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POLICY BRIEF

23-4 The international tax agreement of 2021: Why it's needed, what it does, and what comes next?

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INTRODUCTION

In 2021, more than 135 jurisdictions representing about 95 percent of the world economy undertook a political agreement to transform the future of international taxation. In December 2022, the European Union unanimously moved forward to implement this minimum tax; other countries, including South Korea, Japan, Australia, Canada, and the United Kingdom, are either implementing it or taking substantial steps toward doing so.

The agreement comprises two pillars. Pillar 2 includes a country-by-country minimum tax of 15 percent on multinational company income, regardless of where it is reported. Pillar 1 reallocates some portion of the multinational company tax base toward market jurisdictions. (For details on the agreement, see the appendix.)

The agreement acknowledges that longstanding international tax principles were ill-suited to a modern global economy, creating large discrepancies between the location of economic activities and the reporting of taxable income. Further, countries' uncoordinated policy actions undermined tax sovereignty, leaving governments unable to tax increasingly mobile capital income, and wracked with competitiveness concerns should they attempt to singlehandedly stem corporate tax base erosion.

By coordinating a response to such pressing policy concerns, the agreement sought to solve a global collective action problem in which competition among jurisdictions led to ever lighter tax burdens on mobile multinational income. By working together, countries could address not just tax base erosion, but also tax system fairness, efficiency, and tax administration objectives. Although the international agreement provides an incomplete solution to these longstanding policy problems, it represents an enormous step forward for international tax cooperation.

This Policy Brief describes the impetus for the international tax agreement, evaluates the international tax reforms in terms of their objectives, and discusses the future of international tax cooperation in the years ahead. It also draws lessons for multilateral cooperation in other vexing policy areas, including climate change.

In tandem with these international developments, the United States should reform its international tax system. Even absent the agreement, there are many compelling reasons to adopt a stronger minimum tax. Stemming corporate tax base erosion and profit-shifting would increase US tax revenues while creating a more fair and efficient business tax system. At present, foreign adoption of the global minimum tax facilitates US policy action. Although US reforms have long been impeded by (oft exaggerated) fears that taxes on foreign income would render US companies uncompetitive, the implementation actions of the European Union, South Korea, and other countries demonstrate that any such risks are now much smaller. Beyond building a US tax system fit for purpose, US progress on international tax reform would enhance much needed international cooperation, helping address other global collective action problems.

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THE PRESSING NEED FOR INTERNATIONAL TAX REFORM

The international tax agreement of 2021 was born out of a common understanding that the international tax system was fundamentally flawed. The status quo was built on an intellectually bankrupt foundation that fueled corporate tax base erosion, reduced economic efficiency, and turbo-charged inequality. Government attempts to defend this crumbling foundation generated byzantine rules and mind-numbing complexity.

At the root of the problem lies the arm's length standard, which is both a deeply appealing ideal and a fiction. Under this standard, multinational companies are expected to price transactions among affiliated entities as if they were occurring at arm's length among unaffiliated entities. The very premise of this concept is faulty, as multinational enterprises exist in part to generate profits beyond what would be possible for domestic companies operating at arm's length. In addition, the global nature of market activity makes it difficult to ascertain where profit is truly generated, and the intangible nature of much economic value adds even more ambiguity. These factors, alongside a lax regulatory and legal environment, give multinational companies substantial discretion about where they report their profits for tax purposes, making the tax department a "profit center" for many multinational companies.

Within this context, governments have responded to fears of tax base mobility, especially the mobility of jobs and investment, by lowering corporate tax rates.[1] At the same time, multinational companies are adept at moving profits across jurisdictional boundaries without moving the associated economic activity, leading to situations in which profits per employee were orders of magnitude higher in low-tax jurisdictions.[2] As a consequence of this tax base mobility, historically high corporate tax profits often generated only flat or decreasing corporate tax revenues.[3] For most governments, the choice of lower tax rates did not stem tax base erosion, as profit-shifting was destined for jurisdictions with rock-bottom tax rates.

1 See Keen and Konrad (2013) and Heimberger (2021).

2 See Clausing (2020a); Tørsløv, Weir, and Zucman (2022); and Wier and Zucman (2022).

3 See OECD data on Tax on Corporate Profits.

The race to the bottom in corporate taxation is an example of a prisoner's dilemma. Countries acting solely in their own interest found it appealing to lower their tax rates, because doing so helped them either attract corporate tax base (if other countries' rates remained high) or avoid losing corporate tax base (if other countries were also reducing rates). As each country operating noncooperatively has a strong incentive to lower tax rates, together they chose lower rates than would be optimal with coordination. Although international tax coordination and tax treaties have historically been viewed as necessary to eliminate the possibility of double taxation, over time, governments realized that cooperation was also needed to address the possibility of double nontaxation.

Cooperation on international tax has the potential to achieve three big objectives for governments: reducing corporate tax base erosion, building fairer tax systems, and promoting economic efficiency.

