International Tax Policy

Between Competition and Cooperation

TSILLY DAGAN

TAX LAW

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Bringing a unique voice to international taxation, this book argues against the conventional support of multilateral cooperation in favor of structured competition as a way to promote both justice and efficiency in international tax policy. Tsilly Dagan analyzes international taxation as a decentralized market, where governments have increasingly become strategic actors. Dagan argues that although many of the challenges of the current international tax regime derive from this decentralized competitive structure, curtailing competition through centralization is not necessarily the answer. Conversely, competition – if properly calibrated and notwithstanding its dubious reputation – is conducive, rather than detrimental, to both efficiency and global justice. *International Tax Policy* begins with the basic normative goals of income taxation, explaining how competition transforms them and analyzing the strategic game states play on the bilateral and multilateral levels. It then considers the costs and benefits of cooperation and competition in terms of efficiency and justice.

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Dr Peter Harris, Law Faculty, University of Cambridge, Director of the Centre for Tax Law.

Dr Harris brings a wealth of experience to the Series. He has taught and presented tax courses at a dozen different universities in nearly as many countries and has acted as an external tax consultant for the International Monetary Fund for more than a decade.

TSILLY DAGAN is Professor of Law at Bar-Ilan University, Israel. She is a leading tax theorist who has published extensively on a broad range of tax-related issues and distinctively combines tools from game theory and political philosophy to challenge the field's conventional wisdoms.

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In Memory of my Mother

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Introduction

Rising inequality, within as well as between states, demands effective institutional solutions. Income taxation has traditionally been the textbook policy tool for ameliorating such inequality. States' ability to promote their normative goals through their tax systems has been seriously challenged, however, by the decentralized structure of international taxation, which has set states in competition for capital, residents, and tax revenues. Due to this competition, states operating unilaterally are increasingly unable to sustain their tax bases and fully pursue their normative goals, that is, to collect sufficient taxes to finance their public goods in an efficient and just way. This has presented policymakers and scholars of international tax policy with a weighty task: to design international tax policies that will support – to the greatest extent possible – the goals of justice and efficiency. In seeking such policies, much of the effort has been directed at the supranational level, pursuing cooperative mechanisms that can regulate states' tax competition. A global regime that limits tax competition, it has been asserted, would be praiseworthy from the perspectives of both efficiency and justice. This book challenges this view. It makes the case for more competition – or, rather, more efficient competition – which could, I will claim, do a better job in promoting just and efficient international taxation.

The driving argument made in this book is that international taxation should be analyzed as a decentralized competitive market, whereby governments have increasingly become strategic players maximizing their national interests. While many of the challenges of the current international tax regime derive from this decentralized competitive structure, curtailing competition through centralization is *not* necessarily the answer, as I will show. As opposed to supporters of multilateral cooperation toward more centralization, the solutions I endorse here support competition as a vehicle for promoting the normative goals of international taxation. Thus, rather than strive for a more comprehensive multilateral regime that curtails tax competition, I argue, a multilateral accord should seek to improve – indeed, perfect – competition. Competition, if properly calibrated and notwithstanding its dubious reputation, is conducive, rather than detrimental, to global welfare as well as global justice.

International tax policy is making headlines these days. What started out as a mind-numbing highly technical area of public policy, appealing to only a select few, has become a topic that attracts the attention of not only the media but also political leaders, the business community, and public interest groups. The public has been riveted by revelations of bank account leaks from notorious tax havens and deals with informants; people follow closely such developments as EU institutional pressure on Ireland to collect high enough taxes from Multi-National Enterprises (MNEs) and agreements between countries to disclose information on taxpayers. Unilateral legislation abounds, bilateral treaties are now standard in all countries, and multilateral negotiations and accords are at a peak. The reason is clear: countries' tax policies are being severely challenged by international tax competition, tax planning, and tax avoidance. Countries are gradually losing their capacity to redistribute income and sustain their welfare systems, with greater proportions of the public funding falling on labor's shoulders. This has turned international taxation into a significant dimension of domestic income tax policy and, therefore, a political issue with serious ramifications not only for capital owners and multinational enterprises but for all of us.

