Towards a Fair Fiscal Contract? What Do the Private Sector and High-Net-Worth Individuals "Owe" Society?

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Three consecutive crises–the 2007/08 financial crisis, the COVID-19 pandemic, and the war in Ukraine–have interrupted the implementation of the Sustainable Development Goals (SDGs), most notably disrupting three decades of progress in the steady eradication of poverty and leading to an increase in the number of people living in poverty for the first time in a generation.[2] In actual fact, these crises only impeded progress in SDG implementation that was already slow and exposed the fragility of the advances made. A review of the targets notes that approximately half are "moderately or severely off track and over 30 per cent have either seen no movement or regressed below the 2015 baseline".[3] Consequently, there is growing concern that without urgent action, countries will not be able to meet the SDGs by 2030.

At the same time, Governments are under pressure to do more with less, and the cost of servicing public debt absorbs a higher proportion of revenues than ever before. This is compounded by high inflation rates in both developed and developing countries; though rates have eased gradually in 2023, they are expected to remain above central bank targets, which has led to interest rate hikes and exposed further debt vulnerabilities, especially in developing countries.[4] Citizens are increasingly concerned that the costs and benefits of globalization are not being fairly shared, evidenced by the growing inequities in the distribution of income and wealth. Real wages are falling, and household expenditure budgets are under strain. All of this has intensified existing populist ideologies and led to a greater political focus on whether different segments of society are paying their fair share of taxes, which in turn has prompted the emergence of new international initiatives to tax multinational enterprises (MNEs) and a reassessment of the way Governments go about taxing high-net-worth individuals (HNWIs).

In the wake of the pandemic, media scrutiny has reinforced pressures to quell growing income inequalities. The pandemic created approximately one billionaire every 30 hours as energy, pharmaceutical and technology companies responded to the crisis.[5] Media coverage during this period led to growing support for the introduction of policies to bridge the wealth gap, including increases in taxation in some countries.[6] Among Governments and international organizations, the taxation of MNEs and HNWIs is now seen not only as a way to increase revenue in a strained economic environment, but also as a means to reduce wealth and income inequalities. While many of the issues discussed apply to both developed and developing economies, the solutions available to most developing countries are limited by the capacity constraints in their tax administrations and the political environment.

Why is fairness important?

Modern tax systems rely on the vast majority of taxpayers voluntarily complying with the rules. Attitudes towards compliance depend on a range of factors. Are Governments providing citizens with the services they need in an efficient and uncorrupt manner? Are taxpayers' perceptions of the fairness of the distribution of the tax burden positive, or do they feel that the rich and larger MNEs are avoiding their fiscal obligations? Is the tax administration free of corruption and ensuring that the treatment of all taxpayers is consistent and transparent? Attitudes to compliance are also shaped by the effectiveness of tax controls and auditing systems and the ability of the tax administration to identify non-compliance and to prosecute those engaged in tax evasion and aggressive tax planning. Put another way, what is the likelihood of getting caught? This is the backdrop against which Governments are reviewing their approaches to taxing MNEs and high-net-worth individuals and to mobilizing their domestic resources, which are mainly made up of tax revenues.

Taxation of multinational enterprises

MNEs have the capacity and opportunity to adopt tax planning strategies that take advantage of mismatches and gaps in international tax rules to "artificially shift profits to low or no-tax locations where they have little or no economic activity" in order to reduce their tax liability.[7] This risk is heightened in the wake of digitalization, which proactively facilitates and expands opportunities for tax avoidance/evasion, as the assets and activities of digital firms are highly mobile. Profit-shifting is estimated to cost countries $100 billion to $240 billion in revenue losses annually.[8] More importantly, it undermines the fairness and integrity of the tax system and negatively impacts tax morale as MNEs that have such tax planning strategies gain a competitive advantage over domestic companies. Countries have also seen decreases in corporate tax rates; for instance, Organisation for Economic Co-operation and Development (OECD) countries saw headline tax rates decline from 32.3 per cent in 2000 to 23.1 per cent in 2022, while countries in Africa saw a decline from 34.2 per cent in 2000 to 25.8 per cent in 2022.[9] Globalization gives MNEs the ability to seek out

locations that minimize production costs and maximize profits, and to the extent that tax is seen as a cost, countries have been engaged in a race to the bottom through reductions in the corporate tax rate and incentives intended to lower the effective tax rate–further reducing the revenue collected.

