cigarettes had to set up an entire cigarette factory or distributions system in the Cayman Islands, it would have been very unlikely that they would have set up the same structure simply to avoid paying some taxes. The Cayman Islands may have low tax rates but it lacks many of the things (i.e. infrastructure, a highly educated population, a big and stable market) that would make it a good location for substantial economic investment. Second, it is important to see that capital - in this case the loan and interest payments - can flow freely between the two countries, which might not have been so easy if capital controls were still in place. Third, each country is free and independent in setting up their

tax systems, while Canadian Cigarettes transcends national borders. If there existed international cooperation between Canada and the Cayman Islands on tax matters, such practices might be made more difficult. Fourth, due to the arm's length principle these two group entities are treated as separate companies for tax purposes, rather than as the single multinational they actually constitute. If they were treated as one company, a construction like this would not make sense, for taxable income stays within that one company and you cannot give a loan to yourself (even though essentially that is what is happening now).

Together these components of the international tax regime thus make it possible for a company to borrow money from itself and pay itself interest, thereby reducing it's taxable income in the one country and moving it to a low tax jurisdiction where it doesn't even have any significant, substantial, economic activities.

2.2.2. Transfer Pricing

The second important method that firms apply to shift profits from high-tax to low-tax jurisdictions is through the pricing of goods and services sold between affiliates (Bartelsman & Beetsma, 2003; Creedy & Gemmell, 2011; Gravelle, 2009; Grubert & Mutti, 1991; OECD, 2009; Sikka & Willmott, 2010; Zucman, 2014). Though it is similar to intra- firm lending in some respects, transfer pricing is in fact the form of corporate tax avoidance that is generally seen as most important and, indeed, also as most costly (Feld et al., 2013; Sikka & Willmott, 2010; Zucman, 2014).

To start from a basic example, let's assume that Turkey Tobacco wants to sell its products to its parent, Canadian Cigarettes, which then wants to sell them on the market in Canada. Now say that the costs (of production for Turkey Tobacco and of distribution for Canadian Cigarettes) for a pack of cigarettes are two dollars (one in Canada and one in Turkey), and that they are sold in Canada for six dollars each. Furthermore let's assume that the corporate income tax rate in both Canada and in Turkey is 35 percent. This means that if Turkey Tobacco sells to it's Canadian parent directly, the company will end up paying 35 percent in taxes no matter the price at which the cigarettes are sold between the two affiliates. So lets say that Turkey Tobacco produces 100 million packets of cigarettes and sells them to its Canadian parent for 3 dollars each. Canadian Cigarettes then sells the packets in Canada for 6 dollars each. Both make 200 million in pre-tax profits (3-1x100m in Turkey and 6-4x100m in Canada) which is taxed at 35 percent,

meaning that each group entity is left with an after tax profit of 130 million dollars, and the group as a whole with 260 million dollars.

Now, Canadian Cigarettes, wanting to increase its after-tax profits, is going to put to a different use the mailbox company it set up in the Cayman Islands, where the corporate tax rate is 1 percent. What happens is that Turkey Tobacco now sells the cigarettes to CC Finance first, say for 1 dollar and 10 cents per pack. CC Finance then sells the cigarettes to Canadian Cigarettes for 4 dollars and 90 cents. For this to happen the cigarettes never even have to set foot in the Cayman Islands. They are only there on paper, or digitally, at a mailbox company, but still this is enough to make their acquisition and sale subject to Cayman Islands tax law. The effect of this structure is that Turkey Tobacco now only makes a pre-tax profit of 10 million (100m x (1.1 - 1) = 10m), as does the Canadian Parent (100m x (6 - 4.9 - 1) = 10m). These profits are their taxable income and so they pay 3.5 million in taxes each, and they each have an after-tax profit of 6.5 million. Now, the Cayman Islands subsidiary makes a pre-tax profit of 480 million (100m x (4.9 - 1.1) = 380m). This amount is taxed at 1 percent, which leaves it with 342 million in after-tax profit. When we take company as a whole it thus has an after tax result of 6.5m + 6.5m + 342m = 355m. This means it has managed, trough the artificial manipulation of the prices of the goods sold between the different group entities, to avoid paying 95 million in taxes.

Now there is of course again the arm's length principle, which means that prices must reflect, or at least not vary too much, from the market price. Turkey Tobacco will have to calculate its profits with a price for cigarettes that approximates the price on the market, and so the difference in price in the example is of course exaggerated quite a bit. But the right price of a products can often only be established roughly by looking at comparable products, which means that usually there remains quite some wiggle room (Bartelsman & Beetsma, 2003; Sikka & Willmott, 2010; Zucman, 2015). At high volumes such wiggle room can still, in spite of the arm's length principle, enable companies to avoid paying huge amounts of taxes by artificially manipulating the prices of goods that are traded within a firm.

The main problem with transfer pricing however lies in the pricing of so-called 'intangibles', such as services and intellectual property (patents, royalties etc.) (Bartelsman & Beetsma, 2003; Grubert & Mutti, 1991; OECD, 2013; Sikka & Willmott, 2010; Zucman, 2014). This is so because very often there does not really exist an arm's length market price for such goods (Eden, 1998; Gravelle, 2009; Zucman, 2015). What is the

value of the name 'Google' for example, or Starbucks' proprietary coffee blend? How do you value specialization? And multinational corporations utilize the lack of a market price for such intangible goods to the fullest. Here's how.

Instead of lowering profits in high tax jurisdictions by trying to lower the revenue a company makes in that country, it is of course also possible to achieve the same by increasing the costs (similar to intra-firm lending). So now let's imagine the same corporate structure with one more subsidiary added: 'CC Holding BV' in the Netherlands. Instead of manipulating the price of the cigarettes (or perhaps additional to doing that), the corporate group may do the following to shift profits to low tax jurisdictions. First of all, it can have the subsidiary in the Cayman Islands offer, for example, 'specialized financial management services' to Turkey Tobacco, supposedly assisting it in the financial aspects of its dealings with the parent company. Since this is *specialized* financial assistance, it might be a lot harder to establish a market price for these services than it is for cigarettes. First of all there is no market price in the sense that these expert services are not also sold to a third party (like consumers in the cigarette case). The financial services are provided to Tobacco Turkey only. Furthermore it is hard to argue for comparable products to determine if the price is set appropriately. The latter goes even more for intangibles like royalties or patents (Gravelle, 2009; Zucman, 2014).

Now, say for example that Canadian Cigarettes has the rights to the brand and logo "Canadian Cigarettes". What it can do, in this case, is transfer that right to its Dutch Subsidiary CC Holding BV. This means that every time someone uses this brand, or the logo, they have to buy a license from, or pay royalties to, that Dutch subsidiary. And so does the parent company itself. Now the price of these royalties is hard to determine. Again, what is the price of using the Google brand name? It has no comparable, which means that the company is virtually free to ask any price it wants. The price the parent has to pay is an expense, and thus reduces the taxable income in Canada. That same amount is revenue for the Dutch subsidiary, but it is not taxable income there because in order to incentivize research and development the Netherlands has decided to levy no tax at all on income from royalties and intellectual property (which is also why bands like U2 and The Rolling Stones have 'offices' in Amsterdam).[4]

[4] Note that this is a slight simplification of the way royalties are treated under Dutch fiscal law, for a complete exposition would go beyond the capacity of this thesis. The above description does capture the main gist of the tax laws applying to intellectual property in the Netherlands though, and so it will suffice for present purposes.

Over the past decades, multinationals have developed many ways of bundling up parts of their business - such as intellectual property, brands, logos, marketing, insurance and finance expertise - and owning them offshore (Bartelsman & Beetsma, 2003; Griffiths & Lawrence, 2007). They can then charge for the use of these to other parts of their group onshore. In that way multinationals are able to minimize their profits in high tax jurisdictions, and thus also minimize the amount of taxes they have to pay. The extent to which this is done varies. Canadian Cigarettes, in the example, still pays some taxes in the high tax countries, but this is not necessarily always the case. Many companies actually manage to reduce their reported profits to zero, and some very audacious ones even dare to report a loss.[5]

Note again how transfer pricing is possible only through the characteristics of the international corporate tax system mentioned before. The lack of globalized tax politics leaves countries free to write their own tax codes, which may include effective tools for companies to minimize their tax payments (such as tax exemptions on royalties) (Hay, 2014). The reason that they can make use of these rules is precisely that they can move their money so easily to different countries, where they can incorporate without any economic substance being demanded of them (McGrew, 2014; Zucman, 2015). Mere legal presence is enough to allow multinationals to make use of beneficial tax schemes some jurisdictions offer. And a final but crucial element is the fact that the different parts of a multinational are treated as separate entities, which are to be taxed in the country where they reside. If a multinational were seen a single entity, then transfer pricing would not make sense for all profits would belong to the same company. There would, however, still be the issue of which country would then be allowed to tax these profits. This is an issue that I will return to in the final chapter. For now it seems clear that economic globalization and international intra-firm transfer of goods, services and intellectual property have pushed the arm's length principle of international corporate taxation past its expiration date (Gravelle, 2009; Sikka & Willmott, 2010). This becomes even more apparent when we look at some of the effects of this international corporate income tax regime, to which I will turn in the following section.

[5] Starbucks for example actually managed to report a loss for several years in the UK ("A loss-making machine," 2015).

2.3. The International Corporate Income Tax System: Effects

The effects of tax avoidance are varied, and to give a full account of all of them would be far beyond the capacity of this thesis. Therefore this section will, though it touches upon several effects, focus on two, namely: (1) an increase in domestic socio-economic inequality, and (2) the possibility for some to free ride on public goods. That is, this section will establish premise 1: *the current international corporate income tax system causes an increase in domestic socio-economic inequality and enables free riding on public goods.*

2.3.1. Effects: Inequality

At the root of most effects of the current international corporate income tax system lies the fact that tax avoidance erodes countries' tax bases (IMF, 2014; OECD, 2013). A government's tax base consists of the total amount of assets, investment streams or income, both at individual and corporate level, that are subject to taxation (Auerbach et al, 2013; Bartelsman & Beetsma, 2003; IMF, 2014; OECD, 2013). It is a pool of those things a government can tax, and it is thus the basis of, and most important source for, government revenue. *Corporate profits constitute an essential part of this tax base*, and their taxation is a key component of government revenue in both developed and developing nations, because it is one of the primary ways in which a government can tax capital (Palan et al. 2013; Rixen, 2008; Zucman, 2014, 2015). In the U.S., for example, about a third of total tax revenue came from capital taxes, of which 60 percent came from the corporate income tax (Piketty, 2014; Zucman, 2014). When profits are shifted out of a country, they are thus withdrawn from a government's tax base. The tax authorities no longer have the ability to tax these profits, because they are moved to a jurisdiction that is under the control of another nation's government. And since there is, again, no cooperation on taxation, these profits escape taxation in high tax rate states.

