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Traditional conceptions of the nation-state have been challenged by the growth of the global economy. As increasing numbers of business transactions span international borders, frustrated participants point out the high costs of complying with disparate and even conflicting national laws. Ever more frequently, they espouse various forms of and methods for achieving an international convergence of legal rules. Some call for international agreements establishing uniform laws while others argue for the less complete convergence of "harmonization," but all propose limiting the national prerogatives responsible for legal diversity. Despite these entreaties, actual movement in the direction of uniformity has been painfully slow.

Several factors could account for the slow pace of change. One is that the benefits of uniformity are less than they appear to the proponents of such measures. While convergence may be helpful some of the time, over the entire range of affected cases diversity yields greater benefits. Another possible explanation, however, is less benign. Drawing on public choice theory, it posits that the untoward influence of interest groups prevents even beneficial instances of legal convergence. The survival of legal diversity, then, merely provides another example of special interest groups prospering at the expense of the general public. Put differently, interest group pressure forestalls legal convergence except in cases where it would lead to extraordinary gains.

Because gains from legal convergence often are hard to quantify, it can be quite difficult definitively to ascribe the absence of convergence as resulting from one or another of these factors. Often, the most that can be said is that the political barriers to change should make us suspicious of the slow pace of change. But what are these barriers, exactly? How do they arise and what, if anything, can be done about them?

This article uses one context in which the case for international harmonization or coordination has been pressed by academics, the definition of income for income tax purposes, as a case study in the general problem of public choice influences on the harmonization process. In particular, it argues that one reason tax base harmonization has so little political visibility (let alone viability) is that such convergence would generate diffuse benefits and concentrated losses. By focusing on the institutional and attitudinal impediments to tax base harmonization, the article shows how international tax policy can be as susceptible to domestic political concerns and interests as any piece of national

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legislation. It also speculates on measures that may be used to overcome these obstacles to harmonization.

This article is not intended as a paean to the virtues of tax base harmonization; indeed, reasonable people motivated solely by public-spirited concerns, may prefer to allow full or partial diversity in income definitions at the national level to adherence to an international standard. Many of the substantive objections to harmonized rules in general may apply to the particular case of tax base determinations. The point is, instead, to detail the difficulties faced by those who want to launch a discussion of these substantive issues, and by implication, those of other harmonization proposals.

For the lessons of this article to be meaningful, one must first believe that the concept of tax base harmonization has at least a surface plausibility. Therefore, the first part of the article shows why tax base harmonization may be desirable. The second part attempts to show why, despite such desirability, significant impediments to reaching such a unified definition of taxable income exist. The third part suggests actions that may be taken to make such an agreement more likely.

A. The Benefits of Tax Base Harmonization

The problems created by the differences in national income tax rates have long been discussed. Indeed, over the last decade, a concerted effort has been made to "harmonize" or "coordinate" national tax rates, particularly in the area of capital income taxation.[1] These efforts led to the adoption of a provisional agreement among European Union members on how to tax interest income earned by foreign investors.[2] Although the ultimate implementation of this agreement remains in doubt, academics have begun to

[1] *See* Communication from the Commission to the Council: Towards tax co-ordination in the European Union, A package to tackle harmful tax competition, COM (97)495 final at 2, ¶3 (noting that tax competition "reduces the room for manoeuver to meet other Community objectives..."); ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, HARMFUL TAX COMPETITION: AN EMERGING GLOBAL ISSUE 14 ¶23 (1998) [hereinafter HARMFUL TAX COMPETITION] (stating that tax competition "may hamper the application of progressive tax rates and the achievement of redistributive goals").

[2] *See* Joe Kirwin, *EU States Agree to Long-Term Framework For Cross-Border Tax on Savings Income*, 120 DAILY TAX REP'T GG-2 (June 21, 2000). Under the agreement, affected countries will have a choice between imposing withholding taxes on such income at a specified rate or providing the home countries of those investors with enough information to enable them to levy a home country tax on such income. The plan includes a transitional tax rate of 15 percent, starting in 2003, with the tax-collecting jurisdiction retaining only 25 percent of the taxes so collected and the remainder being remitted to the state in which the nonresident lives. *See* Joe Kirwin, *EU Finance Ministers Reach Accord On Cross-Border Savings Income Levy*, DAILY TAX REP'T G-1 (11/28/00).

discuss the possibility of taking the next step, of "harmonizing" tax bases by developing a uniformly applicable definition of taxable income.

Although tax lawyers, and particularly academic tax lawyers, like tidy solutions, the impetus for the idea of tax base harmonization stems from more than a generalized preference for elegant design. The alleged benefits of uniformity come from two quite disparate sources. A widely recognized source of such gains is administrative convenience. The other, and perhaps more important source at the international level, is the elimination of tax arbitrage. Each is discussed in more detail below.

1. Administrative Advantages

The most obvious advantages to having a uniform definition of income are administrative. Uniformity would allow taxpayers to provide identical information, often on identical forms, to each of several governments, rather than generating separate accounts and forms for each one. This would vastly reduce many enterprises' accounting costs. Even partial convergence could generate significant savings. One needs only think of the difference between the time necessary to fill out one's individual federal return and one's state return to appreciate the significance of standardization. Though state returns may be onerous, especially when taxpayers have to file contemporaneously in several different states,[3] they would be considerably more difficult if taxpayers had to create separate income schedules, applying different realization and recognition rules, depreciation schedules and the like, instead of starting with the "adjusted gross income" figure calculated for purposes of the federal return. Whatever frustration individuals would feel as a result of dealing with an unharmonized system would be (and currently is) magnified for corporate taxpayers. Corporations engage in more numerous and more complex transactions, generating more significant discontinuities in treatment across jurisdictions. These discontinuities often reverberate in future years, creating additional discontinuities in related transactions. For example, when jurisdictions use different depreciation schedules, the amount of gain calculated upon the sale of a partially depreciated asset differs from jurisdiction to jurisdiction, as do the pre-sale calculations of income derived from use of the asset. Differences in realization and recognition rules also affect several years' returns.