1 **Reducing tax base erosion:** There is a strong consensus in the literature that corporate tax base erosion is a large and pressing problem.[4] Although data in this area can be muddy and scholars do not always agree on the precise scale of the problem, there is clear consensus that hundreds of billions of dollars are at stake. For example, the United States sets a minimum tax on the foreign income of US–based multinationals, known as the Global Intangible Low-Taxed Income (GILTI) tax (see the appendix for details). A country-by-country reform of the US GILTI tax would raise hundreds of billions of dollars in revenue; this reform would also raise the GILTI rate and reduce the amount of exempt income. Estimates of the 10-year revenue gain from four independent sources range from $442 billion to $692 billion.[5] Although the reform is more ambitious than Pillar 2 reforms, it shows the large revenue potential of such reforms in the United States.

The Organization for Economic Cooperation and Development (OECD) estimates revenue gains from Pillar 2 adoption at about $220 billion per year.[6] These revenue gains would be spread across many countries. The taxation of US multinational companies is an important part of these revenue gains, given their role in the world economy.[7]

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4 For some examples, see Bilicka (2019); Clausing (2020b); Crivelli, Keen, and de Mooij (2016); Dowd, Landefeld, and Moore (2017); Garcia-Bernardo, Jansky, and Zucman (2022); Guvenen et al. (2022); OECD (2015); Tørsløv, Weir, and Zucman (2022); and Wier and Zucman (2022).

5 See the Treasury Department's revenue estimate for the 2021 Biden reform and for a similar 2023 reform, as well as the Joint Committee on Taxation (JCT) estimate for a similar proposal. Both the Tax Policy Center and the American Enterprise Institute scored the (very similar) Biden campaign proposal. The Tax Policy Center score covers only a nine-year window. These estimates are in line with my own empirical work in Clausing, Saez, and Zucman (2021) and Clausing (2020a).

6 These estimates are based on slides from a January 2023 OECD webinar. The OECD analysis was refined in recent months to reflect additional data on low-taxed profits in tax haven jurisdictions. There have also been robust increases in corporate profits in recent years, including increases in low-taxed profits. The analysis notes that increased pockets of low-tax income in other jurisdictions are not accounted for in their modeling and may raise revenue estimates further. The OECD also provides more modest net revenue estimates for Pillar 1 reforms. In these estimates, nearly all country groups experience revenue gains, with only tax havens (as a group) losing tax base.

7 If it adopted conforming changes to international tax rules, the US government would gain a substantial share of these revenues, given the importance of US multinational firms in the world economy. The OECD analysis does not break down Pillar 2 revenue estimates by country; those breakdowns will evolve based on which countries adopt the reforms.

These reforms are also essential for tax revenue in developing countries. Although the absolute revenue loss from profit shifting is smaller in poorer countries than in richer ones, their relative loss (compared with the size of their economies) is larger.[8] It is difficult for advanced countries to administer international tax systems, responding to the legal and accounting maneuvers of multinational companies; for countries with more limited tax administration capacity, doing so is even more daunting. Poorer countries thus have an especially large amount to gain from a minimum tax regime, which would make it easier to defend their tax base up to the minimum tax level (and beyond), as companies would have no incentive to shift profits out (or less incentive, above that rate). The structure of the minimum tax also makes the tax system easier to administer, as it is based on relatively uniform effective tax rate calculations.[9]

2 **Increasing tax system fairness:** In recent decades, governments have shifted tax burdens away from capital income and toward labor income or consumption. These tax system changes have resulted in less tax progressivity, because capital income is far more concentrated at the top of the income distribution than labor income.[10] The corporate tax system is also an essential part of taxing capital income for tax administration reasons.[11] In some countries, regressive tax systems nonetheless fund progressive government spending, but this is not always the case. Recent decades have seen persistent increases in before-tax economic inequality, making a stronger case for progressive policy levers.

An additional element of fairness concerns the competitive playing field between large, dominant multinational companies and smaller firms. The fact that large multinational companies can avail themselves of much lighter tax treatment than smaller domestic companies makes it harder for smaller businesses to compete.[12] Disparate tax treatments thus fuel market concentration.[13]

3 **Enhancing economic efficiency:** A tax system that benefits larger multinational companies relative to smaller firms will tax economic rents (profits above the "normal" return to capital) more lightly than regular returns. Economic theory suggests that taxing rents is less distortionary than taxing the normal return to capital, because taxation of rents will not alter

8 See, for example, Crivelli, Keen, and de Mooij (2016).

9 The OECD analysis indicates that low- and middle-income countries also gain more from the reforms under Pillar 1. Estimates are from a January 2023 OECD webinar.

10 For example, Treasury analysis indicates that the top 1 percent of the US income distribution receives 12 percent of all labor income but 52 percent of positive capital income.

11 For instance, it is difficult to shift capital tax burdens away from corporations and toward individuals. In the United States, more than 70 percent of capital income goes entirely untaxed by the US government at the individual level because it is held by untaxable entities or in untaxed accounts. Rethinking such tax preferences may be desirable, but it would be exceedingly difficult politically. See, for example, Burman, Clausing, and Austin (2017) and Rosenthal and Burke (2020).