If tax rates remain stable while the tax base erodes, government revenue will decrease (Auerbach et al., 2013; OECD, 2013). If you get 20 percent of a pie, then what you get will decrease if the pie gets smaller. If you want to have the same amount of pie left even if the pie gets smaller, then what you need to do is increase the percentage of the pie that you take. The situation in the case of profit shifting, however, dictates that when you increase corporate tax rates, the incentive for companies to shift their profits abroad only becomes bigger. If you take a bigger share of pie, the pie will shrink even further. This is a reason that, *over the past few decades, corporate tax rates have actually declined* instead of gone up (Edwards & Keen, 1996; Gravelle, 2009; Keen & Konrad, 2014;

OECD, 2014; Piketty, 2014; Rixen, 2011; Zucman, 2014, 2015). In order to keep capital from fleeing the country to low tax jurisdictions, governments in both developed as well as developing countries have gradually lowered tax rates on corporate income so as try to keep capital to stay, or even attract new foreign "investment". Over the last three decades or so, economic integration has made international considerations a central component of tax policy making around the world (UNCTAD, 2015). This situation of countries competing with each other for the taxation of mobile capital is what has been called *tax competition*: since capital is mobile, governments believe that it will go where taxes are lowest and compete against each other by lowering their tax rates (Auerbach, 2006; Auerbach et al., 2013; Keen & Konrad, 2014). The structure of tax competition is thus best described as a zero sum game ending, when global coordination is lacking, in a race to the bottom (Keen & Konrad, 2014). There is only a certain amount of capital that can be taxed, and due to the profit maximizing nature of companies and its high mobility this capital will tend to move to where taxes are lowest. This means that countries with higher taxes will see an outflow of capital while low countries with lower corporate tax rates will see capital flow in (Auerbach et al., 2013; Keen & Konrad, 2014). This is then, again, an incentive for jurisdictions with higher tax rates to lower them, with the idea that some tax income from corporations is better than no tax income from corporations. The situation thus has the structure of an n-player prisoner's dilemma where individual 'rationality' seems to lead to collective irrationality, because in the end all of the competing countries will have only a minimal amount of corporate tax revenue left while each country could be much better off if taxation were internationally coordinated. Trying to maximize corporate tax income will in the end, paradoxically, only lead to less tax revue from corporate income (Egger & Raff, 2014).

This means also that, in effect, countries are violated in their fiscal sovereignty in the sense that their options for fiscal policy are restricted by the international corporate tax regime and the tax competition that results from it (Dietsch, 2011; Dietsch & Rixen, 2014; Slemrod, 2008; Slemrod & Yitzhaki, 2002). Though perhaps *de jure* their choice set is not restricted – they remain in control of what tax rates they set - the consequences of setting high tax rates for corporations are thus that it is not really a feasible option. They are therefore violated in their *de facto* fiscal sovereignty: governments are not actually free to adopt any tax policy they want. As the global integration of national economies deepens, and the mobility of capital accelerates, the ability of policy-makers to pursue fiscal policies at home that are independent of, or at significant variance to, those found

abroad will be progressively diminished (Tanzi & Zee, 2000). They often (feel that they) have no choice but to lower corporate tax rates to stay competitive in attracting capital.

Though corporate tax rates are nowhere near zero yet (with the exception of some tax havens of course), a downward trend in corporate tax rates can indeed clearly be observed in most developed as well as developing nations (Eden, 1998; Egger & Raff, 2014; Keen & Konrad, 2014; OECD, 2013, 2014). Where average corporate tax rates in the U.S. for example were at about fifty percent in the 1980's, they are today on average even less than half of that (Keen & Konrad, 2014; OECD, 2014). And, additionally, this has also caused a decline in the tax rates that apply to those at the top of the income distribution. The corporate income tax was created shortly after the First World War as a sort of backstop to the personal income tax, aimed at taking away the incentive for rich individuals to simply incorporate and avoid paying personal income taxes (Piketty, 2014). When there is a corporate income tax that is higher or at least as high as the personal income tax, this opportunity is no longer there. But when the corporate income tax is lowered, then the personal income tax at the top also needs to decrease so as to avoid the return of this incentive (note that this is exactly what wealthy individuals are doing today again on an international level, as was exposed by the so-called Panama Papers[6]).

In any case, several studies (i.e. Atkinson, 2015; Bourguignon, 2016; Furceri & Loungani, 2015; IMF, 2014; Piketty, 2014; Rixen, 2011) have shown how the spectacular lowering of both statutory and effective corporate and top income tax rates has sharply contributed to the rise of inequality since the 1980's. The contribution to inequality from the lowering of corporate income tax rates, and tax avoidance in general, mainly comes from the fact that most companies are owned by the wealthy. In fact, in the US the top 0.1 percent own about 50 percent of all corporate stock, while 90 percent of the total corporate stock is owned by the top 1 percent (Kinnickel, 2009). These numbers are even higher for most developing countries (Kinnickel, 2009). This again goes to show that it is only the very rich that benefit from the current international corporate income tax system that allows multinationals to avoid taxes, and from the reduction in domestic corporate tax rates this enforces. The current international system of corporate income taxation effectively forces down corporate tax rates, thereby benefiting only those at the top (the 1%) of the income distribution while significantly enlarging the gap between

[6] The Panama Papers is the name used for the 1.6 terabyte data leak that took place spring 2016 and that exposed the millions of offshore accounts and mailbox companies that were being managed by the Panamese law firm Mossack Fonseca (Harding, 2016).

them and those at the bottom (the 99%) (Atkinson, 2015; Piketty, 2014; Piketty & Saez, 2007).

But the effects of the international corporate income tax system on inequality go even further. As said, the state, in the end, needs constant tax revenue to keep its operations going.[7] Since this revenue would decline if tax rates remain the same or decrease while the tax base erodes, governments are forced to either take on debt or compensate the loss in revenue in other ways. Preferring the minimization of sovereign debt, this means that governments will have to get their tax revenue from somewhere else. And that somewhere else is constituted by elements of the tax base that are not as mobile as multinationals' profits: labor, consumption and small-scale non-mobile businesses (Atkinson, 2015; Dietsch & Rixen, 2014; Piketty, 2014; Thomas Rixen, 2011). This is indeed what has happened. International data shows that over the past few decades two things happened simultaneously: government revenue was stable while corporate income tax rates were cut and exemptions of interests, dividends and other financial revenues were granted (IMF, 2014; Keen & Konrad, 2014; OECD, 2013, 2014; Zucman, 2014). For this to be able to occur simultaneously, it must be the case that taxes on labor and consumption increased, and this is indeed what has been observed (Atkinson, 2015; Piketty, 2014; Zucman, 2014, 2015). In the United states, for example, the share of government revenue that comes from corporate taxation has come down to 11 percent today from 25 percent in the 1980's (IMF, 2014; Kinnickel, 2009; OECD, 2014). What this means is that tax avoidance, enabled by the current international corporate tax system, is actively undermining governments' ability to conduct a progressive or even a proportional tax policy, which involves the idea that tax rates respectively increase or stay flat with the amount that is taxed (Atkinson, 2015; Piketty, 2014). Taxation is a government's most important tool for redistribution, and progressive taxation is the central tool governments have to reduce inequality. It is thus for this reason that several scholars have argued that the current international corporate tax system makes a considerable contribution to the *increase* in inequality we see today (Atkinson, 2015; Piketty, 2014; Rixen, 2011). Though decreasing corporate tax rates are not caused by tax avoidance alone (conservative government policy tends to favor the same thing) Zucman (2014, p. 133) has shown that tax avoidance is in fact responsible for about two-thirds of the decrease in corporate tax rates. Thomas Piketty (2014)

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[7] Though it is of course true that spending does not necessarily require revenue (debt is also an option) the state will have to generate some form of income in the end to finance itself (Auerbach, Feldstein, Chetty, & Saez, 2013).

already emphasized that inequality is progressing faster and faster due to the fact that the return on capital is higher than the growth of the economy, and he indeed also underlines the amplifying effect that tax avoidance has on this process. While capital is able to avoid paying taxes, labor, for example, isn't. It is important to realize that, in the end, this process leaves us with an effectively *regressive* tax system including an increasing emphasis on consumption taxes (which are generally also taken to be regressive (Halliday, 2015) in which effective tax rates (and increasingly also statutory rates) are much lower for those are the top of the income distribution than for those in its lower regions (Dietsch, 2011; Rixen, 2011; Zucman, 2015, 2015). Moving profits abroad is much easier than quitting your job and looking for a new one in a foreign country, which means that labor and other less mobile elements of the tax base are increasingly called upon in governments' attempts to gather the funds required to finance the state and the public goods it provides.

2.3.2. Effects: Free Riding on Public Goods

Tax revenue is a government's most important source of income, which it can use to pay for the provision of public goods. Such public goods may include very diverse things, such as education, infrastructure, health care, national defense or a legal system. How far the provision of public goods should go is a matter still heavily debated both in a philosophical as well as a political context (Murphy & Nagel, 2004). It is questioned, for example, whether education is something the costs of which should be borne by the government, or rather by private individuals themselves. And a subject such as infrastructure is even more complicated because it seems doubtful whether something like a system of roads would be provided at all in a free market system (Auerbach et al., 2013; Halliday, 2013). In any case, today most countries provide public goods to some extent. In some developing countries (and even some developed countries) the effectiveness of these public goods may sometimes be questioned (like the workings of the legal system), but still, governments collect taxes to provide such goods, however efficient they turn out to be. Most western countries have a quite far-reaching provision of public goods, including high quality infrastructure, education and the public provision of health care. In general a more extensive provision of public goods requires a higher degree of taxation. That is, the more public goods are provided, the more people have to pay in taxes. No matter how far the provision of public goods goes in a country, however, the idea behind this provision is that if you make use of these goods, you

should pay for it. But this is exactly what the current international corporate income tax system undermines.

The international corporate income tax system creates a situation, domestically, where some are able to use public goods without paying for them, or at least without paying their fair share[8] (Atkinson, 2015; Dietsch & Rixen, 2014). This means that not only does the international corporate income tax system endanger the provision of public goods in the first place[9], it also allows some to free ride on them. And those 'some' are the rich multinationals and their wealthy shareholders, which, generally, just happen to be precisely the biggest, or at least most intensive, consumers of public goods (Bartelsman & Beetsma, 2003; Slemrod & Wilson, 2009; Zucman, 2014). It is multinationals that depend most on a well-trained and healthy workforce, on the usage of roads and infrastructure, on the protection of their property rights and the enforcement of contract law (Atkinson, 2015). Starbucks, for example, makes extensive use of contract law and infrastructure in the UK. Nonetheless it has managed to report a loss in that country for several years in a row, exempting it from having to pay anything for its use of these goods (The Economist, 2015). And even if it is not the case that multinationals pay zero taxes in a country, the fact that the effective tax rates that apply to them are lower than those that apply to the average working individual makes it so that they do not pay their fair share for their consumption of public goods.

In any case, multinationals *depend extensively on the provision of public goods in the countries where their income is generated* (Atkinson, 2015, p.203) while at the same time they pay relatively little for their use, and sometimes do not even pay for them at all. This is what I call free riding on public goods.

Now, the point that these multinationals are intensive users of public goods, also serves as a reply to a popular argument for a positive effect of the current international corporate income tax system and the tax competition it entails. Some economists, and mostly multinationals themselves, have argued that declining tax rates would actually be good for incoming flows of investment (Desai & Dharmapala, 2006, 2009). The argument continues by claiming that more investment would lead to higher economic

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8 'Fair share' I define here, and in the rest of this thesis, in a minimally as 'at least as much, in a relative sense, as those who are paying the least for the use of public goods. So a multinational paying their fair share for their use of public goods I understand as a multinational paying at least as much (as a percentage of their income) as those that are paying the least for it (i.e. a low wage labourer for example).