A number of global initiatives have been adopted to respond to these challenges. Following the 2007/08 financial crisis, the OECD base erosion and profit shifting (BEPS) project was launched by the Group of 20 (G20) to limit opportunities for profit shifting by addressing the mismatches in international tax rules. The OECD/G20 Inclusive Framework on BEPS includes 15 action plans that provide recommendations and guidance for Governments to tackle tax avoidance. This initiative represents one of the earliest concerted efforts undertaken to ensure that profits are taxed where economic activities take place and where value is created. Although it is too soon to measure the actual success of the BEPS recommendations, there has been a shift in attitude on the part of the MNEs, which now recognize the reputation risks attached to aggressive tax practices.

In 2021, a new two-pillar plan (BEPS II) was incorporated within the OECD/G20 Inclusive Framework to keep pace with the emerging challenges deriving from the development of the digital economy.[10] Pillar I involves the reallocation of taxing rights to market jurisdictions for taxable entities with or without a physical presence, and Pillar II aims to curb tax competition by introducing a global minimum effective tax rate of 15 per cent on income from large MNEs within their respective market jurisdictions. The minimum tax is implemented through the adoption of two main rules at the domestic level: (a) the Income Inclusion Rule (IIR) requires an ultimate parent entity to pay a top-up tax in its resident State on its share of the income of any low-taxed constituent entity[11] in which it has an ownership interest; and (b) the Undertaxed Payment Rule (UTPR) acts as a backstop to the IIR, providing an adjustment mechanism that takes care of any remaining top-up tax on the profits of a constituent entity that is not captured under the IIR.

It is too early to determine whether this new framework is fit for purpose and whether it will achieve the desired results. The greatest beneficiaries from Pillar I may be the larger market jurisdictions, which will receive a larger portion of the profits, while the impact on smaller market jurisdictions is expected to be minimal. Under Pillar II, developed countries may be the main beneficiaries, as a large number of ultimate parent entities are located in these countries, which are responsible for charging the top-up tax under the IIR. To mitigate potential revenue loss, developing countries have the option to introduce a qualified domestic minimum top-up tax, though this may create new challenges for administrations that already have limited capacity. In addition, the new framework may introduce constraints on countries' ability to design their corporate income tax systems in ways that are best adapted to their economies, particularly when it comes to the use of incentives and a requirement to eliminate digital services taxes.

Beyond tackling digitalization and tax competition issues, increasing compliance among MNEs is important. New technologies afford opportunities for tax administrations to improve the collection, management and sharing of data and to increase overall efficiency. Clearer tax laws, more efficient tax administration, and robust dispute resolution settlement mechanisms would enhance tax certainty, which would encourage voluntary compliance among MNEs. In recent years, a number of countries have set up cooperative compliance programmes that are intended to provide greater predictability and certainty for MNEs.

Taxation of high-net-worth individuals

In spite of the significant progress made in strengthening tax transparency and the exchange of information between countries, there remain gaps and loopholes that allow HNWIs to employ offshore and onshore tax planning strategies to minimize their tax payments. It is estimated that offshore wealth as a share of gross domestic product (GDP) ranges between 5 and 40 per cent depending on the region under review.[12] The countries of the Middle East and North Africa are at the higher level, with estimates of 40 per cent, while estimates for Southern Asia are closer to 5 per cent.[13]

Countries continue to experience difficulties in getting access to information on who owns and controls offshore vehicles such as holding companies or trusts. This is why there is a growing political consensus that Governments should reassess the use of net wealth taxes, inheritance and gift taxes, taxes on capital gains, and excise taxes on luxury products and services.