12 Regarding the role of fixed costs in tax avoidance, see Bilicka (2019).

13 Regarding the role of tax avoidance in perpetuating market power of larger companies, see Martin, Parenti, and Toubal (2022). For a discussion of the role of large companies in perpetuating market power through favorable government regimes, see Philippon (2019). For a broader discussion of capital taxation and market power, see Clausing (2023).

optimal decisions regarding capital investment, employment, or economic activity. Many scholars have made a strong case for taxing economic rents, but the international mobility of the tax base makes it difficult to achieve higher tax rates on them.[14]

Many countries had common interests in the international agreement, but countries also had different goals. Some countries, such as the United States, are both home and host to multinational companies; other countries are primarily hosts.[15] Host countries were often concerned that the existing international tax system did not give them adequate taxing rights, especially for companies that could access their markets without a physical presence (thereby not triggering the permanent establishment threshold that typically enables source taxation). Also, a vocal subset of countries worried about their ability to provide tax incentives to spur real investments in factories, equipment, and job creation. Finally, very low tax jurisdictions realized that a successful international tax agreement would end their ability to benefit from the profit-shifting activities of multinational companies. Some low tax jurisdictions viewed that loss as an inevitable evolution of their economic policy strategy; others were more resistant.

HOW DID THE INTERNATIONAL TAX AGREEMENT COME ABOUT?

In 2021, after years of slow progress on these issues, the international tax agreement was concluded with a swiftness that astonished many observers.[16] More than 135 countries representing about 95 percent of the world economy reached a political agreement on two pillars that utterly transform the taxation of multinational companies.

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Pillar 1 of the agreement would reallocate some taxing rights to the market jurisdiction for the world's largest and most profitable multinational companies. It marks a departure from the notion that physical presence should determine taxing rights.

Pillar 2 levies a minimum amount of tax on multinational companies' profits regardless of where profits are reported, constraining the race to the bottom in corporate taxation. Under the agreement, companies may continue to allocate profits among their affiliates based on the flawed arm's-length standard, but their tax rate will always be at least 15 percent.[17]

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14 See Avi-Yonah (2020), Clausing (2023), Fox and Liscow (2020), Furman (2020), and Furman and Orszag (2018).

15 In 2021, US outflow and inflows of foreign direct investment were $422 billion and $448 billion, respectively; inflows and outflows have been similar in many recent years. (Data are from the World Bank.)

16 OECD-led negotiations on this topic began in 2013–15. They led to progress on data collection and a number of incremental improvements in tax guidelines, but they did not fundamentally transform international taxation, and the scale of profit-shifting did not change in the years that followed. The OECD's second round of negotiations, aimed at handling issues surrounding the digital economy that were left unaddressed in the prior round, continued in 2019 and 2020, but those negotiations did not make sufficient progress to form an effective agreement. In late 2019, US Treasury Secretary Steven Mnuchin suggested that the United States would support aspects of the agreement only as an optional "safe harbor," in which US companies could opt into the new rules and that the minimum tax regime should be designed to be analogous to the US GILTI minimum tax. Only in 2021 did progress become swifter and more comprehensive.

17 This effective tax rate applies to the Pillar 2 tax base. See appendix for details.

How was progress so swift? Four key ingredients were critical to successful multilateralism.

First, there was a common recognition of the problem. For many years, governments have been seeking solutions to well-recognized common policy problems: large magnitudes of profit-shifting, an increasing separation between the location of economic value and the location of taxable income, and corporate tax base erosion. Governments also understood the problem of tax competition. Fears of tax base mobility often left governments unwilling to raise corporate tax rates—and in fact pressured to lower them—even as the corporate tax is suited to other tax system design goals in terms of progressivity, efficiency, and tax administration.

Second, there was a willingness to undertake transformative policy change, setting aside foundational yet highly problematic international tax system concepts. Earlier rounds of negotiation resulted in more timid incremental reforms that left policy problems largely intact.

Third, the agreement included an enforcement mechanism. Good agreements create incentives for countries to join and reduce the ability of nonadopting countries to free-ride on the commitments of others. Enforcement principles are reassuring to countries that are willing to undertake commitments. The agreement includes an enforcement mechanism known as the Undertaxed Profits Rule (UTPR). Once some countries implement the agreement, the UTPR provides a strong incentive for nonadopters to implement as well. For instance, say that a country does not adopt the Pillar 2 agreement on minimum taxation and keeps rock-bottom tax rates instead. The UTPR means that a top-up tax will still be paid by companies that are resident in such a hold-out country (including its foreign subsidiaries), so long as it serves adopting country markets; this top-up tax will be paid to those countries that do participate. Multinational companies from nonadopting countries will still pay the minimum tax, but revenue will not go to their own governments. This mechanism creates a strong incentive for adoption.