9 This is especially the case in developing countries when the provision of public goods is often lacking and where a decrease in tax revenue can have devastating consequences. It was, for example, estimated that the 120-150bn dollars the developing world loses annually due to corporate tax avoidance is enough to reduce child deaths in the developing world by 85.000 on a yearly basis.

growth, which involves more jobs and more welfare. Now, who doesn't want jobs and welfare? However, this argument builds on and emphasizes the assumption (also underlying tax competition) common among national legislators, that in order to attract capital investments countries need to have lower corporate tax rates than their 'neighbors'. If tax rates are lower, post-tax profits will be higher, and since multinationals aim to maximize their profits they will thus want to go there where taxes are lowest. This is true, however, it is only true ceteris paribus. That is, all other things being equal, then yes, a multinational will chose the location with the lowest tax rates to establish its factories. However, all other things are not equal, and many factors that are important for multinationals in deciding where to invest vary greatly between countries. These other factors vary to such an extent and are of such importance to multinationals that several studies have concluded that *taxation is, in the end, not a major driver of investment* (IMF, 2014; UNCTAD, 2015). Rather, major drivers of investment are precisely those factors that governments can provide using tax revenue. Multinationals decide on where to invest (that is, investment involving real economic activity (the kind that brings growth and jobs) rather than empty flows of capital through a mailbox company), for example, based on the presence of a well developed system of roads and (air)ports, accessible natural resource and human capital, or a politically stable situation in which contract and property rights can be effectively enforced (UNCTAD, 2015). Precisely these factors are in danger because of the international corporate income tax system that erodes countries' tax bases. Non-surprisingly there is thus also no evidence that lowering corporate tax rates leads to an increase in investment, and there is even some evidence that suggests the opposite is true (IMF, 2014). Still multinationals tend to free ride on these public goods, that they need so very much for successfully and profitably continuing their day-to-day operations.

2.4. Chapter Conclusion

This chapter started out by describing the current international corporate tax system and the way in which it enables tax avoidance. The two main principles that ground the system currently in place are the source principle and the arms-length principle. Together with the free movement of capital, and the non-existence of any substance requirements for incorporation, these two principles lead to a situation in which multinationals are virtually free to *shift their profits* away from high tax jurisdictions to so-called tax havens, where they are taxed only to a minimal extent. Common tactics for doing so include

intra-firm debt financing (giving out intra firm loans to reduce profits in high tax countries, and move them in low tax countries) and transfer pricing (price setting of the sale of products and services within a firm). Though consequences are varied, this chapter focused on two. It showed how most importantly the international corporate income tax system and the tax avoidance it enables *lead to a significant increase in inequality* and how it allows for the *free riding on public goods* (thus establishing premise 1).

3. A Comparative Justice Approach

This section involves the normative assessment of the two effects of the current international corporate income tax system identified in the previous chapter, with the goal of establishing premise 2: *An international corporate income tax system that doesn't cause an increase in domestic socio-economic inequality and doesn't enable free riding ride on public goods is, ceteris paribus, comparatively more just than one that does.*

3.1. The Normative Framework

First of all this normative assessment will, as mentioned in the introduction, focus on institutions. It does so from the idea that, indeed, any theory of justice needs to attribute a central role to institutions (Sen, 2011, p. 82) as well as from the idea that institutions are in the end human constructions and the results of political decisions, meaning that we can in fact change them if that is what justice requires (Pogge, 2005; Pogge, 1992). So my normative approach does not pay attention to individual (firm) behavior, in the sense that it will not make any claims about the morality or immorality of the actions of specific actors. Any diagnosis of justice or injustice that results from this analysis is thus not to be attributed to the behavior of companies that avoid taxes, but rather to the institutional framework that enables them to do so.

Furthermore, I follow Sen (2008, 2011) in the idea that, in order to come to such a diagnosis, we do not have to agree on one specific theory of justice as being 'the right one.' That is, we do not have to agree on one particular criterion as being the dominant reason for the diagnosis of injustice, to come to the consensus that an injustice does in fact exist. In modern theories of justice, the characterization of perfectly just institutions has become the central exercise (Kymlicka, 2002; Sen, 2011). And indeed there are many different, and to some extent irreconcilable, theories of what these perfectly just institutions would entail, each with a valid claim to being 'the right one'. However, for getting to robust conclusions on what should be done, the arbitrary reduction of these conflicting theories to one solitary survivor is certainly not a prerequisite (Sen, 2011, p. 4). In this section, I will take a closer look at two of such competing and opposing theories – John Rawls' egalitarian liberalism and Robert Nozick's rights based libertarianism - and use them individually to asses the domestic socio-economic inequality and free riding on public goods that the international corporate tax system brings about.

Both Nozick's and Rawls' theories offer different, though serious, considerations and evaluative concerns, none of which could be readily ruled out as being irrelevant, or unimportant, for an appraisal of these effects. However, though each of these theories may reach a different conclusion as to what a perfectly just society would entail, it is my aim to show that these different criteria may still lead to the same diagnosis of injustice concerning the current international corporate income tax system. This goes to show that specific conclusions for the advancement of justice in this respect need not await the determination of the relative priorities to be attached to these criteria (Sen, 2008, 2011). We may not be able to determine what a perfectly just international corporate tax system would require, but we may be able to identify an international corporate income tax system that is *comparatively more just* than the one we have today, by showing that the latter is *less just along the criteria of all the theories of justice considered.* Given that we adopt a realistic reading of behavioral regularities (i.e. maximizing shareholder value), independent of the theories of justice we employ, we can thus make substantial and robust conclusions about how the institutional framework of international corporate income taxation might be made *comparatively more just.* That is, we can show that, without having to identify a single theory of justice as the right one, an international corporate income tax system that does not contribute to domestic socio-economic inequality, and that does not enable some to free ride on public goods, is more just than one that does (premise 2).

Sen's comparative approach to justice thus entails that a certain institutional arrangement is more just than another if the former is more just according to the criteria of all the theories of justice considered. The strength of the results of this approach increases with the number and range of the different theories that are considered (Sen, 2006, 2011). Naturally, the greater the number and diversity of the theories involved, the less vulnerable a diagnosis of injustice becomes to the claim that it depends on a specific (type of) theory of justice. Unfortunately, the confines of this thesis do not allow for a large number of theories to be taken into account. Therefor the focus in the selection of the theories incorporated in the project has been on *diversity*. This diversity has been aimed for in two different dimensions. First of all Rawls' and Nozick's theory of justice represent two very *different approaches to justice* - Rawls' *equality based liberalism* versus Nozick's *rights based* procedural approach - (Kymlicka, 2002). Second, I chose these two theories because they are both very unlikely candidates, though for different grounds, to produce any claims about the current international corporate income tax system - Rawls because his theory applies to domestic justice only, and Nozick because his theory denies

any taxation whatsoever, except that necessary to support his minimal state. Again, both these reasons serve to increase the strength of the comparative approach. It wouldn't be a big surprise if two obvious theories of justice that lie close to each other both characterize the current international corporate income tax system as unjust, making the comparative approach quite straightforward and not very informative. However, if it can be shown that two opposing theories of justice (and both being 'difficult' candidates) would characterize the current system as unjust, then that would emphasize all the more the possibility for broad agreement between different theories of justice on this topic, thus imbuing the claim that another system would be *comparatively more just* with much more power.

So, more specifically, it is the aim of this section to establish that each of the different theories of justice considered would characterize the domestic socio-economic inequality and the free riding on public goods that follow from the current international corporate income tax system as unjust. It is important to emphasize that these effects that are being assessed, are *domestic rather than global.* Though we are investigating an *international system*, the issues I am concerned with here are not necessarily those concerning the relations between peoples or nations. They are not the concerns of *global* justice, but rather concern the international institutional framework, and how it *relates to domestic* justice (Beitz, 1975). Global justice approaches, both the international and the cosmopolitan version, argue that global justice would in fact require global sovereignty or a global state (Nagel, 2005). For the international approach however, the absence of global justice is not a problem, and so there is no reason for the globalization of politics, while cosmopolitans argue from the perspective that, in the end, humans rather than collectives are the units of moral concerns, and that the absence of global justice is thus a problem warranting the globalization of sovereignty (Nagel, 2005). It is my claim, however, that *not global, but domestic justice, would require international cooperation*. I differ from both approaches to global justice in that I do not require a stance on global justice in arguing for a global solution to this issue, and I claim instead that the latter is entailed by the violation of domestic justice brought about by the international corporate income tax system (Nagel, 2005). This thus does not require me to take a position on whether or not the absence of global justice requires the establishment of transnational sovereignty, but rather it allows me to argue that fiscal sovereignty needs to (partly) be detached form the nation state in order to improve domestic justice. It thus also enables me to claim that the current *international* corporate income tax system is unjust, without having to take a

position in the debate on international or global justice. Rather, I argue that it is unjust because of its effects on domestic justice. Furthermore this makes it possible for me to apply Rawls' theory of justice to the matter at hand, even though his theory is not one that is applicable to issues of international justice. *In this thesis I will thus consider the current international corporate income tax system comparatively less just insofar as the patterns of domestic justice fulfillment it tends to produce are inferior to the patterns that an alternative would tend to produce* (Pogge, 1992; Pogge, 2005).

Now, the next step will be to assess the socio-economic inequality and the free riding on public goods that the current international corporate income tax system brings about in terms of the two different theories of justice.

3.2. Inequality

As was established in section 2.3.1, the international corporate income tax system, and the tax avoidance by multinationals it enables, contribute significantly to domestic inequality (Atkinson, 2015, 2016; Bourguignon, 2016; Piketty, 2014, 2015; Rixen, 2011). On the one hand multinationals and their wealthy owners are able to avoid paying taxen on (a large share of) their capital income, which means that the effective tax rates that apply to them are very low. On the other hand also the statutory tax rates that apply to multinationals, and the one percent of the population that constitutes their shareholders, have declined, while those that apply to the less mobile elements of the tax base have increased, as a consequence of tax avoidance. This means that the latter are increasingly burdened with maintaining the operations of the (welfare)state (Piketty, 2015).