Taxpayers, then, would enjoy lower tax preparation costs in a tax base harmonized world. Governments would benefit from similar economies in the processing and enforcement arenas. Tax administration and enforcement could become much simpler. Given preexisting differences in language and culture and the political sensitivities that are implicated in the operation of a tax system, it strains credulity to

[3] Although the states of the United States utilize fairly consistent definitions of taxable income, they have not agreed on a common formula for allocating multistate income among taxing jurisdictions. *See* TAN 82-84 *infra*.

believe that standardization would lead to the creation of a single international tax enforcement agency. However, with that vision in the background, one can readily see areas for profitable coordination. Exchanges of information would be much more meaningful if the tax authorities knew that they were comparing apples to apples rather than to oranges. Further, taxpayer information could be provided on forms compatible with the computer systems of other countries, making possible the processing of large amounts of exchanged material, something that is currently impossible and undoubtedly makes tax evasion easier.[4]

Uniform, or near uniform, rules regarding more extraordinary transactions also could benefit both taxpayers and their governments. Currently, changes in business structure or organization often must be configured to satisfy different criteria established by several jurisdictions.[5] At a minimum, this entails hiring expert legal or financial representation in each country; less easily quantifiable costs may be imposed by the need to construct or maintain convoluted corporate or transactional structures. In the worst case, valuable business opportunities may be forgone as a result of unavoidably adverse tax consequences.[6] Governments bear some of these costs. In addition to the adverse affects on business expansion, governments may suffer increased governance costs. Taxpayers may take advantage of costly governmental administrative and dispute resolution mechanisms when attempting to cope (successfully or unsuccessfully) with the inconsistent demands of different jurisdictions. Even the substantial fee levied on taxpayers taking advantage of the letter-ruling process[7] likely fails to compensate the U.S. government for the full costs of responding to requests for guidance as to the tax treatment of these uniquely convoluted transactions.

Other dispute resolution facilities, such as courts and competent authority, also provide taxpayer services at government expense. Though taxpayers incur some of the costs of such institutions, taxpayers in general fund a sizeable percentage of the overall costs. Many litigated cases involve disputes about tax base definitions. One perennial question in the United States has been whether a particular foreign tax can be deemed an "income tax" even though its base calculation methods differ from U.S. methods with

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[4]*See IRS Foreign Information Returns Program*, 62 TAX NOTES 411, 413-414 (January 24,1994) (detailing technical barriers to effective use of foreign tax information); David Spencer, *OECD Information Exchange Recommendations Are A Significant First Step In Resolving Tax Evasion*, 8 J. INT'L TAX'N 353, 389 (1997).

[5]*See* Thomas L. Evans, *Respecting Foreign Mergers Under U.S. Tax Law*, 88 TAX NOTES 93, 99 (July 3, 2000).

[6]*Id.*

[7]*See* Rev. Proc. 98-1, 1998-1 C.B. 7 (establishing schedule of user fees in Appendix A).

respect to timing rules, deduction allowances or gross receipts formulas.[8] Differences spill over into other areas as well, ranging from technical issues such as whether to use U.S. or foreign tax principles for purposes of calculating the amount of "accumulated profits" under the foreign tax credit rules[9] to transfer pricing allocations.[10] Similar disputes undoubtedly arise at the administrative level. Again, greater harmonization of the underlying tax rules should reduce or eliminate such costs.

Administrative costs may be reduced still further because the standardization of tax base definitions may allow for some simplification of the underlying tax rules. For example, some aspects of the complicated foreign tax credit provisions of the Internal Revenue Code can be traced to the need to compensate for differences between the operation of the U.S. income tax system and that of other countries. To understand how and why this is true, one must first understand, at least in general terms, how the tax credit works.

Under international norms, income can be taxed by the country within whose borders it has been generated (the "country of source") as well as by the taxpayer's country of residence and (if an individual) the taxpayer's country of citizenship. Obviously, if each such country exercised its full taxing authority, most international

[8] *See, e.g.,* Bank of America v. United States, 459 F.2d 513 (Ct.Cl. 1972) (differences allowed because tax still reached net gain); Keasbey & Mattison Co. v. Rothensies, 133 F.2d. 894 (3rd Cir.) cert. denied, 320 U.S. 739 (1943) (differences precluded treatment as an income tax). While taxpayers may deduct all business-related taxes in calculating their income for tax purposes, foreign income and "in lieu of" taxes may be credited on a dollar for dollar basis against U.S. income tax liability. *See* I.R.C. §§ 901 and 903. The economic difference between the two treatments is substantial. *See* JOSEPH ISENBERGH, INTERNATIONAL TAXATION 123-124 (2000) (explaining value of credit over deduction). Elaborate regulations promulgated by Treasury in 1983 under section 901 spelling out allowable variations, *see* Treas. Reg. § 1.901-2, merely stemmed and did not halt such litigation. *See, e.g.,* Texasgulf, Inc. v. Commissioner, 107 T.C. 51 (1996) (profit for purposes of Ontario Mining Tax sufficiently like "net gain" even though calculated by deducting a "processing allowance" rather than actual business expenses). *See generally* Glenn E. Coven, *International Comity and the Foreign Tax Credit: Crediting Nonconforming Taxes*, 4 FLA. TAX REV. 83, 94-110 (1999) (detailing administrative and judicial history of definitional dispute). Such disputes are now often resolved prospectively through bilateral tax treaties. *See* CHARLES I. KINGSON AND CYNTHIA BLUM, INTERNATIONAL TAXATION 565 (1998) (problem arises mainly with taxes levied by non-treaty countries or at sub-federal levels).

[9] *See* United States v. Goodyear Tire & Rubber Co., 493 U.S. 132 (1989).