Fourth, leadership played a decisive role. In 2021, the Biden administration, and particularly Treasury Secretary Janet Yellen, helped push this deal forward, alongside leaders in Germany, France, Japan, and elsewhere. Key leaders at the ministerial level prioritized the international tax agreement, expending time, effort, and political capital to achieve success. In recent months, other important acts of leadership moved countries toward implementation. In December 2022, the European Union unanimously moved forward to implement this country-by-country minimum tax by issuing a Council Directive; it required lengthy negotiations with key hold-out countries (Poland and Hungary). Other countries, including South Korea, Japan, Australia, Canada, and the United Kingdom, are also taking steps toward implementing this minimum tax.[18]

18 See Goulder (2023), Hannon (2023), and February 2023 OECD Tax Talks presentation slide 13.

WHAT DID THE INTERNATIONAL TAX AGREEMENT ACHIEVE? WHERE DID IT FALL SHORT?

The international tax agreement does not put an end to tax competition, but it does limit tax competition in important ways. With adoption of the Pillar 2 country-by-country global minimum tax, no country will have an incentive to offer multinational companies tax rates lower than 15 percent.[19] Pillar 2 substantially reduces corporate tax base erosion for all countries, by eliminating the incentive to shift profits out of countries with effective tax rates of 15 percent. Even when tax rates exceed 15 percent, the differential between the domestic rate and the lowest rate abroad will be smaller, weakening the incentives that drive profit-shifting and corporate tax base erosion. The OECD predicts that Pillar 2 will generate about $220 billion a year in additional corporate tax revenue. These revenue estimates speak to the importance of the agreement for stemming corporate tax base erosion.

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International cooperation was crucial to achieving this outcome, because countries have incentives to undercut each other's tax bases in the absence of cooperation. Further, the UTPR is an important tool in furthering this cooperation, since it helps adopting countries defend their tax base and counter the competitiveness worries of their domestic companies. Otherwise, companies based in nonadopting countries would have an advantage relative to companies based in adopting countries, and such companies could shift profits out of the adopting country tax bases toward more lightly taxed destinations without incurring top-up taxes.

These tools of international cooperation enable more efficient and harmonious outcomes than unilateral alternatives. In the years building up to this agreement, many countries unilaterally levied digital services taxes (DSTs) of various forms. These taxes often disproportionately affected US companies. DST proliferation stemmed partly from attempts by countries hosting digital companies to unilaterally extract revenue from highly profitable companies that often paid very low tax rates throughout the world. Imposition of these taxes generated substantial bipartisan opposition in the US Congress, and the US Executive Branch made it clear that it viewed these taxes as discriminatory, causing the US Trade Representative (USTR) to threaten tariffs in response. Although the USTR logic was in many respects flawed, it generated a dynamic of retaliation and counter-retaliation that increased the risk of a trade war.[20]

19 In contrast, a globally blended tax, such the US GILTI provision, retains the incentive for jurisdictions to offer rock-bottom tax rates, because any GILTI tax due can be offset by tax credits from operations in higher-tax jurisdictions. In fact, even high-tax foreign income is tax-preferred to US income, because it generates tax credits that offset GILTI income on low-tax jurisdictions (domestic income generates no such benefit).

20 Trade wars have real costs. Consumer face regressive consumption taxes, workers and businesses in export sectors face reduced markets for their products, and purchasers of intermediate imported goods bear higher costs. Trade wars also adversely affect international relations, which makes it more difficult to solve other global collective action problems, including climate change, public health, and security. For more on the flawed USTR analysis, see Shay (2022).

The international tax agreement's multilateral cooperation was not just transformative, it was also timely. Governments agreed to pause their plans for DSTs in exchange for progress on the international tax deal.[21] While the Pillar 1 agreement on tax base reallocation is a work in progress, the Pillar 2 agreement is already being implemented throughout the world. This adoption of a minimum tax regime for multinational income reigns in tax competition and corporate tax base erosion.

Although adoption of the country-by-country minimum tax is transformative, tax competition pressures will still persist in other forms. Governments will still be able to subsidize their companies directly, even if the new floor of effective tax rates is 15 percent. Subsidies are more difficult to enact than tax cuts, however, for several reasons. First, forgone tax revenue often exerts less budget pressure than direct expenditure; in a time of fiscal constraints, subsidies are difficult.[22] Second, international agreements, including both World Trade Organization (WTO) and European Union rules, limit the use of subsidies. Third, tax breaks are less transparent than direct subsidies. It might be difficult to "send checks" to the most profitable companies in the world; it is far easier to enable them to pay low effective tax rates, especially when many tax preferences are opaque and operate through lax tax or regulatory regimes. As one example, the US government's "check the box" regime enabled the creation of income that was stateless (taxed nowhere), and many countries have adopted tax regimes that favor certain taxpayers or industries.[23]

Further, the minimum tax itself was also not as strong as some proponents desired, nor as strong as the Biden administration had proposed for US adoption. While the rate (15 percent) is higher than many expected (with 10 to 12 percent deemed likely by some observers), it falls below the Biden proposal of 21 percent. Importantly, the agreed minimum tax also included "substance-based carve outs" that allowed some domestic return on tangible assets and payroll to be exempt from the minimum tax.