At the same time, the international context is changing the way in which we generally think about income taxation. The traditional perspective envisions a state ruled by a sovereign that is entrusted with exclusive tax legislative powers, seeking (at least ideally) to maximize welfare (efficiency) and justly (re)distribute it, while reinforcing the underlying normative values shared by its constituents. From the current globalized perspective, however, the powerful sovereign is only one of approximately 200 sovereigns competing with one another for investments, residents, and tax revenues. Taxation is the currency of this competition, with states luring investments as well as residents to their jurisdiction with attractive taxing and spending "deals." Hence, in conditions of tax competition, tax policies almost inevitably become marketized, as countries attempt to tailor their taxation and benefits packages to the needs and requirements of their most valuable current and potential investors and residents. Mobile capital enjoys lower tax rates; foreign investors benefit from attractive exemptions; and sought-after MNEs enjoy favorable tax regimes (e.g., favorable regimes for R&D). As a result of this marketization, redistribution is increasingly falling by the wayside. State welfare systems are struggling to survive, while the wealth disparities within and between states grow wider. The challenges of income taxation in this globalized competitive setting are substantial, almost overwhelming, leading many to lament the demise of the welfare state and sending policymakers as well as scholars in search of a viable solution for sustaining the efficiency and justice goals of income taxation.

At its base, international taxation is decentralized: there is no central government that sets the rules and tax rates or allocates rights to tax. Despite the considerable recent efforts of cooperation, and notwithstanding views that a customary international law of taxation has emerged and that its rules limit states' choices, every country is still independently making its own tax policy and setting its own rules and tax rates. These national policies interact to create the international tax regime. The decentralized nature of international taxation has led to several inconsistencies between systems, producing barriers to cross-border economic activities as well as opportunities for tax avoidance. Decentralization makes the international tax regime not only market-competitive but also highly fragmentized. Sophisticated taxpayers are able to pick and choose among the components of the various tax systems using tax-planning instruments and thereby free-ride states' public goods and services. The fragmentation and marketization of international tax in these conditions of competition have eroded the ability of states both to collect taxes to finance their public fisc and to redistribute wealth. This, in turn, has seriously undermined the legitimacy of states' use of their coercive power to tax.

The starting point of the analysis in this book is the marketized and fragmentized structure of international taxation. Seeking to arrive at a nuanced understanding of how this regime operates, it frames international tax in market competition terms: understanding states as providing goods and services to their constituents and investors for a price – i.e., the taxes they pay. At the heart of the analysis, therefore, is the state, which is conceived of as a rational actor that interacts with peer state-actors as well as with its constituents and other taxpayers. The picture of international taxation drawn by this analysis is of a complex market where states strategize, cut deals, cooperate, or defect, all toward the goal of maximizing their national interests. But taxes, of course, are not ordinary prices, and state-supplied goods and services are not ordinary commodities. Nor is the interaction among states or with their constituents ordinary market relations. The roles, goals, and measures of success are (or at least should be) quite different. Thus, this book does not stop with the market analysis, but goes one step further, critically examining and normatively evaluating the results of this market interaction and emphasizing not only efficiency but also distributive justice and political participation.

The book uses the market analogy as well as game theory to understand the operation of the international tax regime as a strategic, competitive game played by market actors with market-like motivations and market strategies. In the tax market, countries design (or, if operating rationally, need to design) their international tax rules to best serve their national interests, while their choices interact and compete with the choices made by other countries. This strategic-market view of international tax sets the book's methodological framework. First, I explain how states could tax strategically on the *unilateral* level, anticipating or reacting to other states' strategies, to best advance their national interests. Second, I apply game theoretical analysis to consider whether explicit *bilateral* cooperation under tax treaties could prove superior to unilateral strategies. Third, I look at the *multilateral* level, comparing competitive and cooperative strategies, and using network theory to hypothesize about the costs and benefits of various multilateral cooperative accords. This market-based analysis exposes the interests – and the power struggles – that underlie the current regime and offers important insight on how to design future multilateral initiatives.

From a normative perspective, the book takes a critical look at the outcomes of the international tax regime in terms of distributive justice, efficiency, and political participation, arguing for more competition (or more efficient competition) as a better way than cooperation to advance a just and efficient international tax regime. In so doing, the book considers what goals international taxation *should* pursue, examines what it can pursue, and offers some tentative recommendations. This normative analysis stears away from the current scholarship as well as recent policy initiatives, which tend to condemn tax competition for the erosion of states' tax bases, taxing powers, and, in particular, redistributive capacity. These phenomena have led scholars and policymakers down different paths in search of a solution. Since competition is commonly blamed for the ills of the international tax regime, curbing it through cooperation has been assumed to be the most effective approach. The idea of cooperation has gained considerable influence and support and is taken to be unquestionably desirable; competition, in contrast, is commonly deemed unequivocally undesirable. This book takes an opposing view. It argues that conventional analysis – in sweepingly rejecting competition and endorsing cooperation – has been too quick to dismiss the benefits of competition