[10] *See* Texaco v. Commissioner, 98 F.3d 825 (5th Cir. 1996), cert. denied, 520 U.S. 1185 (1997) (foreign law rather than fair market value determined transfer price of oil between related entities); Proctor & Gamble Co. v. Commissioner, 961 F2d 1255 (6th Cir. 1992) (foreign law used to limit of royalty payments allocated under section 482).

transactions would be taxed out of existence. Generally speaking, international norms require the country of residence to take steps to avoid crippling duplicative taxation. Although some countries meet this obligation by excluding foreign source income from their tax base, the United States protects its residents by allowing them to credit foreign income taxes against their U.S. income tax liability. The amount of this credit is limited to the amount of the taxpayer's U.S. tax liability multiplied by a fraction, the numerator of which is the taxpayer's foreign source income for the year and the denominator of which is the taxpayer's worldwide income for the year.[11] The amount of credit allowed after application of this "foreign tax credit limitation" essentially corresponds to the amount of U.S. tax due with respect to the taxpayer's foreign income, thus reserving to the United States a full income tax on income sourced within its borders. For example, suppose a taxpayer subject to tax in the United States at a 38% rate earned $2000 from sources in the United States and $1000 from sources in France, which levied a 40% ($400) tax. This taxpayer would be allowed to claim only $380[12] in foreign tax credits, leaving a residual U.S. income tax liability of $760.[13] Twenty dollars of the French tax would be non-creditable (i.e. could not be used to offset U.S. income taxes due on other, U.S. source income) and non-refundable (the government would not send her a $20 check if, for example, that French-source $1000 was her only income), unlike, for example, the earned-income tax credit or the credit for taxes withheld by one's (U.S.) employer on one's salary income. The effect of denying the taxpayer a credit for this $20 is to cause the taxpayer, rather than the federal treasury, to bear the burden of the higher French tax rate.[14]

Congress realized almost immediately that for the foreign tax credit limitation to work properly, credits must offset the U.S. tax due in the tax year the credit-generating foreign income is reported for U.S. tax purposes. Its first formulation of this rule often did not allow this to happen. Because foreign taxes, like U.S. taxes, are payable in the year after the associated income is earned, Congress discovered that all too often "the credit is taken against the United States tax for the year following the year in which was earned the income on which the foreign tax was imposed..." As a result, taxpayers found themselves unable to claim tax credits for the full amount of foreign income taxes paid, even when those source taxes had been levied at rates lower than U.S. rates. To solve this problem, in 1924 Congress amended what was then section 222 of the 1921 Internal Revenue Code to allow taxpayers generally on the cash method to claim the foreign tax

[11] I.R.C. § 904(a).

[12] $380 = 1000/3000 X 1140.

[13] $760 = 2000 X .38 = 1140 - 380.

[14] France also bears the burden of this disallowance because it lessens the attraction of France for U.S. investors.

credit on an accrual basis.[15] Congress later became concerned about double taxation caused "because of the manner in which this country-by-country limitation works where the methods of reporting income are different in the United States and the foreign country."[16] It thereupon provided for the creditability of foreign taxes that oscillated between "too high" and "too low" (by U.S. standards) because of differences in realization and other timing rules by allowing taxpayers to carry excess credits back two years and forward five years. These carryover credits can be used to offset U.S. income tax owed with respect to foreign source income after the application of the carryover year's foreign tax credit.[17] By its terms, this carryover and carryback is not limited to later-reported income generated by such legal mismatches; as long the total amount of the credits being claimed do not exceed the carryover year's foreign tax credit limitation amount, the carryover credits may be used to offset U.S. taxes due on unrelated (to the foreign income underlying the carryover credit amount) foreign-source income.

Practically from the beginning, commentators noted the under-inclusive nature of this remedy.[18] Experience also has shown it to be over-inclusive; the existence of this extensive window period allows taxpayers additional opportunities to search for (and often create) low-taxed foreign income to make excess foreign tax credits creditable. Because the foreign tax credit limitation does not apply on an item-by-item basis, but allows taxpayers to group items of income and their associated tax payments prior to its application, taxpayers with excess credits often seek to earn low-taxed foreign income to "blend" with their high-tax income, thus bringing the total amount of foreign tax below the limitation amount. For example, if the taxpayer described above earned an additional $1000 in Japan, which was taxed in Japan at a 15% rate, its foreign tax credit limitation for the year would be $760 ($2000 x 38%), and all $550 ($400 to France, $150 to Japan) of its foreign tax payments would be creditable. Effectively, the $20 of formerly non-creditable French income tax would offset U.S. income tax that would otherwise be payable with respect to the Japanese-source income. The carryover period extends the time during which the taxpayer can look for and generate the low-taxed foreign income

[15] H.R. REP. NO. 68-179, at 22 (1924), *reprinted in* 96 INTERNAL REVENUE ACTS OF THE UNITED STATES 1909-1950: LEGISLATIVE HISTORIES, LAWS, AND ADMINISTRATIVE DOCUMENTS (Bernard D. Reams, Jr. ed., 1979).

[16] H.R. REP. 85-775, at 27 (1957); *see id.* at 27-28 (listing variations between U.S. and foreign income tax calculations).

[17] *Id.* at 28. The carryover provision is currently codified in section 904(c) of the Internal Revenue Code.

[18] *See* ELISABETH A. OWENS, THE FOREIGN TAX CREDIT: A STUDY OF THE CREDIT FOR FOREIGN TAXES UNDER UNITED STATES INCOME TAX LAW Pt. 5/2, at 320-321 (1957) ("This averaging device, however, will not necessarily solve the problem in all cases....").

necessary to avoid the impact of the foreign tax credit limitation, which makes for more effective tax planning.[19]

Taxpayers' exploitation of these tax planning opportunities were partially responsible for the Congressional decision to add the complicated "basket" system of tax credit limitations in 1986. The basket restrictions of section 904(d) require taxpayers to separate their foreign income, and the foreign taxes paid with respect to such income, into "baskets" of statutorily defined types of income. Taxpayers then calculate their foreign tax credit limitation on a basket-by-basket basis. This system prevents taxpayers from blending credits generated by categories of traditionally low-taxed income with credits from higher-taxed income in an effort to avoid the impact of the foreign tax credit limitation. Blending would become more difficult in the absence of a carryover period because taxpayers would have to ensure the exact timing of the income to be blended. Inasmuch as taxpayers have learned to "park" foreign profits in foreign corporations for eventual release in the form of dividend income, though, it may not be difficult enough to justify dispensing with the basket rules.