The mind-numbing labyrinths of current tax rules are hard to defend, and this agreement does not eliminate them. In some respects, complexity is an inevitable result of tensions between the arm's length standard, a highly global economy that is replete with intangible sources of value, and the need to defend the corporate tax base. With these inherent tensions as a starting point, the global minimum tax makes good sense, as it requires companies to pay some minimum amount of tax regardless of how they structure their tax matters. In addition, the agreement applies only to the world's largest companies. Companies with

21 In particular, Pillar 1 was intended to reduce the pressure for DSTs, as it would reallocate a subset of the tax base for the largest profitable companies (regardless of whether they were digital) toward the market jurisdiction.

22 Subsidies might be especially difficult for countries that lack fiscal space. In a higher interest rate environment, these sorts of constraints become more binding.

23 "Check the box" facilitates the creation of complex chains of ownership in which key entities in the chain are classified differently for tax purposes by different governments. By planning around these disparate tax treatments, multinational companies create income that is stateless, such that key governments do not recognize income streams as taxable under domestic tax law. For a good exposition of this problem, see Kleinbard (2011, 2012). For empirical evidence in this area, see Samarakoon (2023).

revenues greater than €750 million are in the Pillar 2 regime. They are likely to have tax teams that can handle any complexity associated with complying with the global minimum tax.

Pillar 1, which is more complex, affects only about 100 companies. It has a more uncertain future than Pillar 2, partly because of the more contentious negotiations required to reallocate taxing rights. Pillar 1 may also be more difficult to adopt, as doing so involves coordinating actions with other countries.

The difficult road ahead for Pillar 1 raises important questions. For instance, host countries of multinational companies hoped to gain revenue from the reallocation of taxing rights toward market jurisdictions. Absent sufficient progress on Pillar 1, they may resort to DSTs and other unilateral measures. Such actions would reduce tax certainty for taxpayers, subjecting them to more ad hoc tax regimes and generating greater risks from trade conflicts.

The international agreement is far from perfect, but it is still an enormously important step forward for both multilateralism and the international tax system. Indeed, when the international agreement was reached, in late 2021, former Secretary of the Treasury Lawrence H. Summers described it as "arguably the most significant international economic pact of the 21st century so far" and a "triumph for Detroit over Davos." Particularly encouraging was the US government's embrace of multilateralism, coming after several years of reckless unilateralism.[24]

The swift consensus formed during 2021 brought together the full G7, the full G20, and more than 135 jurisdictions, all backing transformative new international tax rules. Important countries have now taken serious steps toward implementing the global minimum tax, setting in motion a dynamic that will become reinforcing. Nonadopting countries will have strong incentives to join, both to gain corporate tax revenues and to provide their resident multinational companies with a tax system that is aligned with that of the rest of the world.

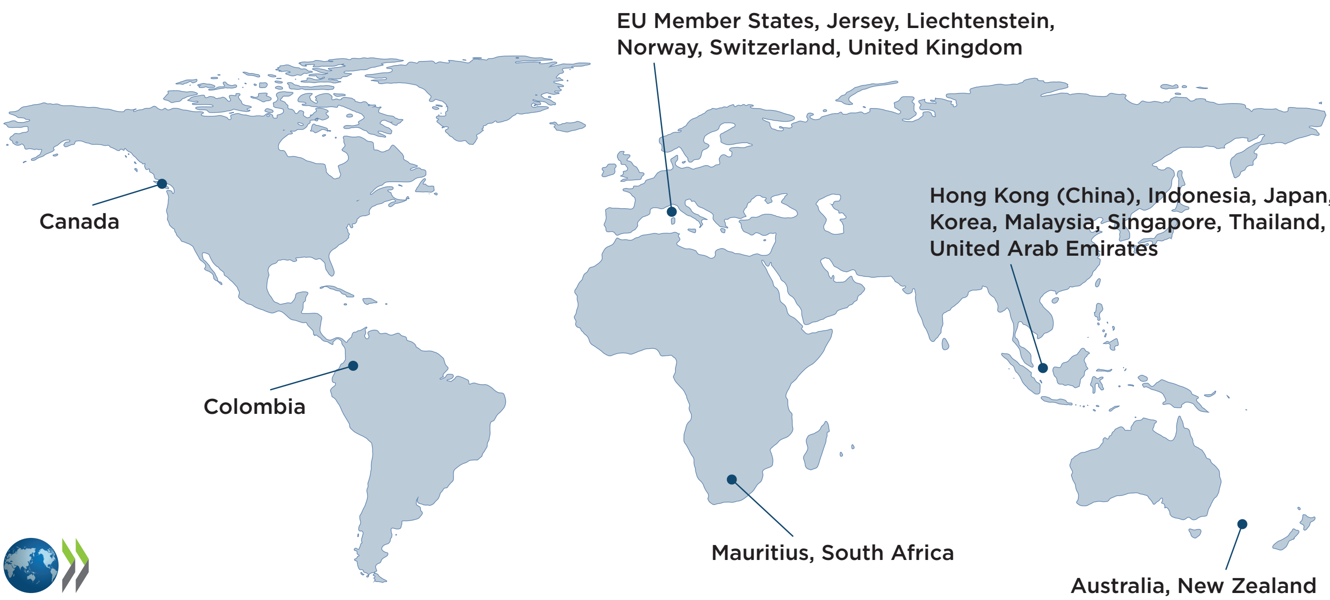
The agreement represents a step forward for both multilateral economic cooperation and fairer tax systems. By working to tax mobile multinational capital at some minimum level, governments have shown their willingness to recast global rules in a way that benefits broader society. In a time of frequent fiscal shortfalls, shoring up progressive sources of revenue is a particularly welcome achievement.