Organizations as diverse as the International Monetary Fund (IMF), the World Bank and Oxfam have called upon countries to introduce annual net wealth taxes (NWT). Oxfam estimates that an annual graduated tax on the rich could raise approximately $2.5 trillion a year, which could be used to help countries recover from the economic crisis and as a tool to address wealth inequalities.[14] NWT, combined with more effective inheritance, gift and capital gains taxation, could make a substantial contribution to revenue mobilization and–of equal importance–could influence perceptions of tax fairness and build greater trust in government.

At this point, it is worth asking why so few countries use NWT. Part of the answer is that they fear this would lead to an exit of HNWIs to low-tax jurisdictions. Another explanation is that such taxes have traditionally been difficult to administer and, in practice, have not always yielded much revenue. However, in today's more transparent environment–where tax administrations have unprecedented access to information,

especially on assets held offshore—it is far more difficult to hide wealth. In addition, new technologies such as artificial intelligence (AI), machine learning and blockchain offer administrations new ways to collect, store and use data to track assets. These two developments provide a more conducive environment for operationalizing NWT and other taxes on capital and property. In addition, they enable up-to-date asset valuation (outdated valuations constitute a common problem with such taxes).

Within this new context, the IMF and the World Bank recently advocated a rethinking of wealth taxes as a way to finance the cost of the pandemic and to finance assistance programmes for low-income households, which have seen their real incomes decline because of price increases in energy and other basic goods and services.[15] Argentina introduced a one-time levy on citizens with assets over $2.5 million dubbed the "millionaire's tax" to pay for medical supplies and relief measures during the pandemic.[16] In Colombia, a bill was recently approved that establishes a permanent annual "equity tax" charged to individuals with a net worth above approximately $600,000.[17]

Taking the debate forward

Governments have the power to change perceptions of the fairness of the tax system, which in turn can strengthen their relationship with the public. In an age of tax transparency and with the technologies now available, Governments can broaden the tax base by reviewing and revising the way they go about taxing MNEs and HNWIs. This debate has to extend beyond personal and corporate income taxes. It has to encompass value-added and goods and services taxes as well as other taxes on consumption, with particular attention given to luxury products. Governments need to review the way they tax wealth and capital, especially immovable property. More resources must be provided for tax administrations to strengthen tax compliance through better enforcement and the improvement and expansion of taxpayer services. New technologies such as AI, machine learning and blockchain can play a key role here, but this must be accompanied by a review of taxpayers' rights in the digital age.

Building a political consensus for change is vital. One of the best investments Governments can make—especially in developing countries—is enhancing the capacity of tax administrations to enforce the tax rules fairly. This would include, among other things, the training of tax administration staff and legislative reform to allow the sharing of information and the digitalization of tax administration. More generally, Governments need to promote a "win-win" approach to taxation, especially in their relationship with MNEs, moving away from the zero-sum "you lose, I win" mentality. This is the rationale behind cooperative compliance programmes.[18] Stronger, assertive action is needed to counter all forms of illicit financial flows, which not only undermine the revenue base but also erode confidence in the Government.

Throughout this process, the United Nations represents the only truly inclusive forum and can play a leading role in developing standards that work for developing and emerging economies, intensifying capacity-building programmes, and providing a collaborative space where Governments, business communities, academics and civil society can come together to design a tax system which promotes fairness and contributes to the achievement of the SDGs.

Endnotes

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8 Ibid.

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10 The Inclusive Framework was established in 2016 and presently comprises 142 country members (jurisdictions) collaborating on the implementation of the BEPS action plans.

11 Defined in article 1.3 of the Global Anti-Base Erosion Model Rules; see https://read.oecd-ilibrary.org/taxation/tax-challenges-arising-from-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two_782bac33-en#page7.

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18 See additional details on the principles underpinning the cooperative compliance concept in Jeffrey Owens and Jonathan Leigh Pemberton, *Cooperative Compliance: A Multi-Stakeholder and Sustainable Approach to Taxation* (Wolters Kluwer, 2021).