The point here is not that the tax base harmonization will enable Congress to turn the tax credit mechanism into a simple, elegant device; much of its complexity (as well as its very existence) stems from the underlying reality of tax rate differentials. But tax base harmonization may enable Congress to simplify the mechanism somewhat without decreasing its effectiveness. That simplification can benefit both taxpayers and the government.

Harmonization of tax base definitions also may reduce another source of complexity in the tax system, complexity caused by instability of the tax rules. At the very least, it should reduce the transition costs associated with attempts to use the tax system to micro-manage the economy or "one-up" the competition. The tortured development of the United States' rules for allocating deductions for research and development costs provides a textbook example of the political and administrative chaos (and concomitant institutional costs) that can be entailed by international disparities in tax rules.[20]

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[19]*See* JOSEPH ISENBERGH, I INTERNATIONAL TAXATION: U.S. TAXATION OF FOREIGN TAXPAYERS AND FOREIGN INCOME ¶20.6.1, at 564 (1990) ("a taxpayer with excess credits in any year had five years under the overall limitation in which to find enough foreign-source income taxed at low rates to absorb the excess credit amount").

[20]This history of the allocation of interest deductions is equally instructive. As that history is the focus of a paper written by another scholar, *see* Daniel N. Shaviro, *Does More Sophisticated Mean Better? A Critique of Alternative Approaches to Sourcing the Interest Expense of U.S. Multinationals*, 54 TAX L. REV. 353 (2001), there is no need to repeat it here.

Once again, the underlying issue was (and remains) the proper operation of the foreign tax credit limitation. The question this time was against which income to deduct research and development expenses. The more such expenses could be deducted against U.S. income, the larger the ratio between foreign source and worldwide income, and thus the larger the foreign tax credit limitation amount (and the more taxpayers liked it); the more such expenses had to be deducted against foreign income, the lower the foreign tax credit limitation amount (and the less taxpayers liked it).

Prior to 1977, Treasury's "sketchy" regulations implementing the statutory allocation and apportionment requirement[21] allowed taxpayers practically free rein to deduct a disproportionate amount of such expenses against U.S. source income, thus inaccurately inflating the foreign tax credit limitation amount.[22] Concerned that taxpayers were taking advantage of that situation by "double-dipping", or taking deductions for the same expenses against U.S. source income for U.S. tax purposes and foreign source income for foreign tax purposes, in 1977, Treasury issued regulations that allocated part of such deductions to the location in which such research and development was carried out and part on the basis of relative sales of products within the same product category of the products to which the research related.[23] Taxpayers contended that these rules discouraged U.S. based research and development activities because some foreign countries allowed deductions only for research and development conducted within their borders. This interplay of foreign law and the U.S. regulations, they claimed, in some cases prevented an effective deduction for U.S. based research and development expenses in any country, engendering overtaxation. The failure to take foreign law into account when drafting these regulations, the taxpayers claimed, forced them to move their research operations abroad.[24]

Apparently convinced by this argument, Congress imposed a moratorium on the application of the 1977 regulations during the years 1981-1985, allowing all research and development costs incurred in the United States during that period to be allocated against U.S. source income. In 1986, Congress enacted a temporary rule allocating 50 percent of research and development costs to the situs. Congress adopted a 64 percent situs allocation rule in 1988, which it re-adopted as a "temporary" section 864(f) of the Code

[21]*See* I.R.C. §§ 862(b) (for purposes of determining source of income of U.S. residents), 871(b) (for purposes of determining source of income for nonresident aliens with U.S. trades or businesses).

[22]BORIS I. BITTKER & LAWRENCE LOKKEN, FUNDAMENTALS OF INTERNATIONAL TAXATION ¶ 70.10.1, at 70-46 (1998).

[23]Treas. Reg. § 1.861-3(e).

[24]Which, of course, was precisely the response the foreign countries were hoping for. *See* Charles I. Kingson, *The Coherence of International Taxation*, 81 COLUM. L. REV.1151, 1233 (1988) ("Germany and other countries must be conscious of the effect of their actions.").

in 1989. Section 864(f) was reenacted in 1990 and 1991, but as a practical matter continued in force until 1993 when Congress reduced the situs allocation to 50 percent. In part, the 1993 revision can be attributed to Congressional budget restraints. However, by 1993, it had become clear that not even a 100 percent situs rule would be sufficient to keep research and development activities in the U.S. (all other factors being equal); taxpayers still would benefit by moving such operations to higher-tax jurisdictions with similar tax rules. The foreign tax savings would outweigh any conceivable U.S. tax detriment, particularly for taxpayers in excess credit positions. And many U.S. taxpayers were in excess credit positions after the 1986 tax reform act.[25]

If countries were constrained by an international base definition, their ability to skew rules unilaterally to attract (or repel) certain taxpayers or activities would be severely limited. Although such unilateral actions already are constrained somewhat by the possibility (certainty?) of retaliatory actions by other countries, this constraint is less than totally effective. For example, the United States is currently embroiled in what seems to be a wasteful series of tit-for-tat actions with regard to interest expenses.[26] A switch to a harmonized tax base may reduce the number, and thus the cost, of these ultimately futile series of rule changes.

It would be wrong to regard taxpayers as helpless pawns, at the mercy of erratic and irrational or selfish legislatures. Indeed, one of the biggest problems created by tax base variety is that taxpayers routinely use tax base discrepancies to achieve overly favorable tax results. How and why that happens is the focus of the next section of the paper.

2. Taxpayer Arbitrage

Because different countries have different timing and substantive rules, a transaction may have different tax consequences depending on the identity of the taxpayers or the location in which is it carried out. A transaction may be treated quite differently even by jurisdictions nominally taxing income at similar rates. Multinational taxpayers may be penalized by such discrepancies; a transaction may generate income subject to full taxation by two or more countries. However, most taxpayers can avoid that unpleasant result by obtaining the appropriate tax advice in advance of structuring significant business transactions with international implications, in short, by incurring

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[25]*See* BORIS I. BITTKER & LAWRENCE LOKKEN, *supra* note 22, at ¶ 70.10.5, pp. 70-75 - 70-76 (recounting history).