24 This multilateralism has been apparent in other areas, too. The United States rejoined the Paris Climate Accord and worked multilaterally with many countries on steps to respond to the Russian invasion of Ukraine. In other areas, however, the Biden administration has been less multilateral in spirit. For instance, the national content requirements in the clean energy subsidies provided under the Inflation Reduction Act show clear disregard for WTO rules, and other restrictions on trade and investment that have been justified on national security grounds don't always meet that test. As one example, the continuation of the Trump era trade restrictions on steel and aluminum, and the defense of those tariffs on national security grounds by the USTR, strike many experts as an implausible use of that rationale.

POSSIBLE FUTURES FOR INTERNATIONAL TAXATION

As of March 1, 2023, 19 economies plus the European Union had begun implementing the Pillar 2 agreements (figure 1).[25] The EU directive was a particularly important step forward, committing EU member states to complete implementing legislation, regulations, and administrative changes, with provisions applying at the beginning of 2023 (for the bulk of the provisions) or 2024 (for the UTPR).[26] Many other important countries—including South Korea, Japan, the United Kingdom, Canada, and others—have moved toward implementation, with steps ranging from engaging in pre-legislation consultations (Australia) to passing legislation (South Korea).

Figure 1
Inclusive framework members implementing Pillar 2 of the international tax agreement



Note: This document, as well as any data and map included herein, are without prejudice to the status of or sovereignty over any territory, to the delimitation of international frontiers and boundaries and to the name of any territory, city or area.

Source: OECD Tax Talks presentation slide 13, February 2023. Reproduced with permission.

Once implementation proceeds, most multinational companies will face a tax environment that will be *as if* the entire world had adopted the global minimum tax. (Almost all US multinational companies operate in one of these jurisdictions.) They will pay 15 percent in the adopting countries, who will also top up their tax burdens on a country-by-country basis. This reality will encourage more and more countries to adopt Pillar 2 reforms.

25 KPMG and other accounting firms are tracking developments as well. See KPMG's April summary.

26 See the Council Directive text.

Questions remain about whether the United States will adopt a country-by-country minimum tax that is consistent with these international reforms. To some extent, the United States is close. Indeed, the US government led the way on minimum taxation, adopting the GILTI tax in 2018. It taxes US-headquartered multinational companies at a minimum rate of 10.5 percent (up to 13.125 percent, depending on foreign tax credits) on a globally blended basis. However, because this tax rate is lower than the Pillar 2 minimum tax rate and is applied on a globally blended (rather than country-by-country) basis, it does not conform to the Pillar 2 rules, subjecting many US multinational companies to UTPRs abroad.

These UTPRs are efforts by foreign countries to protect their own tax bases. If Canada adopts a strong minimum tax and the United States does not, US multinational companies operating in Canada could shift income out of Canada toward a tax haven, eroding the Canadian tax base and putting Canadian companies at an unfair disadvantage.

The US government nearly adopted Pillar 2–consistent reforms late in 2021, when the House of Representatives passed the "Build Back Better" tax package. However, by the time the Senate passed the Inflation Reduction Act, in the summer of 2022, the Pillar 2–compliant tax reforms had been dropped, and there was instead a new Corporate Alternative Minimum Tax (CAMT). Although this tax has some superficial similarities to the global minimum tax, including (confusingly) the same rate, it has important differences. The main difference is that the CAMT it Is not imposed on a country-by-country basis. It therefore preserves the incentives of tax haven jurisdictions to offer rock-bottom tax rates, as the US minimum tax due on income earned in such jurisdictions can be offset by tax credits from income taxed in higher-tax locations. It also preserves the tax preference that favors all foreign income over US income, as higher-taxed foreign income generates tax credits that offset tax due on lower-tax country income; domestic income does not have that advantage.