3.2.1. Rawls and Inequality

In his seminal 1971 *A Theory of Justice,* John Rawls establishes two principles of domestic distributive justice. Note, again, that it might not seem correct, at first, to apply these *domestic* principles to the *international* institutional framework that is the subject of this thesis. However, remember that though we are speaking of the *international* corporate income tax system this does not require a stance on *international* or *global* justice. I am concerned with an international system, however I am investigating *the effects of this system on domestic justice*. This means that I am here making a normative assessment of the *domestic*

socio-economic inequality that results from the current international corporate income tax system, which is a perfectly suitable subject to which to apply Rawls' theory.[10]

Rawls establishes his two principles of justice by performing a thought experiment, asking what governing principles individuals would choose when reasoning from a fair and impartial point of view. According to Rawls, the risk averse individuals in this 'original position,' uncertain of what their position in society will be (the 'veil of ignorance'), will choose to adopt a 'maximin strategy', meaning that they will choose governing principles with the aim of maximizing the worst possible position that they might end up in (Kymlicka, 2002; Solimano, 1998). Starting from an equal division as a benchmark, the participants in the original position decision-making will argue that inequalities are to be allowed under the provision that they are to the benefit of those least well off, and that the benefits of these inequalities are to be attached to positions that are available to all. So everyone should have equal opportunity to be better off than others, and if this is the case then this inequality should be to the benefit of those worst off. This is what Rawls calls the *difference principle*, and formulated more precisely it entails (Rawls, 1999, p. 266):

> **Principle 1:** Social and economic inequalities are to be arranged so that they are both:
>
> > **Principle 1a:** To the greatest benefit of the least advantaged, consistent with the just savings principle, and
> >
> > **Principle 1b:** Attached to offices and positions open to all under conditions of fair equality of opportunity.

Now, how do these principles relate to the inequality that the current international corporate income tax system produces? To start with the latter part of the difference principle 1b, it seems that the economic inequalities that result from tax avoidance do not meet the requirement of fair equality of opportunity. That is, the benefits that result from avoiding taxes are not available to every individual alike. As explained in chapter two, tax avoidance requires the possibility of moving across borders, and this possibility is something that is available much more to capital than to labor. While for multinationals it is today no problem to move to their profits to the Cayman Islands to

[10] Note that Rawls does put forward a theory of global (or rather, international) justice in his *Law of Peoples* (2001). However, applying this theory would require me to take a specific stance in the global justice debate, which is what I am trying to avoid here (for it is not necessary to do so for the claim I want to make).

benefit from the highly lucrative tax regime there, it is much more difficult for, say, a steelworker to move his labor income to a tax haven. Capital thus being the more mobile factor, and mobility being a requirement for avoiding taxes on income, means that only capital income has the opportunity to avoid being taxed. Besides the fact that this thus creates inequality between those who obtain income from capital (located at the top of the income distribution) and those who obtain income from labor, it also means that these inequalities are not arranged in such a way that they are *attached to positions open to all.* The position of being able to avoid taxes on income is not available to a steelworker, or to a supermarket employee, while it is available to the (owners of the) steel factory or the supermarket. So the inequality that results from the current international corporate income tax system thus seems to be in transgression of principle 1b, which means that Rawls would say this it is unjust, and in need of a redistribution.

But, one might ask, doesn't everyone have the same opportunity to become a steel worker or the owner of a multinational, and doesn't that solve the conflict with Rawls principle 1b? The answer is no. It may indeed seem true that the position of being able to avoid taxes is tied to the position of being the owner of an international company, and that if there were equal opportunity to owning an international company it seems that everyone would also have equal opportunity to avoid taxes. However, in practice it is certainly not the case that everyone has an equal opportunity to become the owner of a multinational. The requirements of becoming the owner of a multinational are precisely those things that wealth can help you acquire. That is, wealth is needed to buy or own stock in a company, but also, for example, to get the right education. And note that the latter is increasingly the case when tax avoidance keeps eroding the tax revenue that is needed to pay for the public provision of education (Atkinson, 2015). Your chances of becoming the owner of a multinational firm are much bigger when you come from a family with wealth, or when you have a Harvard Business School degree. As Piketty has extensively argued, wealth doesn't travel much in terms of moving between different groups of people (Piketty, 2014). Wealth today is situated very much within one percentage and it stays with those that are born into that group. So, no such equality of opportunity exists today, and so neither does an equality of opportunity to avoid taxes.

But moreover, on a more theoretical level, even in an ideal world in which everyone has the opportunity to become the owner of a multinational, this would not necessarily mean that everyone has an equal opportunity to avoid taxes. Note that though the latter (equality of opportunity to avoid taxes) depends on the former (equality of

opportunity to be the owner of a multinational), the former is neither a sufficient nor a necessary cause for the latter. It is quite possible to have a situation in which there is no equality of opportunity to become the owner of a multinational but where everyone (or no one) is able to avoid taxes (and vice versa). What I want to emphasize is that that the unequal opportunity to avoid taxes does in fact also result from the international corporate income tax system*, and cannot simply be reduced to the fact that not everyone has an equal opportunity to become the owner of a multinational,* because the latter is not a sufficient cause of the latter. The point of that claim is that this shows that the conflict with Rawls' principle 1b does not merely apply to the inequality of opportunity to own a multinational, but also very much to the current international corporate income tax system.

But the conflict with Rawls' difference principle goes further. I have argued how the inequality this system produces, comes without bringing any adequate corresponding benefits to society at large (Piketty, 2014). If corporations actually had to pay the taxes that a country would levy on them, this would allow for a serious expansion of the welfare state. That is, it would allow for the financing of both comprehensive social security and income redistribution systems (Piketty, 2014, 2015). On the contrary, however, cuts in corporate and top income tax rates have generally caused a need to cut in public spending on such things as education, health care and social security (Atkinson, 2016; Bourguignon, 2016; Piketty, 2014, 2015).

Some in favor of cutting tax rates for corporations have argued that tax avoidance, and lowering corporate tax rates, are actually in the benefit of those who are less well off. The central argument behind these statements is that the incidence of (increases in) corporate taxes lies mainly with workers and consumers. When corporate taxes are increased, they claim, corporate management will simply transfer these costs to workers through lowering (or not raising) wages, or to consumers by increasing the price of their products. This argument seems to be questionable at best, however, if only because, as Lee Sheppard (Sheppard, 2011) put it:

> "if the incidence of corporate income tax falls mainly on workers and consumers then why do corporations go to such great lengths to avoid them?".

But the claim has been shown to be false in several more substantial ways as well. For one it is observable that both corporate tax rates as well as real wages have declined over the past decades. If, indeed, the employees of a firm pay for corporation tax, wages and

tax rates should be inversely related. Furthermore, empirical research has shown that about 80 percent of the costs of the corporation tax falls on the company shareholders with the rest distributed over consumers and employees (Clausing, 2012; Dwenger et al., 2011).

Taken together with the fact that there is no evidence that cutting corporate tax rates would lead to higher investment and economic growth, it seems that the current international corporate income tax system not only makes those at the top of the income scale better off, it also makes those at the bottom worse off. They get less social benefits and pay more in taxes.

So not only does the inequality that results from corporate tax avoidance violate the fair equality of opportunity element of Rawls' principle, it doesn't seem to satisfy principle 1a either. The fact that this small segment of society is able to avoid paying the taxes that the state requires them to pay, has the effect that the revenue the state needs to collect in order to continue its operations has to come increasingly from those that are unable to avoid taxes. The group that cannot avoid taxes includes the larger part of society, and certainly also those least well off. They are the ones that are increasingly burdened with financing the state, including its social security and income redistribution systems (Piketty, 2014, 2015). So not only do they have to pay more, what they receive is also cut. The system of progressive taxation that exists (or rather, existed) in most nations is being actively undermined by the international corporate income tax system that turns it into a regressive alternative in which the lowest tax rates (effective and increasingly also statutory) apply to those at the top of the income distribution. Whether or not one agrees with the welfare state, it is clear that this development is eating away at it, which entails a worsening of the situation for those who are least well off. And this is something that Rawls' principle of justice clearly wouldn't allow.

According to Rawls, justice would thus require a redistribution to correct for this unjust inequality. And in fact not only for this inequality. According to many economists (Atkinson, 2015; Bourguignon, 2016; Piketty, 2014, 2015) the inequality we see today is detrimental to economies allover the world. The levels of inequality that currently exists, are effectively undermining the efficiency of the market and are holding back long-term, sustainable, economic growth (Berg & Ostry, 2011; Berg et al., 2014; Cynamon & Fazzari, 2014; Piketty, 2014). This means that especially those worst off are damaged by it. If in fact inequality was lower, this would entail much more efficient markets, involving faster growth, which would be to the benefit also of those who are at the

bottom of the income distribution. Thus, in general, the domestic inequality that exists today would, according to Rawls, require a serious redistribution through a progressive tax system from the wealthy to those worse off (Musgrave, 2002). *However, such redistribution is also precisely what is being undermined by the international corporate income tax system.* Tax competition causes a decline in the statutory tax rates that apply to multinationals and their wealthy owners, and the opportunity to avoid taxes causes effective tax rates for multinationals to approach zero. Because of the international corporate income tax system, there is a redistribution taking place, however, not in a progressive but rather in a regressive direction.

A redistribution to approximate justice is the task of the distributive branch of the justice supporting institutions (Rawls, 1999, p.245). The most important of these distributive institutions is "a scheme of taxation to raise the revenues that justice requires" (Rawls, 1991, p.246). In this case that would mean a highly progressive system of taxation (Atkinson, 2016; Piketty, 2015). But national governments' capacity to engage in such progressive taxation is increasingly constrained by the risk they face of losing their tax base to lower-tax jurisdictions (tax competition). Progressive taxation is thus impeded, especially since capital is the more mobile factor and capital income weighs heavier at the top of the income scale (Musgrave, 2002). According to Rawls (1999, p. 246):

> "Social resources must be released to the government so that it can provide for the public goods and make the transfer payments necessary to satisfy the difference principle."

But governments are robbed of their capacity to do precisely this. This means that the international system of corporate income taxation is actively undermining Rawls' distributive branch of justice supporting institutions in it's attempt to satisfy the difference principle. Fairness, therefore, would indeed seem to require more progressive domestic taxation, as well as international tax cooperation to allow for the effective execution of such a tax regime (James, 2013).

So, summarizing, for Rawls the international corporate income tax system poses an inequality related injustice on several levels. On the one hand, the current international corporate income tax system is *creating* inequality that is unjust because it is not arranged according to fair equality of opportunity and because it is not to the benefit of those least well off. And while it is not the international corporate income tax system alone that is causing this rise in domestic inequality, it *is* that system that is undermining

the possibility to correct for it through domestic redistribution. So besides the fact that, according to Rawls, the international corporate income tax system is *creating* unjust inequality through forcing domestic tax systems to become more regressive, it is also actively *undermining the correction* of unjust inequality. In this sense it seems quite clear that Rawls would support the claim that an international corporate income tax system that does not cause this kind of increase in domestic socio-economic inequality nor undermines it's correction would be more just than one that doesn't, ceteris paribus.

3.2.2. Nozick and Inequality

A completely different perspective we find in Robert Nozick's *Anarchy, State and Utopia,* which represents the Libertarian approach to justice. Nozick's theory starts from the idea of self-ownership, which means that each person is the morally rightful owner of him- or herself (Solimano, 1998) and from this notion he develops his principles of distributive justice. These principles are (1) a principle of justice in acquisition, regarding the initial acquisition of holdings according to the proviso, demanding that you take while leaving enough and as good for others, (2) a principle of justice in transfer, demanding that the transfer of a good is voluntary, and (3) a principle of rectification of justice which holds that no one is entitled to a holding except by applications of 1 and 2 (Nozick, 1974, p. 151; Mack, 2015). From this, it thus follows that a distribution is just if everyone is entitled to the holdings they posses under the distribution (Nozick, 1974, p. 151). So, if in fact there exists an unequal distribution that satisfies these requirements there is, according to Nozick, no moral problem with it, even if this inequality is not beneficial to those worst off. In that sense, Nozick's theory is usually equated with the justification of a capitalist free market economy (Mack, 2015; Olsaretti, 2013). As long as the transfer of goods is voluntary, and the initial acquisition of goods satisfies the proviso, any inequality is justified.