[26]Harmonization of tax bases would not prevent countries from trying to attain similar ends by adjusting tax rates. As I have argued elsewhere, *see* Julie A. Roin, *Competition and Evasion: Another Perspective on International Tax Competition*, 89 GEORGETOWN L.J. 543, 600-601 (2001), the relative transparency of tax rate adjustments allows public oversight of such tactics, at least in democratic societies.

administrative costs of the type previously discussed. Taxpayers' ability to use these differences to keep some income from being taxed anywhere poses the more critical danger. This is the problem of "tax arbitrage." Many examples of this phenomenon have been exposed by the tax press. Many others undoubtedly remain undisclosed, protected by confidentiality agreements and taxpayer self-interest. Three recent examples of this phenomenon should suffice.

The first was the problem posed by "dual resident companies." Because countries use different rules to define corporate "residence" for tax purposes, some companies are considered residents of--and were allowed to deduct their foreign losses against--two different sets of "home country" income. For example, a U.S. company may have claimed a deduction for the same expense against U.S. source income for U.S. tax purposes and against U.K. source income for U.K. tax purposes. This treatment generated a lower worldwide tax obligation than would have existed had the taxpayers been resident solely in either of their countries of purported residence. Consequently, the Senate Finance Committee concluded that "the dual resident company device creates an undue incentive for U.K. corporations (and Australian corporations) to acquire U.S. corporations and otherwise to gain an advantage in competing in the U.S. economy against U.S. corporations."[27] At least one commentator suggested that this asymmetry is irrelevant because a country could "facilitate a similar result by allowing their resident companies to borrow and deduct interest on the borrowing, use the borrowed funds to create an affiliate in a tax haven, and have that affiliate finance a U.S. acquisition with a loan giving rise to deductible interest."[28] However, the United States (and perhaps other countries as well) has gone to great effort to prevent its residents from achieving "similar results" through such substitute transactions. The anti-conduit rule,[29] when combined with the earnings-stripping rule,[30] prevent taxpayers from obtaining favorable tax results under alternate structures. These legislative efforts throw the legitimacy of dual resident transactions into question by recasting them as end-runs around the restrictions placed on such "substitute transactions." Of course, one may contend that it is the non-U.S. home country jurisdiction, rather than the United States, that should be upset by this evasion. Particularly when the rule implements a generally accepted norm (or, at least, one accepted by the United States in drafting its own tax system), though, it is hard to see why the United States should help countenance such schemes.

[27]S. REP. NO. 99-313, at 421 (1986).

[28]H. David Rosenbloom, *The David R. Tillinghast Lecture: International Tax Arbitrage and the "International Tax System"*, 53 TAX L. REV.137, 149 (2000).

[29]I.R.C. § 7701(l).

[30]I.R.C. § 163(j).

And even when the taxpayers (ultimately) come from a country which allows such substitute transactions, a host country legitimately may try to reduce the opportunities for achieving such favorable tax results. A country may decide that the increase in investment attractiveness that comes from being the target of such arbitrage is outweighed by the resulting revenue losses and/or competitive inefficiencies. In the most extreme case, one could envision a situation in which no one invested in their "home" countries; instead, all investment was transnational for tax reasons. In the best of all worlds, only ownership and not actual business activities would be affected; the only loss would stem from the transaction costs associated with the necessary changes in ownership. More likely, though, some business activities would change (for the worse) because of imbalances in capital flows or the market misperceptions of foreign owners. A country thus may try to reduce such harms by restraining the number and amount of instances in which this behavior occurs, even if unable to eliminate them entirely. Congress did exactly that by enacting changes to the consolidation rules under section 1503(d) of the Internal Revenue Code in 1986--changes which of course add to the complexity of the Code. Those changes would have been unnecessary if all countries shared as single, exclusive definition of corporate residence.

More recently, concerns have been voiced about so-called "hybrid entities," companies treated as corporations under a foreign countries tax regime but as transparent, tax "nothings" from the U.S. perspective thanks to the freedom afforded taxpayers under the "check the box" regulations.[31] Particular concern has focused on taxpayer's ability to use tax treaty provisions to make deductible, tax-free distributions from foreign entities. For foreign law (including treaty) purposes, such distributions are treated as interest payments made to a parent company. As interest, foreign law generally allows their deduction as an expense of the foreign "subsidiary" while the applicable tax treaty reduces or eliminates the gross withholding tax normally leveled against the recipient parent company. Thus, no foreign tax is imposed at either subsidiary or parent level. For U.S. tax purposes, however, these distributions are treated as having no tax import when received by the U.S. home office of what is treated, from the U.S. perspective, to be a single corporate unit. Taxpayers cannot make interest (or dividend) payments to themselves. The inter-office payment is of course equally ignored when the taxpayer computes its world-wide income, all of which is immediately taxable in the United States. If the taxpayer is otherwise in an excess credit position, this technique creates low-taxed foreign income which absorbs excess credits rather than creating additional U.S. income tax liability. From a marginal perspective, such income is free of both foreign and U.S. tax and has the added advantage (to the taxpayer) of making investment in a relatively high-tax jurisdiction more attractive–and perhaps more attractive to the U.S. taxpayer than to an entity wholly domestic to the high-tax jurisdiction. A wholly domestic enterprise may be unable to lay off the tax differential between the U.S. and foreign tax

[31] *See* Treas. Reg. §§301.7701-1 -301.7701-4, T.D. 8697, 1997-1 C.B. 215.

rates. Indeed, it was exactly such an inability of U.S. bidders faced with foreign competitors that caused Congress to enact section 1503(d) in 1986. [32]

True believers in "capital export neutrality" (who would support granting credits for all foreign income taxes, even those that exceed those that would be imposed on the foreign income were it earned domestically) may applaud the result of bringing the taxpayer's effective tax rate on the foreign investment to U.S. levels. However, even they should object to the means by which such neutrality is achieved, because those means encourage additional foreign investment in a (advertently or inadvertently) low-tax jurisdiction. This contravenes the supposed justification for adhering to a capital export neutral tax policy to begin with: preventing tax considerations from intruding into the business decision of where to locate investment/business activities.[33]

Nor should proponents of capital import neutrality applaud the availability of such arbitrage, for it does not result in all taxpayers operating in a single jurisdiction paying tax at the same rate. The arbitrage described above allowed businesses owned by foreign taxpayers to pay less tax than their domestic counterparts in their country of source. And arbitrage can be used to do even more. Rather than allowing investors to benefit from low tax rates prevailing in the countries in which they do business, some arbitrage transactions allow investors to pay tax at rates lower than those prevailing in either their country of residence or their country of economic source by allocating income either to no source or to an unrelated tax haven country. Cross border income is taxed favorably compared to income earned by the domestic residents of both countries. An example of this sort of arbitrage is provided next.

