FOREIGN AFFAIRS

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The Global Minimum Tax Lives On

America Has Abandoned It for Now but Will Likely Come Around

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For decades, countries have attempted to attract multinational companies by lowering corporate taxes, and companies have responded by shifting reported profits toward low-tax jurisdictions. As a consequence, governments have lost hundreds of billions of dollars in revenue at the same time that multinational companies often pay single-digit tax rates. Although corporations and their shareholders have benefited from this race to the bottom, governments were left with no alternative but to shift tax burdens toward consumers and workers.

Last year, more than 135 countries signed an agreement to transform international taxation by requiring profitable companies to pay at least 15 percent in corporate tax, regardless of where they reported their profits. As Lawrence Summers, the former U.S. secretary of the Treasury Department, noted at the time, this political agreement represented "a triumph of Detroit over Davos": leaders put their workers and citizens above shareholders, addressing a long-standing global collective-action problem.

Unfortunately, although U.S. leadership was pivotal in forging this agreement, U.S. lawmakers have come up short. Senator Joe Manchin, the West Virginia Democrat who has outsize influence in an evenly divided U.S. Senate, declared that moving first on the global minimum tax would be disadvantageous to U.S. companies, and it was not included in the Inflation Reduction Act. This means the United States will not be party to the agreement, since the agreement required all signatories to enact changes to their tax codes. The Inflation Reduction Act did include a corporate alternative minimum tax, but that should not be confused with adopting a global minimum tax: it does not tax the foreign income of U.S. multinational companies on a country-by-country basis, so companies will still have an incentive to operate in countries with rock-bottom tax rates.

All is not lost, however. The agreement has an enforcement provision —"the undertaxed profits rule"—that provides a strong incentive for countries to implement the minimum tax. Simply put, countries that enact the agreement's provisions will be able to tax multinational companies based in countries that do not adopt the provisions, but the resulting revenue will go to adopting governments, not nonadopting governments. This provides a strong incentive for countries—including the United States—to eventually follow through on their pledge to abide by the agreement.

THE FINE PRINT

It is unfortunate that the United States was unable to lead in adopting the global minimum tax after U.S. Treasury Secretary Janet Yellen's crucial leadership in forging this transformative agreement. There was good reason for U.S. leadership. International tax is a classic example of a case in which countries can improve their joint outcomes by acting cooperatively. Acting on their own, countries have an incentive to lower their corporate tax rates to attract jobs, investment, and a mobile tax base. This lure is reinforced by fear: multinational corporations threaten to move their activities offshore if governments do not bend to their will. But the agreement proceeded from a growing consensus among nations that the race to the bottom in corporate taxation needed to end. Yellen logged many hours brokering the deal. By October 2021, countries that together represented about 95 percent of world GDP were on board.

The agreement's most important feature is that it levies some minimum amount of tax on multinational companies' profits regardless of where they report their profits; this tax is levied on a country-by-country basis, so companies cannot avoid minimum tax on lightly taxed income through tax payments to higher-tax countries.

This puts an end to the destructive race to the bottom in corporate taxation. Under the agreement, multinational companies could continue to move profits toward the lowest tax countries in the world, but their tax rate would be at least 15 percent regardless. The Undertaxed Profits Rule even extends this logic to nonadopting countries, since it acts to top up tax rates for companies headquartered in nonadopting countries yet operating in adopting countries; these top-up taxes are paid to adopting countries.

The United States may eventually follow through on its pledge to adopt the global minimum tax.

The assumption was that the United States would adopt the measure as part of the Build Back Better legislation, and conforming changes to the U.S. tax code were introduced and passed by the House of Representatives in the fall. But by the end of 2021, the Build Back Better legislation was languishing and did not reach the Senate floor—in part because of Senator Manchin's lack of support.

If the United States had adopted international tax reform, it would have given the European Union a strong incentive to move forward on the pact as well. But because of the undertaxed-profits rule, if another signatory to the pact adopts the global minimum tax, there will be pressure on the United States to follow suit: for example, if the EU and Japan adopt the agreement and the United States hangs back, U.S. multinational companies will still pay a top-up tax on their profits, but these payments will fund government operations in Europe and Japan rather than meeting U.S. fiscal needs.

To be sure, adoption of the pact is not guaranteed. The EU is seeking the unanimous support of its members to adopt the minimum tax, and Hungarian Prime Minister Viktor Orban's government has threatened to block it. Republicans in Congress, moreover, have supported Hungary's obstruction, seeking to sink the deal.