As a consequence of this, Nozick rejects any redistributional scheme other than that required by his principles of justice (i.e. the correction of an involuntary transfer) and accordingly any state action that goes beyond the "narrow functions of protecting against force, theft, fraud, enforcement of contract and so on" (Nozick, 1974, pp. 31–1). A central authority with these functions is what Nozick calls the minimal state, and it thus restricts its activities to the protection of individual rights of life, liberty, property, and contract, and eschews the use of state power to *redistribute income*, to make people moral, or to protect people from harming themselves (Halliday, 2013; Mack,

2015). Nozick believes that unjustly taking someone's holdings violates their rights. "Holdings to which people are entitled may not be seized, even to provide equality of opportunity for others" (Nozick 2013, p. 235). Thus, a system that works to reduce the rightfully earned holdings of some, so that they can be equally distributed to others, is unjust.

Concerning taxes it follows from this view that the only justification for such interference would be the protection of important individual rights themselves. Indeed, Nozick argues that:

> "The minimal (night-watchman) state is equivalent to the ultraminimal state conjoined with a (clearly redistributive) Friedmanesque voucher plan, financed from tax revenues. "Under this plan all people, or some (for example, those in need), are given tax-funded vouchers that can be used only for their purchase of a protection policy from the ultraminimal state" (Nozick, 1974, p. 26-27).

And then proceeds to claim that:

> "[…] the transition from an ultraminimal state to a minimal state morally must occur" (Nozick, 1974, p.52).

And that:

> "[…] no state more powerful or extensive is legitimate or justifiable" (Nozick, 1974, p. 53)

Thus, government interference with economic liberty through taxation would be justified *only* to provide in national defense, a judiciary system, and a police force, in order to ensure that freedom and security are preserved for all, and contract and property rights enforced. No taxation merely to promote the general welfare, or to secure distributive justice or equality of opportunity, would be permissible (Murphy & Nagel, 2004). In fact, Nozick argues that any such from of *redistribution through taxes* would be on par with forced labor (Nozick, 1974, p. 169).

Accordingly, where Rawls would argue that if the inequality that results from a free capitalist market economy is not to the benefit of the least well-off, justice would require a redistribution through taxation, Nozick would argue that as long as the transfers in such an economy are voluntary, any state enforced redistribution would be inherently unjust. Where justice for Rawls would require a progressive tax system to counter the rise in inequality resulting from free market exchange that we witness today,

Nozick would argue such inequality does not warrant any *redistributive* system of taxation at all (Musgrave, 2002). There exists no moral problem as long as all transfers that led to this inequality were voluntary. And so if no system of redistributive taxation is allowed, it also seems no problem that tax avoidance is undermining a progressive tax system, or in fact undermining any tax system at all for that matter.

Therefor, the fact that the current international corporate income tax system is undermining any *redistributive* effort to counter inequality that follows from a free capitalist market economy does not, according to Nozick, pose an injustice by itself. But what about the fact that this system is *creating* inequality, by *redistributing* from the poor to the rich? I argue that Nozick would say these inequalities are unjust because he doesn't allow for *redistribution* through taxes. That is, Nozick explicitly claims that "redistribution through the compulsory tax apparatus of the state" is "immoral" (Nozick, 1974, p. 52). Note how Nozick speaks here of *redistribution through the tax system* specifically, and not the tax system in general, as being immoral. He does so because, indeed, his claim is not that taxation is always immoral: some taxation is required. That is, the minimal state requires taxation for the protection of rights, and the transition from the ultraminimal to the minimal state is "morally legitimate and violated no one's rights" (Nozick, 1974, p.113). Ergo, some taxes are justified. Since the minimal state and the taxes it involves are legitimate according to Nozick, it seems that indeed his problem with taxation lies with it being used as *tool for redistribution*, which is not a legitimate activity of the minimal state. It therefor seems that Nozick would think a tax system that does not redistribute, and that thus *does not affect the relative inequalities that a free market generates*, is more just than a tax system that does.

This means, I argue, that Nozick would prefer a flat rate, or proportional, tax system that does not affect relative inequalities to a progressive or a regressive system. Let's take Nozick's famous Wilt Chamberlain thought experiment as an example here. In his Anarchy State and Utopia Nozick explores the hypothetical situation that everyone in society, say 9 sports fans and Wilt Chamberlain, at point D1 has the same amount of money, say $10. Then, all the sports fans decide to go and see Wilt Chamberlain play basketball, and pay $2,50 a ticket for that privilege, which goes directly into Wilt's pockets. Now, after the match, at point D2, all the sports fans only have $7,50 left, while Wilt has $32,50. According to Nozick, since every individual voluntarily gave up $2,50 to see Wilt play basketball, everyone in D2 is entitled to his or her holdings, and so if D1 was just then so is D2. Regardless of whether the inequality at D2 is in the advantage of

those least well off (and of whether the inequalities are attached to positions open to all), it is justified because it came about through free and voluntary transactions. And so, any redistributional scheme that transfers money involuntarily from Wilt to the sports fans in order to correct this inequality would be unjust. Now, say that there exists a progressive tax system that taxes those at the top of the distribution (Wilt) at 20 percent, and those at the bottom (the sports fans) at 1 percent. We assume further that the revenue is used to provide some protection of rights that Nozick deems necessary (police, legal system, etc.). Now say that taxes are collected, and that in D3 Wilt has $26 and the sports fans all have $6,75 left. Then let's assume that indeed Nozick would say that taxation is allowed in this case to provide for this provision of rights protection. Still, D3 would not be just according to Nozick because it follows from a progressive tax regime, which is *redistributive.* The fact that everyone benefits equally, but that some pay more is not acceptable for Nozick. Why is this? I argue that it is because the inequality that exists in D2 is just, and because the inequality changes due to the tax policy. In D2 the relative inequality between Wilt and the sports fans was 0.2 meaning that the sports fans had about 20 percent of what Wilt had. Now, in D3 the relative inequality between them is about 0.25. So in D3 Wilt relates differently to the sports fans in terms of wealth than he did in D2. This means that indeed there has been some sort of redistribution, which is not what taxes are allowed to do in the Nozickean framework.

Now, my claim would be that in this sense the only tax system that would be acceptable to Nozick is a proportional tax system. If in fact everyone is taxed at the same rate, then the inequality between different individuals won't change. Any other system would discriminate either against those that choose to work more, or against those that work less (Halliday, 2013). If Wilt and the sports fans are all taxed at 10 percent, then indeed Wilt will in both D2 and D3 be 5 times as rich as the sports fans. In that sense, no redistribution has taken place, especially when taking into account the diminishing marginal utility of money.

In any case, the system that exists today is certainly not progressive or proportional. What exists today is a system that the current international corporate income tax regime, and the tax avoidance it enables, have forced it into more of a regressive model where the lowest effective tax rates apply to those at the top of the income distribution (Atkinson, 2015; Piketty & Saez, 2007; Zucman, 2015). This means that, indeed, the current international corporate income tax system causes national tax systems to become regressive and thus *redistributional.* For a regressive tax system

redistributes just like a progressive system does, except in the opposite direction: from the poor to the rich (or, in Nozick's idiom, from the needy to those who choose to work extra time (i.e. Nozick, 1974, p.169)).

Because the international corporate tax system causes national tax systems to become more regressive, I argue that Nozick would oppose it just like he would oppose a progressive tax system for the reason that they are *unjustly redistributive*. The state taking money from Wilt to give it to the sports fans would be just as unjust as taking money from the sports fans and giving it to Wilt. Besides the fact that he would probably prefer as low as tax rates as possible, I would thus argue that if there is to be taxation for maintaining the protection of rights that the minimal state is to provide (Nozick, 1974, p. 26-27), Nozick would prefer a proportional tax system to either a regressive or progressive one because *it would not be redistributive*. However, both a proportional and a progressive tax system are actively undermined by the current international corporate tax system. It doesn't matter at what percentage you want to tax capital income in the form of corporate profits, if profits can be shifted, then effective tax rates will be very low for those that are able to do so. And moreover, tax competition will still force down corporate tax rates. This means that a non-regressive tax system is not attainable, in theory at least, because corporate tax rates will approach zero if there is no international cooperation.

Summarizing the argument made above: the inequality that results from the current international corporate tax system is unjust according to Nozick because it is the result of a *redistributional* tax system that is the result of tax avoidance and tax competition. Labor has to pay taxes while capital doesn't, which means that this tax system is *redistributive* from labor to capital, which is something that Nozick would characterize as immoral and unjust (i.e. Nozick, 1974, p. 52/ 167-171).

3.3. Free Riding on Public Goods

In section 2.3.2 we saw that the current international corporate income tax system creates a situation in which multinationals, and through them their wealthy owners, are able to make use of government provided public goods, without paying for that consumption. Profits are shifted to locations that usually have nothing more to offer than their low tax rates, while at the same time the countries where these profits are created and where public goods are consumed get paid much less than this consumption costs (in other words, less than their share of what it costs the state to provide these

public goods) or sometimes do not get paid at all. Huge amounts of profits are created in the U.S. or in China for example, making use of the extensive and high quality public goods these countries offer, such as education, infrastructure and a (well-functioning) legal system (Palan et al., 2013). In order to provide these goods, states tax individuals and corporate income. But by shifting their profits to a different jurisdiction with low tax rates, multinationals are able to significantly reduce the effective percentage they pay compared to what the state asks them to pay for the public goods it provides, allowing them to ultimately pay less in taxes as a percentage of income than nearly everyone else does. This means that multinationals are able to free ride (meaning that they pay less than what they are supposed to pay, less than their fair share) for the public goods they use in the countries they operate in.

3.3.1. Rawls and Free Riding on Public Goods

In his *A Theory of Justice*, John Rawls also addresses the problem of public goods. That is, public goods are essentially goods that everyone will want more of rather than less, and so their provision is to the benefit of everyone, but when there is a large 'public' there exists an incentive to free-ride because, according to Rawls (1999, p. 236):

> "[…] whatever one man does is not going to seriously affect the amount produced".

This will be especially prevalent in the case of indivisible public goods, such as national defense. It is impossible to exclude one citizen from the protection against foreign invasions and so she will receive it, whether or not she pays taxes. Therefor it follows, Rawls (1999, p. 237) argues, that justice requires that:

> […] "arranging for and financing public goods must be taken over by the state and some binding rule requiring payment must be enforced."

This follows, because in the original position, even if all individuals would want the provision of a public good and would be willing to pay for it, they would presumably only do so if they have some reassurance that others will pay as well. According to Rawls (Rawls, 1999, p.236):

> "Assuming that the public good is to everyone's advantage, and one that all would agree to arrange for, the use of coercion is perfectly rational from each man's point of view. […] The characteristic features of

> essential public goods necessitate collective agreements, and firm assurance must be given to all that they will be honored. […] Social resources must be released to the government so that it can provide for the public goods."