The hybrid entities technique is a variation of a preexisting scheme that operated by taking advantage of variations in the definition of interest and dividend income. Taxpayers would characterize payments from their foreign subsidiaries as interest for foreign tax purposes (thus becoming entitled to a deduction plus treaty protection) while characterizing the receipts as dividend income in the hands of the parent for U.S. tax purposes. Again, the object was to lessen foreign tax payments and hopefully use up (or prevent the creation of) excess foreign tax credits. Several other variants of this scheme exist, all of which play off the differing treatment of a foreign entity under U.S. and foreign law.[34]

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[32] *See* S. Rep. No. 99-313, 99th Cong., 2d Sess., at 420 (1986).

[33] *See* Julie A. Roin, *The Grand Illusion: A Neutral System for the Taxation of International Transactions*, 75 VA. L. REV. 919, 933 (describing the adverse effects of blending opportunities).

[34] *See, e.g.* Thomas R. May, *Warning: Hybrid Entities: Proceed With Caution*, TAX NOTES 533, 533 (January 24, 2000) (describing how the check-the-box regulations made "both practical and attractive" some "international tax planning strategies" using entities "classified inconsistently under U.S. and foreign tax law") ; New York State Bar Association, *Notice 98-11: Tax Treatment of Hybrid*

The latest variation on this theme involves "reverse hybrids," entities regarded as U.S. corporations for purposes of U.S. law and fiscally transparent for purposes of foreign law. U.S. investors use such entities to generate timing advantages.[35] These structures allow taxpayers to defer income recognition without deferring recognition and utilization of associated foreign tax credits. Though at some point the income will have to be recognized for U.S. tax purposes and without any tax credits (since those were claimed and used in an earlier year), the timing mismatch can be "awfully rich" for taxpayers.[36] Foreign taxpayers use these entities to obtain treaty benefits (a reduction or elimination of source tax) for income that in practical terms is also exempt from residence country tax.[37] Treasury has issued regulations[38] denying U.S. treaty benefits for entities claiming fiscal transparency in their alleged country of residence and has been working to convince other nations to do the same (i.e. to look to the treatment of the entity in the state of alleged residency for purposes of determining entitlement to treaty benefits), with mixed success.[39] Congress attempted to limit the availability of such treaty benefits by adding section 894(c) to the Code in 1997.[40]

These are just three of the many devices which arbitraged differences between tax base definitions to reduce taxpayers' worldwide tax obligations to levels below those that would have applied had the same transactions been carried out by domestic taxpayers wholly within either of the affected countries. Some of these devices no longer work because of intervening legislative or regulatory enactments. But innumerable others exist, with more and different ones exploited as clever tax lawyers outpace regulators in locating and closing off such opportunities. Although in some cases the arbitrage

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Entities, TAX NOTES 877 (May 18, 1998).

[35]*See* Lee A. Sheppard, *More Check-the-Box Fallout: Reverse Hybrids*, 87 TAX NOTES 1196, 1196 (May 29, 2000) (using example of U.S. partnership which owns a foreign holding company which owns a foreign operating company regarded as a passthrough under foreign law and a corporation under U.S. law). Two years ago, Treasury issued a notice stating that the government is considering deferring foreign tax credits in these situations, but has yet to promulgate a formal policy dealing with the issue. *Id.; see also* Notice 98-5, 1998-1 C.B. 334 (1998).

[36]*See* Lee A. Sheppard, *supra* note 35, at 1197 (quoting Stephen Shay).

[37]*See id.*, at 1197-1198.

[38]*See* T.D. 8889, 2000-30 I.R.B. 124, 65 Fed. Reg. 40993 (July 3, 2000), corrected Announcement 2001-4, 2001-2 I.R.B. 286. However, the new regulations fail to deal with all the situations in which such problems arise, as well as covering some innocent situations. *See* Lee A. Sheppard, *Hybrid Problems Continue Under Improved Treaty Regulations*, 88 TAX NOTES 316 (July 17, 2000) (discussing remaining problems).

[39]*See* Lee A. Sheppard, *supra* note 35, at 1198.

[40]*See* I.R.C. § 894(c) (enacted by P.L. 105-34, § 1054(a)).

between tax systems is foreseen and desired by one or both of the affected countries,[41] and in others, foreseen and not desired, in most, it is fair to say, such arbitrage is neither foreseen nor desired by either of the affected countries. These are not situations in which a taxpayer (or a country) benefits by investing in a low-tax environment rather than a high-tax environment; arbitrage involves the artificial (and individual) construction of a lower tax regime by making use of the inconsistent provisions contained in two higher-tax regimes.

Though many allege that tax avoidance is a victimless or harmless activity, in fact, avoidance activities create two problems. In some cases, tax avoidance requires very little in the way of changes in behavior; its sole real-world effect is to decrease government revenues. Those who regard this effect as harmless fail to appreciate the fact that such lost revenue must be recouped, generally by increasing taxes on other taxpayers or by moving to different taxing mechanisms. It is possible, but hardly plausible, that governments systematically choose relatively less efficient taxing mechanisms in the first instance and move to more efficient mechanisms in response to revenue shortfalls. More likely, though, tax arbitrage, like other forms of tax shelter activity, drives up governments' marginal cost of funds by forcing increases in taxes that are more distortionary than a properly operating (i.e. one with no arbitrage opportunities) income tax system.[42] In other cases, taxpayers have to undertake real changes in their business activities to achieve the desired arbitrage gains. For tax reasons, they may build cars in Ireland rather than the United States or France. These tax-induced departures from baseline behavior are, by definition, inefficient and undesirable[43], thus adding to the

[41]The rules regarding the deduction of research and development expenses discussed above are an example of "planned" arbitrage, initially by only one of the affected countries. In other cases, unplanned arbitrage may be regarded favorably by one of the affected countries. Neither Britain nor Australia, for example, seemed to object to the effect of "hybrid entities" on the ability of their residents to acquire U.S. companies (though they did not try to protect their entities' advantage by protesting the Congressional action, either). Inasmuch as countries have often tried to use targeted tax breaks to entice foreign investment, they may not be upset when taxpayers construct one for themselves. On the other hand, they may object to the "unfair competition" with domestic investors or simply feel that the investment would have been made regardless of the tax situation, and desire greater revenue.