The present situation risks US multinational companies facing a complex array of minimum taxes that are misaligned with what the rest of the world is doing (see appendix). If US law does not change, many US multinational companies will end up paying at least three minimum taxes: the GILTI tax, the CAMT, and foreign UTPRs.[27] However, a relatively simple reform could transform those three taxes (and their different tax bases) into one reformed GILTI tax. Transforming the GILTI tax into a country-by-country tax at a 15 percent (or higher) rate would turn off foreign UTPRs. One possible concession toward that reform would also turn off the CAMT for GILTI taxpayers.[28] Such a reform would provide the business community with a more certain and stable international tax environment.[29]

27 They may also pay tax under the Base Erosion Anti-Abuse Tax (BEAT) in some situations.

28 Whether the CAMT is repealed in total or just turned off for GILTI taxpayers would depend on other considerations. All multinational CAMT payers should be in the GILTI regime; however, some CAMT payers may be solely domestic companies.

29 Pillar 1 reforms have much to offer the business community. A Pillar 1 agreement would forestall the use of discriminatory DSTs, lowering the risk of trade conflicts and the associated business disruption. There is less at stake in terms of higher tax payments for these companies, as the dominant feature of Pillar 1 rules is a redistribution of taxing rights among countries rather than an increase in tax payments on net. (There is a small increase, but it is much smaller than in Pillar 2.)

The tax policy debate can be fierce in the United States, with business interests fiercely opposing increases in tax burdens. But there will be important opportunities for compromise in the years ahead. The expiration of many of the Tax Cuts and Jobs Act provisions in 2025 will bring lawmakers to the table, as the large revenue cost of extending these tax cuts could focus minds on sources of new revenue.

Many business provisions are changing under current law, including rules on the amortization of research and development (R&D), stricter limits on the deductibility of interest, phase-outs of expensing provisions, and the scheduled changes in GILTI and Foreign-Derived Intangible Income (FDII) rates. The wide array of business tax desiderata may allow a move toward better alignment of US international tax rules with those rapidly being adopted in the rest of the world. Conforming US tax reform would be highly desirable for both the United States and future efforts at international cooperation.[30]

The international tax agreement comes with ample lessons for other global collective action problems.

LESSONS FOR MULTILATERALISM

The international tax agreement comes with ample lessons for other global collective action problems. First, multilateral solutions yield enormous benefits. Unilateral solutions are difficult to pursue, because governments fear competitive pressures from nonadopting countries. Group efforts benefit from wide participation, reducing the importance of hold-out jurisdictions and free-riding behavior, which can reduce incentives for policy ambition.

Second, in an era of important inequalities, it is important to create rules that serve the broader interests of society. While trade agreements benefit workers and consumers in myriad ways, they have also often contained more contentious provisions that protect investor interests or strengthen the economic rights of intellectual property holders. Notably, this international tax agreement has fairness as a centerpiece. By seeking to raise tax burdens on economic profits earned by successful multinational companies, it enables both more progressive tax systems and more revenue for pressing fiscal needs. It also provides a more level playing field, enhancing fair market competition between smaller and larger companies.

Working to solve other global collective action problems would also serve broad societal interests. Perhaps the most obvious example is climate change, whereby a truly global externality risks generating catastrophic damage if not swiftly addressed by more ambitious government policy actions. International efforts on climate policy could learn much from the international tax agreement about the importance of a shared understanding of the policy problem, a commitment to transformative policy action, an enforcement mechanism, and political leadership.

With respect to climate change, the world does have a clear, shared understanding of the policy problem and the stakes involved. Political leadership and transformative policy action have been insufficient, however, and international efforts (including by the United Nations Framework Convention on Climate Change [UNFCCC]) lack enforcement mechanisms. One possible

30 I elaborate on the case for US adoption of international tax reforms in my April 18, 2023 testimony before the US Senate Committee on the Budget.

enforcement tool would involve using the carrot of trade liberalization and market access alongside the stick of tariffs to motivate more serious policy action, as suggested by Nordhaus (2015), who advocates for a "climate club." Of course, using trade policy in this manner comes with risks as well as rewards.[31]

Given the urgency of climate change, it is important to think though how principled enforcement mechanisms might motivate policy ambition. With sufficient leadership among a group of countries, the same dynamic that fueled rapid progress in international tax cooperation could take hold. At the same time, misuse of trade policy tools could generate animosity and conflict. Policy coordination—and a fundamentally multilateral approach—are therefore essential.

The world faces important global collective action problems, including efforts to protect public health from future pandemics, address nuclear proliferation, and work toward resolution of territorial conflicts. The Russian invasion of Ukraine and the worsening relations between the United States and China have made multilateral efforts more difficult. In this context, it is particularly important for countries to maintain open engagement on issues of strong mutual interest.

31 See Clausing and Wolfram (2023) and Clausing, Garicano, and Wolfram (2023).

APPENDIX: THE INTERNATIONAL TAX AGREEMENT AND US CURRENT LAW

INTERNATIONAL AGREEMENT DETAILS

The international tax agreement was organized under the auspices of the OECD/G20 Inclusive Framework, which now involves about 140 countries. The framework countries have been working on issues related to tax base erosion and profit-shifting (referred to as BEPS) for more than a decade. The two pillars arose from negotiations on issues left unresolved in an earlier round of BEPS efforts in 2013–15 (see the OECD website for details).