ALL TOGETHER NOW

Manchin and Republican lawmakers say they are acting out of concern for U.S. competitiveness. But even if the pact resulted in a tax hike for some businesses, the international agreement would benefit corporate America by creating a more stable tax system. For example, many countries have implemented digital-services taxes on large U.S. multinational technology firms such as Facebook and Google. Of course, individual nations have a right to levy taxes as they see fit. But these digital taxes often appear to unfairly single out U.S. companies. The discrimination has raised hackles among Democrats and Republicans alike, which led to threats of retaliatory tariffs, first under President Donald Trump and now under President Joe Biden. One benefit of the international tax agreement is that it provides a multilateral answer to the question of who should tax multinational profits. Another is that it staves off cycles of retaliation.

Creating a fairer tax system would also be healthy for competition in the U.S. private sector. Global companies that can shift activities and profits across borders are often the largest, most profitable companies in the world. They benefit from tax burdens that are far lower than those faced by smaller, domestic competitors that operate solely domestically. These disparities in tax treatment help turbocharge the growing concentration of economic power in the hands of a small number of large companies.

Governments and citizens will also benefit from a minimum global tax. Unlike labor income, capital income from investments held by individuals is often subject to little, if any, tax. If governments cannot tax corporations, tax burdens shift toward consumption and labor income. Although a consumption tax can in principle reach investment income, for the wealthiest taxpayers, much of their income will never be consumed, so it will not be taxed by value-added taxes abroad—or by retail sales taxes in many U.S. states. The burden of funding the government instead falls on the shoulders of workers, while the richest in society escape with light tax burdens.

Multilateral action is needed to solve global collective-action challenges.

These dynamics are particularly damaging given rising income inequality, inequality that is fueled in part by the concentration of investment (or capital) income. Richer households are much more able to set aside savings, or they may have benefited from inherited wealth, so they receive disproportionately more capital income. Indeed, the top one percent of the U.S. income distribution receives 12 percent of all labor income from wages, but an even larger share—52 percent—of positive capital income. The failure to adequately tax capital exacerbates the trend toward ever higher income inequality—in turn, fueling right-wing populism.

These trends have long-run consequences for the health of capitalism. When people think the economy is rigged against them, they often look for someone to blame. Populist economic policies, some of which are deeply misguided, become more appealing than they should be. Indeed, the Trump administration managed to enact large regressive tax cuts at the very same time that it raised tariffs—which end up being a regressive consumption tax because consumers must pay more for the imports they buy, and poor consumers spend more of their income on heavily tariffed products such as food and clothing. The Trump administration blamed trading partners and immigrants for working-class woes. These protectionist policies harmed our relations with key allies; they also harmed the middle-class voters they purported to help.

COLLECTIVE ACTION NEEDED

Now more than ever, multilateral action is needed to solve global collective-action challenges, such as the existential threat of climate change and deadly rounds of pandemics. The global tax agreement addresses a seemingly intractable problem, one that, like climate change, has persisted for decades and led to outcomes that favor small groups at the expense of larger citizenries. Tackling global tax challenges in a cooperative fashion can help build trust as well as momentum for addressing other problems. It can also demonstrate the usefulness of effective enforcement and bold leadership.

If the EU adopts the global tax, the United States would have a strong incentive to adopt it as well in years ahead, lest U.S. multinational companies face taxes abroad that do not benefit U.S. fiscal needs. If Hungary or other recalcitrant EU member states balk, even a handful of other countries could move forward. Canada, Japan, and the United Kingdom, for example, have large economies and a strong incentive to act on global tax. Once some countries take the lead, the undertaxed-profits rule will induce others to follow.

It would be tragic if instead the agreement withered away and the race to the bottom in corporate taxation continued. Although that may seem like a short-run victory for shareholders of profitable multinational companies, it would set the world on a dangerous path that would fuel both populist resentment and policy unilateralism. That could spark new conflicts among friendly countries, disrupt economic ties, and erode much-needed solidarity.

In such volatile times, there is hardly anything more important than building trust and shoring up multilateralism. The global minimum tax represents an opportunity to not just address decades of vexing international tax developments but also lay a foundation for international cooperation in other areas. With the United States stalled, it will be up to other governments to summon the courage to move forward.