[42]It goes without saying that if arbitrage opportunities cannot be foreclosed, another taxing system may become preferable to the income tax system, and a well-run country would switch to that alternate system. However, this still may leave the country in a position inferior to where it was prior to the development of arbitrage schemes, i.e. when it had a functioning income tax system. Switching tax regimes may make the best of a bad situation, but successfully eliminating arbitrage opportunities may prevent that bad situation from arising to begin with.

[43]I do not mean to suggest that all tax-induced changes in behavior are inefficient and undesirable; as I have made clear in other work, *see supra* note 26, it may be quite efficient from the perspective of both taxpayers, countries and society as a whole for taxpayers to move business operations from high-tax to low-tax jurisdictions. This article singles out only tax disparities created by arbitrage, or the unintentional interaction of two disparate tax systems. No legitimate purpose is

inefficiencies caused by revenue shortfalls. These costs may be hard to see and harder to quantify, but they exist nonetheless.

3. Insufficiency of alternate solutions

From any single government's point of view, it is extremely difficult to shut down such arbitrage opportunities through minor legislative "fixes". There are far too many inconsistencies (and ways to use them to generate benefits or fall into traps) to construct a rule for each one. Nor is the field a static one; other countries change their tax rules as frequently as we do. Such changes often create new opportunities for arbitrage. And reacting to particularly egregious abuses as they arise (more or less the U.S. strategy) seems quite arbitrary to observers.[44] Further, the retrospective nature of the remedy maximizes political opposition to changes that benefit the government; it is always harder to take away tax benefits taxpayers believe are "theirs" than to prevent their acquisition ab initio.

Tax treaties in the form of bilateral agreements dividing taxing jurisdiction over income earned in one treaty partner by a resident of the other have traditionally played a role in ameliorating conflicting base computation rules. Traditionally, however, their focus has been on discrepancies that operate to the detriment of taxpayers, rather than their benefit. For example, many treaties contain "nondiscrimination" clauses mandating equal tax treatment for fully domestic taxpayers and domestic enterprises owned by residents of the treaty partner. They prevent source countries from imposing particularly harsh tax rules on non-residents, rules which almost by definition will fail to correspond with the home country tax rules. Thus, such clauses would take precedence over national laws restricting deductions claimed by non-resident business entities, laws which otherwise would have increased the level of source taxation by artificially increasing the size of the tax base. Of course, the taxpayer rather than the U.S. government may be the direct beneficiary of such clauses since the additional source taxation may have been made non-creditable by the foreign tax credit limitation.

Admittedly, some treaties do deal with specific tax anomalies. The U.S. - India treaty, for example, provides that the source of income derived from providing certain technical services will depend on the location of the payor for both U.S. and Indian tax

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served when a U.S. company builds a car assembly plant in Ireland because it has figured out a way to pay taxes at an effective rate of 5 percent (rather than the statutory rate, applicable to Irish companies assembling cars in Ireland, of 15%) on its Irish operations by making use of arbitrage opportunities while Irish companies do the same in the United States, taking advantage of their own arbitrage opportunities. It is hard to see the economic or social benefits of maintaining a tax system which encourages cross-investment for its own sake, and not because of some underlying economic or political advantage.

[44] *See* H.David Rosenbloom, *supra* note 28, at 154 .

purposes, overriding the normal U.S. source rule in favor of the Indian one.[45] Other treaties provide for the deduction of certain types of business expenses otherwise not allowable under foreign law. More recently, taxpayers and Treasury have begun using treaty-based competent authority proceedings jointly to resolve transfer pricing issues.[46] However, although Treasury has begun asking for treaty language aimed at prohibiting specific arbitrage schemes,[47] by their nature treaty remedies are partial and retrospective in nature. Further, treaties are even less subject to updating and amendment than legislation.[48] Thus, like legislative "fixes," they are unlikely to provide a systemic solution to the problems caused by tax base differentials.

Indeed, only one solution would be truly systemic: world-wide agreement on the definition of taxable income. International cooperation leading to the development of a common understanding of the tax base would simultaneously render obsolete the problems of multiple books, excess complexity, and arbitrage identified above.[49] Is tax base harmonization indeed then the next logical step, one which we should expect to see at least seriously discussed if not adopted in the relatively near future? One might think so. After all, in subnational jurisdictions with overlapping income tax systems, tax base

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[45] *See* Convention between the Government of the United States of America and the Government of the Republic of India for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Concluded September 12, 1989, Art. 12 (Royalties and Fees for Included Services) and Art. 25.3.b (Relief from Double Taxation).

[46] *See* Rev. Proc. 96-53, 1996-2 C.B. 375 (setting out procedures for initiating process); *IRS Reports Completed APAs Reached Record High of 60 During Calendar 1999,* 1995 DAILY TAX REP. 14 G-1 (Jan. 21, 2000).

[47] *See, e.g.,* Testimony of the Staff of the Joint Committee on Taxation before the Senate Committee on Foreign Relations Hearing on Tax Treaties and Protocols with Eight Countries, Joint Committee Print JCX-53-97, Oct. 7, 1997 (testimony of Ken Kies, Chief of Staff of Joint Committee) (proposed treaty with Austria includes an "anti-abuse rule covering certain 'triangular cases'"); *but see* Joint Committee on Taxation Staff Explanation of Proposed Protocol to U.S.-Canada Income Tax Treaty, JCS-15-95, at 35-38, May 23, 1995, *reprinted in* 100 DAILY TAX REP'T L-30, L-48 - L-50 (May 24, 1995) (describing "provision not found in any other treaty, that either of the Contracting States may deny treaty benefits 'where it can reasonably be concluded that to do otherwise would result in an abuse of the provisions of this Convention.'").