Pillar 2 of the agreement includes a country-by-country minimum tax of 15 percent on multinational company income, regardless of where it is reported. This regime applies to multinational companies with more than €750 million in consolidated revenues. The minimum tax is implemented through an income inclusion rule (IIR) that levies top-up taxes on a country-by-country basis, accounting for a substance-based income exclusion that may exempt a baseline return on tangible assets and payroll. An under-taxed payment rule (UTPR) levies tax on multinational group affiliates that are not subject to a top-up tax under an IIR. The UTPR protects the corporate tax base in adopting countries from tax base erosion as a result of profit-shifting activities of affiliates of companies headquartered in nonadopting countries. Implementation of Pillar 2 is underway in several countries, making it likely that most multinational company income will be affected.

Pillar 1 of the agreement would reallocate some portion of the multinational company tax base toward market jurisdictions. The details of Pillar 1 are still being negotiated. The agreement would apply only to about 100 of the world's largest and most profitable multinational corporations—companies with more than €20 billion in global revenue and a return on revenue of more than 10 percent. A percentage of the excess profit of such companies would be reallocated to the market jurisdiction. As this pillar pertains to taxing rights, it requires coordination among countries as well as detailed negotiations about profit tax base reallocation.

COMPARISON WITH CURRENT US LAW

The Tax Cuts and Jobs Act (TCJA): Under current US law, domestic corporate income is taxed at 21 percent, and some companies pay minimum taxes as described below. In 2017, the TCJA reduced the statutory corporate tax rate from 35 percent to 21 percent; it also enacted a suite of international tax law changes. Under this legislation, the United States moved from a purportedly worldwide system of tax (that taxed both foreign and domestic income) to a purportedly territorial system of tax (that exempted most foreign income from taxation).

However, US law included hybrid elements both before and after the TCJA. Before TCJA, foreign income was not taxed until repatriation, so foreign income benefited from indefinite tax-free treatment if that income was kept abroad. (Companies could borrow against these offshore earnings, gaining indirect access to the funds.) After TCJA, some foreign income was taxed currently, under either the GILTI tax or the BEAT. TCJA also implemented an export tax preference for high profit firms under the FDII.

The Global Intangible Low-Taxed Income (GILTI) tax: The GILTI tax applies to the foreign income of US-headquartered multinational firms on a globally blended basis when such income exceeds a 10 percent return on foreign tangible assets. The United States taxes GILTI income with a 50 percent deduction relative to domestic income. Foreign tax payments are creditable at a rate of 80 percent. The tax rate on foreign income (above a 10 percent return on assets) ranges from 10.5 to 13.125 percent and is scheduled to increase after 2025.

The GILTI tax provides incentives for both offshoring and profit-shifting. To see why, consider a company with an affiliate in a zero-tax jurisdiction abroad. The first 10 percent return on foreign tangible assets is tax free, providing an incentive to move tangible assets offshore. Subsequent foreign income beyond that 10 percent return is taxed at a 50 percent discount relative to domestic income. Of note, current law US tax also favors the earning of income in *high-tax* countries abroad, relative to the United States. As a result of global blending, income reported in higher-tax countries generates tax credits that offset tax due on low-taxed income, reducing the tax burden on both sources of foreign income to about half the US rate.[32] The GILTI tax also maintains the incentive for foreign countries to offer rock-bottom tax rates, because any GILTI tax due can be offset by tax credits from higher-tax foreign countries.

Because of the disadvantages of a globally blended system, the international agreement instead employed a country-by-country minimum tax. A country-by-country tax tops up tax rates for income earned in low tax jurisdictions regardless of multinational companies' other sources of foreign income. This feature makes the minimum tax more effective in stemming profit-shifting and tax competition.

The Base Erosion Anti-Abuse Tax (BEAT): The BEAT is a minimum tax that applies whenever deductible payments to foreign-related entities exceed a threshold. It can affect the profit-shifting activities of foreign multinational companies as well as US multinational companies.

The Foreign-Derived Intangible Income (FDII) deduction: The FDII provides a tax deduction for foreign-derived intangible income, with several perverse consequences. First, as companies' domestic tangible assets increase, they receive lower FDII deductions, enhancing their incentive to undertake tangible asset investments abroad (which also generates tax-exempt foreign income under the GILTI tax). Second, the FDII deduction provides a tax break for excess profits, tilting the tax playing field in favor of highly profitable companies with greater market power. Third, the FDII deduction favors export income, a policy preference that has no policy rationale and is inconsistent with WTO rules.[33]

The Corporate Alternative Minimum Tax (CAMT): The CAMT was adopted as part of the Inflation Reduction Act of 2022. It has some superficial similarities to the Pillar 2 minimum tax, including the same rate, as well as important differences. Like the GILTI tax, it operates on a globally blended rather than a country-by-

32 Clausing (2020b) explains these incentives.

33 These WTO rules benefit the United States and the world trading system by discouraging export subsides.

country basis. It taxes companies with more than $1 billion in book profits at a minimum rate of 15 percent. It contains features to avoid clawing back existing investment incentives, R&D incentives, and general business credits.

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