So Rawls' argument is that public goods are to the benefit of all and so their provision will be agreed to in the original position. Because everyone will only want to pay for the provision of these goods, only if they know that everyone else will pay their share as well, it follows that in the original position rational individuals will also choose to establish some system that will enable the enforcement of payment. Such a system would be just, because it follows from a just procedure, namely decision-making in the original position from behind the veil of ignorance.

Now, such a system in which the payment for public goods can be enforced, an effective system of taxation, is actively undermined by the current international corporate income tax system. Indeed, in most countries, both a company and an individual would be punished if they failed to pay the taxes that they are required to pay by law. But not paying the taxes you are legally obliged to pay is tax evasion. Tax avoidance does not involve any illegal evasion of taxes. Rather, it involves aggressive, strategic, tax planning so as to avoid being legally liable to pay taxes in the first place. The current international corporate income tax system thus makes it so that multinationals have the opportunity to make use of the public goods that are provided in a certain country, without being legally obliged to pay taxes there. This shows again how these old rules for taxing corporate profits as payment for the use of public goods are no longer appropriate in a globalized economy, and clearly this is something that Rawls would characterize as a violation of justice. If, in fact, justice requires the effective enforcement of the payment for public goods (because it is the outcome of a just procedure), then it is unjust if such a system is undermined. The fact that the international corporate income tax system allows multinational companies to free ride on public goods is something that enables precisely this and it should therefor be characterized, according to Rawls, as unjust.

This means that Rawls would prefer, in terms of justice, a system that does not allow for this free riding on public goods, or, in other words, a system that does not undermine countries in their effective collection of payments for the use of the public goods that it provides, to a system that does, ceteris paribus.

3.3.2. Nozick and Free Riding on Public Goods

Nozick takes a different, but to some extent actually similar, approach to this issue of public goods. As I have described before, Nozick argues for the existence of a minimal state, where taxation would only be justified in order to provide for the protection of important individual rights (Nozick, 1974, p. p. 26-27; Murphy & Nagel, 2004, p. 65). Let me now first describe how Nozick gets to this minimal state. That is, before he argues for the minimal state, he discusses the ultra minimal state. This ultra minimal state does not allow for taxes at all, but rather it is build on the idea that individuals can buy the protective and enforcement services of the government voluntarily. This means that it is ok if you don't buy them, but then you will just have to take your chances (Mack, 2015). Nozick is very clear here on free riding: it is not to be allowed. That is, Nozick (Nozick, 1974, p. 26) argues that the state should:

> "[…] provide protection and enforcement services only to those who purchase its protection and enforcement policies. People who don't buy a protection contract […] don't get protected."

But, because Nozick is aware of the indivisibility of many public goods, especially the ones that he believes a minimal state should provide, and because he questions whether a free market would provide these goods for all (i.e. Nozick, 1974, p. 28) he argues that taxation is sometimes justified to collect the payment for them. It is not possible to say that if you do not pay, or pay less than your fair share, for the legal system you are (to be) excluded from it. And so, in the minimal state, taxation is justified, as opposed to the ultra minimal state, to support national defense, a judiciary system, and a police force, in order to ensure that freedom and security are preserved and contract and property rights enforced for all (Nozick, 1974, p. 113; Murphy & Nagel, 2004).

It seems clear enough that Nozick is opposed to free riding in that he argues that if you don't pay you shouldn't be able to enjoy those basic public goods, or, more precisely, *that you shouldn't be able to enjoy the public goods you haven't paid for*. And the fact that he realizes that sometimes free riding cannot be discouraged by the exclusion from a public good simply because some public goods are non-excludable and because his rights-based approach requires them to be provided for everyone, shows even more clearly that for Nozick taxation is justified precisely to make sure no free riding is taking place (Nozick, 1974, p.112-113). It thus seems quite clear that Nozick would also be opposed to an international arrangement that clearly undermines this system of taxation, one of the reasons of which, at least from Nozick's perspective, is precisely to make sure

free riding is not possible. Free riding on public goods is unacceptable to Nozick, and because this is precisely what the current international corporate tax system enables, it seems fair to say that Nozick would prefer a system that allows countries to effectively tax multinationals to pay for their use of public goods, to a system that doesn't, ceteris paribus.

Now this conclusion must be qualified slightly, because the provision of public goods that we see in many (developed) countries today, goes far beyond the public goods that Nozick believes are a legitimate reason for taxation (Nozick, 1974, 26). Things like infrastructure, health care and education, are, according to Nozick, not the kind of public goods that can be justifiably financed by levying taxes, since they go beyond the tasks of the minimal state (Nozick, 1974, p.53). Though Nozick would probably say that you don't get to use the public goods you don't pay for, I believe that in the sense of the minimal state he would not say that free riding on, for example, infrastructure would be unjust. Neither companies nor individuals can be legitimately taxed for the provision of infrastructure, and so not paying taxes for their use would not be unjust by itself. Everyone should in fact be able to not pay for the use of these goods if they want to. However, multinationals do not only make use of these more extensive public goods of course. Moreover, the basic public goods that Nozick thinks are a legitimate reason for taxation, are essential to any company's operations. That is, every company heavily depends on, for example, the protection of their property rights and the enforcement of contract. Arguably, companies enter into more contracts than anyone else, and usually they also have more property that needs protection. Their use of public goods that are to be provided by the minimal state is thus extensive. And the fact that these public goods are a legitimate ground for taxation, according to Nozick, means that multinationals' use of these goods without paying (their fair share) constitutes an injustice.

So, at a first instance Nozick would require that these companies only get to consume the public goods that they pay for and that they be excluded from the part of the public goods they do not pay for. However, since it is often not a viable option to exclude them from these public goods, they can be legitimately taxed in order to secure their payment for the public goods they consume. This means that if there were a system, like the international corporate income tax system, which undermines this, then that would constitute an injustice.

3.4. Chapter Conclusion

So what should we conclude from this section, in light of the institutional comparative approach introduced at the beginning of the section? What the comparative approach requires is that institutions are assessed in terms of justice without this assessment depending on one specific theory of justice. That is, it tries to establish that though different theories might disagree on what a perfectly just society is they might nonetheless agree that some injustice is going on. In that way, we could thus argue that, without having to sort out which of the various competing theories considered is the right one, we can still come to a conclusion on what a step towards, comparatively, more justice would entail. In this section I have discussed two important effects of the current international corporate income tax system, namely (1) the fact that it creates and amplifies socio-economic inequality, and (2) the fact that it enables multinational corporations to free ride on public goods. I then submitted both these effects to a normative analysis from two widely diverging perspectives, namely John Rawls' egalitarian liberalism and Robert Nozick's libertarianism. It is my claim that each of these theories would characterize both effects as unjust, even though these theories would disagree on what a perfectly just arrangement would be. Concerning the socio-economic inequality that the international corporate income tax system creates, Rawls would certainly argue that it is unjust because it violates his different principle: it is not to the advantage of those least well off, and not attached to fair equality of opportunity. At the same time Nozick would also think this inequality, and the tax system from which it results, are unjust because they constitute (result from) redistribution. Nozick would want *inequality to not be affected* by the tax system, and Rawls would want a tax system that *reduces inequality*. The current international corporate tax system, however, does neither. The basic claim is thus that though Nozick and Rawls would certainly disagree on what the right tax system is – Nozick would require a non-redistributive system (i.e. proportional) while Rawls would require a certain redistributive system (progressive) – they seem to be able to agree to the fact that a regressive tax system, which *increases inequality*, is unjust. And so, because the international corporate tax system allows multinationals to avoid paying taxes and thus creates precisely such a regressive tax system in which lower effective and statutory tax rates apply to those at the top of the income scale than to those at the bottom, both would agree to the claim that an international corporate income tax system that does not *create* inequality would, ceteris paribus, be more just than one that does.

Furthermore, although they would disagree on the exact provision of public goods and on what public goods can be justifiably financed by a tax system, it seems that Nozick and Rawls agree that a system in which it is possible to free ride on public goods, and in which it is impossible for countries to effectively collect the funds required for maintaining these goods, is unjust. For Rawls, the existence of a state to enforce the payment for public goods is something that rational individuals will decide upon in the original position, which means that undermining such a system is unjust. For Nozick, from his rights-based approach, it is precisely the protection of important individual rights and the possibility to free ride on that protection that justifies taxation by the minimal state. So, even though they might not agree on grounds for taxation and public goods, they do agree that it should not be possible to make use of public goods that you haven't paid (your fair share) for. So they would both be able to subscribe to the claim that an international corporate income tax system that does not allow for the free riding on public goods is more just than a system that does, ceteris paribus.

The agreement, regarding these two effects of the current international corporate income tax system, between the different theories of justice considered thus allows us to, following Sen's comparative approach to justice, establish premise 2: *an international corporate income tax system that doesn't cause an increase in domestic socio-economic inequality and doesn't enable some to free ride on public goods is, ceteris paribus, comparatively more just than one that does.* Together with premise 1 established in chapter two, which held that: *the current international corporate income tax system causes an increase in socio-economic inequality and allows for the free riding on public goods,* we can thus deduce conclusion 1 that: *An international corporate income tax system that doesn't cause an increase in domestic socio-economic inequality and doesn't enable some to free ride on public goods is, ceteris paribus, comparatively more just than the current one.*

This means that from a comparative point of view we can say that an institutional framework for the international taxation of corporate income that is able to avoid these two effects would be comparatively more just than the system currently in place, all other things remaining equal, *because the latter is judged to be less just along the criteria of all the theories of justice considered.* Even though such a framework might not be perfectly just from the perspective of either of the two theories included in the analysis, they might be able to agree that the one we have now is worse in terms of justice. One example of an alternative system that would be comparatively more just will be introduced in the following chapter.

4. An Alternative System

It is not only the purpose of this thesis to normatively assess the status quo, but it also seeks to suggest a possible way to change it, adhering to the famous Marxian maxim[11] that philosophers should construct a critical theory which provides both diagnosis of the faults of existing society, and also contribute in a positive way to the struggle for its transformation. It will proceed by doing so, based on the conclusion in chapter three that a transformation of the international corporate income tax system that is able to mitigate both the rise of inequality and the free riding on public goods it enables, will be *comparatively more just than the system currently in place,* ceteris paribus. The aim of this chapter is to introduce precisely such an alternative system, and to show that a move towards greater justice in international taxation is indeed possible. More concretely, this chapter will first establish premise 3, which holds that: *A unitary international corporate income tax system with formula appointment doesn't cause an increase in domestic socio-economic inequality and doesn't enable some to free ride on public goods.* Based on this premise and conclusion 1 (established in chapter three) it will then deduce conclusion 2: *a system of unitary taxation with formula appointment is, ceteris paribus, comparatively more just than the current system.*

First of all it is good to emphasize again that the solution that is proposed here, does not concern the behavior of firms. Like I did in the analysis of the problem, so also in this exposition of a possible solution will I hold on to the idea that business is doing its job: optimization and planning with the goal of maximizing shareholder value. The companies accused of not paying corporation tax to the countries where they operate have always argued that they meet all their tax obligations under the fiscal law. I grant this, and interpret that kind of argument, combined with the fact that an injustice exists, as a sign that the law (institutional arrangements) should thus be changed (Atkinson, 2015, p. 204). That is, I argue that the injustices that result from the current corporate income tax system do not call for a change of firm behavior, but rather for a change of the system though political action and political will. The fact that the current system enables corporations, and through them the wealthy one percent, to shift their tax burden onto labor and consumers, cannot be defended. It is comparatively unjust – as I have shown in chapter three – and it has no advantages in terms of welfare (Atkinson, 2015; Keen & Konrad, 2014; Piketty, 2014; Sorensen, 2004). Tax avoidance does not lead

[11] First published by Friedrich Engels (Engels, 2005, p.72) Marx's original statement (the eleventh thesis on Feuerbach) was: "*the philosophers have only interpreted the world, in various ways; the point is to change it.*"

to more sustainable economic growth or to an expansion of social benefits in any sense. In fact, it has even been shown extensively that the opposite is true (Berg & Ostry, 2011; Berg et al., 2014; Desai & Dharmapala, 2006; IMF, 2014). Tax avoidance contributed heavily to inequality through which it is harmful to sustainable economic growth, and base erosion leads to both an increasing burden on those least well off, as well as to a reduction in social benefits that are provided through tax revenue.

It is important to emphasize again that in the end the institutions we have are a social construction and the result of a political choice: we can change them if we want (Inglehart, 2016; Pogge, 2005). A possible way in which to make such a change towards a more just institutional arrangement will be introduced in the next section, namely establishing a global tax authority that administers a system of unitary taxation with formula appointment (Atkinson, 2015; Keen & Konrad, 2014; Rixen, 2008; Rixen, 2011; Sorensen, 2004; Zucman, 2014, 2015). This alternative is proposed without the claim that it is the perfect solution, and that no better alternative exists. Rather, the purpose of this section is merely to show that there are comparatively more just alternatives, and that since change is possible if there is political will, justice prescribes that inaction is not an option.

4.1. Unitary Taxation with Formula Appointment

It is important to quickly recall the issues with the current international corporate income tax system that enable the avoidance of paying taxes on corporate capital income. Remember that corporate income taxes were devised at a time when capital was much less mobile, both due to the nature of economic transactions and existing technology, as well as the existence of international protectionist barriers (Hay, 2014; McGrew, 2014). Still then, the source and arms-length principle worked fine. Different elements of a multinationals' corporate structure in different countries were simply considered as different companies for tax purposes, according to the arms-length principle, because the profits were usually still reported in the countries were they were generated (Eden, 1998; Rixen, 2008). However, globalization has changed things significantly. Today, highly mobile capital – intellectual property and financial capital – crosses borders with great ease and is able to be shifted anywhere within a multinational's corporate structure. The problem is thus that there exists a growing dichotomy between economic reality and the assumptions underlying the existing international tax system, which will have to be bridged (Rixen, 2008). Right now, in this system of national sovereignty combined with

high capital mobility and the arms-length principle, there thus exists a huge incentive for multinationals to move their profits to those parts of their corporate structure that are incorporated in jurisdictions with highly favorable tax regimes. The incentives for companies to use transfer pricing, and other devices, to shift profits between jurisdictions - and for governments to design their tax systems to affect that incentive - would be removed if, instead of seeking to identify profits earned in particular jurisdictions, *taxes were simply levied on the aggregate of a multinationals' profits over all jurisdictions* (Keen & Konrad, 2014). This is a system that is called unitary taxation with formula appointment (Rixen, 2008; Rixen, 2011).

The central idea behind this system of unitary taxation with formula appointment is that, instead of treating multinationals a consisting of separate companies in different countries, they should be treated as one single corporation, and their profits should be pooled together and distributed among the countries involved (Keen & Konrad, 2014; Palan et al., 2013; Sorensen, 2004; Zucman, 2014, 2015). First of all this would thus require the establishment of some international tax authority, that would administer the process. Right now, the profits that companies generate are taken up in the tax base of the country where they are reported, which means mainly the tax bases of tax havens that levy virtually no taxes on corporation's income. What a system of unitary taxation with formula appointment would consist of firstly, would be the transfer by all countries in which the corporation is incorporated, of that part of their tax base that represents the companies' reported income. On the basis of these parts of national tax bases that are transferred to it, the international corporate tax authority would then establish a *common consolidated corporate tax base*, which represents *a corporation's global profits*.

Let's take again, as an example, the case of Canadian Cigarettes that was introduced in chapter two. In that case we saw that the company reported only very small profits in Turkey and Canada by shifting the major part of their income to the Netherlands and the Cayman Islands. A system of unitary taxation would require all these countries to transfer the profits Canadian Cigarettes and all its subsidiaries report (and that in the current system they are simply allowed to tax) to an international tax authority, which would then establish a common consolidated tax base for Canadian Cigarette's representing their global capital income.

As a next step, this common consolidated tax base would then have to be distributed among the countries involved. This would happen according to some formula

that represents *real economic activity*.[12] Right now, what is important for tax purposes is mere *legal presence*. Companies are able to generate profits in the one country and then have them taxed in another country where they have no more than a mailbox to establish their presence for the law (Palan, 2006; Palan et al., 2013; Zucman, 2015). It is quite straightforward that profits should be taxed where they are created, where economic activity takes place This was not a problem before capital became so mobile, but it is now, for it is possible to move your profits to a jurisdiction other than where they are generated.

There is quite some debate on what such a formula that should distribute the common consolidated tax base should look like exactly, but there seems to be a reasonable amount of agreement that it should represent some combination of sales, production, payroll and assets located in each country (Keen & Konrad, 2014; Rixen, 2008; Sorensen, 2004; Zucman, 2014, 2015). So instead of legal presence, corporations would be taxed based on their economic presence/ activity. For actual trade and production of goods, it seems rather clear what real economic activity consists in (i.e. factories or shops), while for intellectual property this is more diffuse. In both cases, however, it is important to look at *where and how value is added* (Zucman, 2015; Keen & Konrad, 2014). Therefor, most accounts of unitary taxation with formula appointment suggest looking at research and development activities in the case of intellectual property rights. That is, in the case of profits made by the collection of payments for the use of patents etc., the taxation of these profits should take place in the country where these patents were developed, and not simply where they are held (Eden, 1998; Sikka & Willmott, 2010; Zucman, 2015)

Unitary taxation with formula appointment thus means that an international tax authority attributes to each country a share of aggregate profits representing a multinational's economic presence in its jurisdiction. Another important element of the system is that each country may then tax the share it receives *at whatever rate it chooses* (Eden, 1998; Keen & Konrad, 2014; Rixen, 2008). This is important, because transferring part of their tax base to an international institution to some extent constitutes a violation of state sovereignty the way it is now. However, it is actually only a minimal sacrifice of sovereignty that will in effect enable countries to regain *de facto* control over their tax policies (Rixen, 2011). Countries will no longer be forced to cut corporate tax rates to attract capital, or keep it from fleeing the

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[12] Much debate is going on regarding what such a formula should look like, but in general real economic activity means those activities that involve the production, distribution and consumption of goods and services. It are those activities that add or create value, that generate income.

country. This is so because under a system of unitary taxation with formula appointment, there no longer exists the possibility for companies to move their profits abroad without moving their economic activity as well. And this is precisely something that multinationals do not want to do if there are only tax benefits to be gained. That is, Apple has no interest in moving its research and development facilities out of Silicon Valley, nor does it want to transfer its production or sales facilities (factories, shops, etc.) to the Bahamas, simply because the Bahamas lack almost all the elements that such activities require (i.e. good infrastructure, a large and well-educated population, etc.).

This also immediately shows how free riding on public goods will be banned. Generating profits heavily depends on the use of public goods, and so companies generally use most public goods in the countries where they have their economic activity. Now, since taxation of profits becomes linked to economic activity, so does the use of public goods become linked to economic activity. So countries where companies are very active in a real economic sense, will now be able to actually collect payment for those companies' use of the public goods that the country provides. If the price they ask is too high, companies are still free to move and not pay. But if they use them, then they pay.

In general, such a system is thus to be expected to put an end to tax competition, simply because making use of low tax rates on profits would, in this alternative system, necessarily also involve shifting economic activity (Keen & Konrad, 2014; Slemrod & Wilson, 2009; Zucman, 2015). Because these two are now linked, competition for capital will consist much more in providing those circumstances that are required for profitable economic activity, and mere fiscal advantages will not be enough to draw capital into your country.

Let's take the case of Canadian Cigarettes as an example again to expose the workings of this system a bit more precisely. So, indeed, the profits that the company reports in all the countries in which it is active, are collected by an international tax authority that establishes a common consolidated tax based from Canadian Cigarette's global profits, which it then distributes, according to a formula representing real economic activity, among, in this case, Turkey, Canada, the Cayman Islands and the Netherlands. In the example of Canadian Cigarettes we saw that the 'distribution' of profits under the old system did not at all represent economic activity. While production took place in Turkey and sales, research and development in Canada, most profits were reported in the Netherlands and in the Cayman Islands, where Canadian Cigarettes only has a legal presence in the form of mailbox companies that do not employ a single

employee or sell a single cigarette. Under a system of unitary taxation with formula appointment, an international tax authority would distribute Canadian Cigarette's profits according to economic presence, which means that they would be distributed mostly to Turkey and Canada. In Turkey the cigarettes are produced, in Canada Cigarettes are sold. And in these countries Canadian Cigarettes has its assets in the form of distribution networks and factories, and the research and development department that developed the brand. Under this international tax regime it would require Canadian Cigarettes to move all its production, research and development or its sales to, for example, the Cayman Islands in order to make use of the tax rates there. In that case the Cayman Islands would be assigned a substantive part of Canadian Cigarette's profits. However, the Cayman Islands only has a very small population to employ or to sell to, and its climate is not favorable for tobacco production. In other words, the fact that the Cayman Islands offers low tax rates is no longer enough to incentivize Canadian Cigarettes to move its profits there. Real economic activity stays in Turkey and in Canada, and accordingly they are now assigned the major share of the profits which they can tax in whatever way they see fit. This also enables Turkey and Canada to collect the payment they require for the use of public goods in their respective jurisdictions. Under the status quo, Canadian Cigarettes made extensive use of the public goods (i.e. educated population, enforcement of property rights and contract law, infra structure etc.) of both Canada and Turkey. However, they paid very little in taxes in precisely those countries. At the same time Canadian Cigarettes did hardly place a burden on the public goods provided in the Netherlands or in the Cayman Islands, but still this is where they were being taxed.

Furthermore it is important to remember that this alternative system of international corporate income taxation allows any country to adopt whatever tax scheme they want. They can tax the share of the consolidated tax base that they are assigned at any rate they choose. And because tax rates are no longer a (major) driver for attracting capital – because this is now bound to real economic activity – they are indeed de facto free to choose their tax rates without having to fear the extensive flight of capital. There are some restrictions of course. If a country would choose to tax profits at 90 percent, for example, then it would probably be more profitable for a company to move. So it is not the case that tax rates won't play a role at all. But their ability to attract capital would be greatly restricted by the requirement that the tax base to which they apply represents real economic activity. This means that countries can now adopt a proportional tax

system (which Nozick would think is just) or a progressive tax system (which Rawls would think is just) but they would no longer be forced to cut corporate tax rates and compensate by increasing taxes on labor and consumption, thus creating a regressive tax system that contributes to inequality. Though Nozick and Rawls may disagree on what would be the best system – proportional or progressive - they would agree that a system that involves regressive redistribution is unjust. And indeed, the national tax systems of many countries today have become more and more regressive (Atkinson, 2015; Piketty, 2014; Piketty & Saez, 2007). The fact that the rich have become richer much faster than the poor over the past few decades, causing the accumulation of the lion's share of the worlds wealth in the hands of only one percent of the population, is something that the current international corporate income tax system has heavily contributed to (Atkinson, 2016; Bourguignon, 2016; Piketty, 2014). Effective tax rates for the rich are much lower than they are for the poor, and countries have no *de facto* sovereignty to do anything about it. If tax rates on corporate income are increased, profits will simply be shifted, and if tax rates on labor or consumption are lowered then it won't be possible to maintain the current welfare state or even a minimal state that Nozick would prefer.

What the above has attempted to show is that adopting a unitary tax system with formula appointment can mitigate both free riding on public goods and the rise in inequality as a consequence of a regressive income tax system. This thus establishes premise 3 that: *A unitary international corporate income tax system with formula appointment doesn't cause an increase in domestic socio-economic inequality and doesn't enable free riding on public goods.* Taxation of corporate income would be reconnected to economic activity, and thus the use of public goods. Furthermore this would allow countries to adopt any tax regime they want on a national level. Both theories of justice considered in this thesis, that of Rawls and that of Nozick, should thus be able to agree that this is indeed a step towards more justice, and following Sen's comparative approach to justice we can thus conclude that: *a system of unitary taxation with formula appointment is, ceteris paribus, comparatively more just than the current system* (conclusion 2).

And such a system is not in fact a Utopia at all. A unitary tax system with formula appointment is already in place among for example the different states in both the US and Canada, that previously (pre early 20th century) witnessed an interstate form of tax competition eroding state tax bases (Brownlee, 2006; Thorndike & Ventry, 2002; Zucman, 2015). In these countries, profits of companies are now pooled into a nation-wide common consolidated tax base, which is then distributed among the different states

according to a complicated formula that accounts for sales and employment. States are then free to set any tax rate they want. A proposal for a similar system with the goal of tackling tax avoidance is also currently under review by the different European institutions (Oliver, 2015).

Implementing such a system on a national level would, of course, be much more of a challenge, but there is in fact no reason why this cannot be done in small steps at a time. Theoretically, it seems that there would be no real solution unless every country in the world participates in such a scheme, for otherwise there would always still be an incentive for corporations to move their profits to those countries that are not playing ball. This does not mean, however, that smaller advances towards such a system would not bring benefits. Both Zucman (2015) and Sorensen (2004) emphasize that setting up such a system between the United States and the European Union would already bring significant advances in welfare. Similarly there are many other countries that would benefit greatly from joining such a system, and together these countries will be able to put economic pressure on tax havens to participate as well (Zucman, 2015). As Zucman (2015) argues for example, all small economy tax havens depend heavily on foreign markets and so it should not be too difficult to get them on board once there is a system in place that involves those big economies on which they rely (Zucman, 2015). Additionally, the benefits of regional cooperation have been confirmed in several studies (i.e. Keen & Konrad, 2014; Sorensen, 2004; Zucman, 2014) that, although they all emphasize the importance of aiming for global cooperation (which would bring significant welfare benefits) underline the potential gains that come with cooperation on a lower level (which are important results in light of the *ceteris paribus* clause in the normative argument). In any case it seems that such a system would come with a significant potential for an increase in welfare, while continuing in the way things are organized at this moment will quite certainly bring about the opposite.

4.2. Chapter Conclusion

The purpose of this fourth chapter was to introduce one possible alternative system of international corporate income taxation, which would be more just than the one currently in place. It was not the purpose of this chapter to argue in anyway that indeed this system is 'the right one'. There might very well be better systems out there, but that is not the point of this exposition. Rather, what I wanted to show in this chapter is that there are indeed arrangements possible which would be *comparatively more just*. One such

arrangement is that of unitary taxation with formula appointment, which involves the collection of multinationals' global profits into one common consolidated tax base and the distribution of these profits among the countries in which the company is active, on the basis of real economic activity. In that way, multinationals will no longer be able to avoid paying taxes in the countries where they generate their income with the effect that *a unitary international corporate income tax system with formula appointment doesn't cause an increase in domestic socio-economic inequality and doesn't enable some to free ride on public goods* (premise 3). From this premise, and conclusion 1, we can thus deduce conclusion 2: *a system of unitary taxation with formula appointment is, ceteris paribus, comparatively more just than the current system.*

5. Conclusion and discussion

5.1. Conclusion

In this thesis I have given an exposition of how the current corporate income tax system works, why the consequences it brings about are unjust from a comparative point of view, and introduced a possible alternative system that would, ceteris paribus, be more just than the one currently in place.

First of all I explained how due to the increased mobility of capital, corporate profits are able to move freely between elements of a multinational's corporate structure in different countries. Combined with the source taxation of corporate profits, and the fact that the different entities of multinational corporations in different nations are seen as separate entities in the current system of international corporate income taxation, this allows multinationals to avoid or minimize taxes in high rate countries where they generate their profits.

I then identified two important consequences that follow from this system, and the tax avoidance it enables, thus establishing the first premise of the thesis' central argument::

> **Premise 1:** The current international corporate income tax system causes an increase in domestic socio-economic inequality and enables free riding on public goods.

I then proceeded to the normative assessment of these two effects of the current international corporate income tax system. Here I showed that though they might not agree on what a perfectly just system would entail, both Rawls and Nozick could agree to the claim that the identified effects are unjust. I thus argued that both theories considered would be able to agree to the statement that a system that doesn't have these effects would be more just than one that does, given that all other things stay constant, which, following Sen's comparative approach, allows for the deduction of premise 2:

> **Premise 2:** An international corporate income tax system that doesn't cause an increase in domestic socio-economic inequality and doesn't enable some to free ride on public goods is, ceteris paribus, comparatively more just than one that does.

Having established premise 1 and premise 2 allowed for the deduction of conclusion 1:

> **Conclusion 1:** An international corporate income that doesn't cause an increase in domestic socio-economic inequality and doesn't enable some to free ride on public goods is, ceteris paribus, more just than the current one.

In a more constructive section I then continued by introducing an alternative to the current international corporate income tax system: unitary taxation with formula appointment. I showed how this system would be able to avoid the two effects identified in chapter two, thus establishing premise 3:

> **Premise 3:** A unitary international corporate income tax system with formula appointment doesn't cause an increase in domestic socio-economic inequality and doesn't enable some to free ride on public goods.

Premise 3 and conclusion 1 then allowed for the deduction of conclusion 2:

> **Conclusion 2:** A system of unitary taxation with formula appointment is more just, ceteris paribus, than the current system.

5.2. Discussion

In this discussion I would like to give some suggestions for future research relating to both the success and the weaknesses of the project undertaken in this thesis.

First and foremost, this thesis has explored (as far as I am aware, in one of the first attempts to do so) the applicability of Amartya Sen's comparative approach to justice to an actual, and timely, political economy issue, namely that of tax avoidance. And the results are positive. That is, though political philosophy has for a long time tended to paralyzed itself by remaining in endless discussions about perfectly just societies, this thesis has confirmed Sen's theoretical suggestion that resolving these discussions is not necessary for coming to a conclusion on how justice *in the world* can be improved. The results of this thesis thus (in both its theoretical as well as its constructive dimension) warrant optimism about the application of political philosophy from a comparative approach. It is possible to come to concrete positive normative recommendations, without that depending on a single theory of justice that can just as easily be contested, making such recommendations of little practical relevance. It is my convictions that the fact that this thesis applied such a comparative approach to justice with a positive result *should motivate* future research exploring its applicability to other real world political economy problems as well (i.e. inequality in general, immigration, discrimination, tax evasion, etc.). Why stop at tax avoidance? The advancement of justice

is a crucial undertaking that has been impeded by the inability to come to a decision on what the right principles of justice are. However, this thesis has shown that, as Sen has argued, the advancement of justice does not depend on such a decision. We've seen now that a comparative approach can be successful, and in that way I would say that this thesis provides an important motivation for exploring the applicability of the same approach to other issues.

However, I am aware of the fact that this thesis, and its positive result (on which my previous suggestion for further research builds), come with some caveats on which their success is dependent. This provides another way in which this thesis asks for further research, for these caveats are mainly the result of the limited capacity of this thesis, and so further research should be able to go a long way in filling up those lacunas.

First of all the argument in this thesis builds on a ceteris paribus clause. That is, the project only investigates two effects of tax avoidance and the current international corporate income tax system, simply assuming that all other things remain equal in an alternative system that mitigates these effects. More concretely, in the case of unitary taxation with formula appointment, it might be so that though this system manages to mitigate free riding on public goods and (part of) an increase in domestic socio-economic inequality, it comes at a cost to welfare or that it causes other injustices (note however how chapter four already briefly mentioned some results that suggest the opposite). The claim that a system would be more just than the system that exists right now is, therefor, heavily dependent on the assumption that it doesn't cause such other injustices, or mitigates any positive effects that the current system might have. Determining whether this is the case or not requires a much more extensive and comprehensive exploration of the current international tax system, it's effects, any proposed alternatives, and of course also their normative assessment. This is, clearly, something that goes far beyond the capacity of one thesis, which is why its argument depends on a ceteris paribus clause. It can of course be questioned whether one can every really get rid of such a clause, for as it is often argued in philosophy of science one can never be sure of all the effects and confounding factors involved. But, no doubt it is possible to take into account much more than what is incorporated in this thesis, thus limiting the amount of things that have to be *assumed* to remain constant. In that way, future research could thus, through both theoretical and empirical research, broaden the scope of this project in terms of effects that are taken into account, and contribute to a more solid foundation for the results of this thesis, especially regarding its practical implications.

Another way in which future research could contribute to (or undermine!) the results of the thesis, is by broadening the scope of the comparative approach itself. The strength of the comparative approach very much depends on both the number and the range of theories considered. In this thesis, this approach depends on only two theories of justice, namely that of John Rawls and that of Robert Nozick. Again, due to constraints both in time and in space it would go beyond the capacity of this thesis to involve more theories of justice than just these two. Nonetheless, this does represent its Achilles heel. While I have argued that indeed the differences between the two theories considered goes some way in achieving the broad range that the comparative approach requires, it is still a fact that the claim in this thesis (more specifically the second premise) builds on only two of them. There are many more plausible theories of justice out there, and so this project would benefit greatly from future research increasing both the range and number of theories considered.

Clearly the directions for future research suggested above are related. That is, the strength of the results of such a comparative approach (also applied to different subjects) would benefit greatly from a broadening of scope both in terms of effects and theories of justice taken into account. In other words, a strong and comprehensive application of the comparative approach to justice requires a broad perspective in both dimensions: more (wide ranging) theories applied to more effects. Therefor I think that future research in these directions can indeed serve to unlock a much greater power embedded in the application of the comparative approach to justice, of which this thesis has only provided an initial exploration.

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