[48] *See* AMERICAN LAW INSTITUTE, II FEDERAL INCOME TAX PROJECT, INTERNATIONAL ASPECTS OF UNITED STATES INCOME TAXATION: PROPOSALS OF THE AMERICAN LAW INSTITUTE ON UNITED STATES INCOME TAX 12 (1991) ("The treaty-making process is a slow and arduous one."); H. David Rosenbloom, *Toward A New Tax Treaty Policy For A New Decade*, 9 AMER. J. TAX POL'Y 77, 79 ("treaties have a disturbing tendency to remain in effect long after their usefulness has been called into question...).

[49] It would not, however, lead to any improvement in the transfer pricing area. Transfer pricing issues are highly fact specific and it is the conflict over the legal interpretation of those facts, rather than differences in prevailing laws, that generally create the problems.

uniformity prevails – sometimes as a matter of law imposed from above[50] but sometimes as a "spontaneous" development.[51] This article argues that the path towards similar uniformity in the international context will be much bumpier with an uncertain end. While some of opposition to tax base harmonization may be principled,[52] additional obstacles will arise from the combination of institutional dynamics and taxpayer reluctance feeding into those dynamics explained in Part B below.

B. The Relative Unattractiveness of Tax Base Harmonization

Though economists have emphasized the need for international tax base harmonization – either in conjunction with or instead of tax rate harmonization – for over thirty years,[53] there has been little discussion, let alone movement, in that direction in the income tax context. Instead, tax rate harmonization has been accorded higher priority, despite widespread knowledge of the toothlessness of such proposals in the absence of tax base harmonization. One of the first lessons of any tax policy class is that the effective tax rate is a function both of the tax base and the nominal tax rate; reductions in the tax rate can be completely offset by upward re-valuations of the tax base and visa versa. The relative innocuousness of tax rate proposals of course may have been the source of their legislative – and voter--appeal. Any serious tax base harmonization proposal will significantly impinge on preexisting legislative prerogatives. In addition, it

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[50]*See* Brian J. Arnold, *General Description: Canada, in* COMPARATIVE INCOME TAXATION: A STRUCTURAL ANALYSIS 25, 25-26 (Hugh Ault 1997) (mandatory intrajurisdictional uniformity in Canada); Peter Melz, *General Description: Sweden, in id.*, at 97, 97 (same, in Sweden); *see also* Richard Vann, *General Description: Australia, in id.*, at 5,5 (state and national income tax bases harmonized prior to abolition of state income taxes during WWII).

[51]Although not required by (federal) law to do so, most states of the United States which levy income taxes do so on a base which closely corresponds to the base of the federal income tax. *See* JEROME R. HELLERSTEIN, WALTER HELLERSTEIN & JOAN YOUNGMAN, STATE AND LOCAL TAXATION CASES AND MATERIALS 406 (6th ed. 1997) ("The outstanding characteristic of state corporate income taxes...is their broad conformity to the federal corporate income tax base."). Some variations remain, both between the federal and state bases and between the bases of various states. For example, most states reverse the federal tax code's exclusion of interest from municipal bonds while excluding the interest from Treasury bills; they also disallow the deduction for state and local taxes. States also differ in their methods for allocating that base among themselves, utilizing different formulas. But the basic definitions, realization rules, and structure follow the federal pattern.

[52]Again, I remain agnostic on the question of whether the economic benefits of tax base harmonization outweigh its costs; I am perfectly willing to believe (and intend to explore in another article) that the cost-benefit calculus in the international context differs from that in the national/subnational context.

[53]The Commission of the European Community has been recommending income tax base harmonization since 1980, with little effect. *See* Commission of the European Communities, Report from the Commission to the Council on the Scope for Convergence of Tax Systems in the Community, S. 1/80 Bull. of the Eur. Communities 13 (1980).

is likely to threaten the interests of powerful taxpayers – in many cases, the very taxpayers who would most benefit from the administrative advantages of a harmonized rate base. This inbred resistance to tax harmonization will be hard to overcome by appeals to others, whose interests in the issue will be far more remote.

1. Legislative Hostility to Tax Base Harmonization Proposals

National legislatures and legislators are the natural enemies of tax base harmonization proposals. Tax base harmonization reduces legislative control over national tax policy without creating a corresponding increase in control over world-wide tax policy. National legislators thus would lose a significant element of political power, power that generates benefits in the form of campaign donations, honoraria and other in-kind benefits.[54]

No national legislature (or group of legislators within such a legislature) could expect to exert as much control over the shape and contents of an internationally harmonized tax base definition as they would over a national definition. Additional interests–some of which may be at odds with domestic political considerations–will have to be taken into account to achieve a multilateral agreement. As the number of relevant actors increases, the amount of power exercised by each relative to the whole necessarily decreases. Further, to preserve harmonization in future years, restrictions will doubtless be placed on the ability of national legislatures to amend the agreed upon rules.

In theory, this loss of control over national tax policy could be offset by an increase in the amount of control exercised over the tax rules of other nations. That is, because tax rules would have a wider reach than before, each national legislature would have less power over any individual rule, but the system of rules as a whole would be much more powerful. The legislature's power would therefore become broad and shallow, rather than narrow and deep, but the overall amount of such power--and its concomitant benefits--could remain the same. If one prefers to use a pie analogy, harmonization would cause each legislature's slice of the pie to shrink in relative terms. However, at the same time the pie would grow in size. If the pie grew big enough, the legislature's (and any particular legislator's) newly configured slice might contain the same surface area as its original slice.

Though one might think that would mean that the new slice would be equally capable of satisfying the legislature's appetite for political power, several factors suggest that most legislatures and legislators would object to a trade of this nature. And since a

[54]*See* Richard L. Doernberg & Fred S. McChesney, *On the Accelerating Rate and Decreasing Durability of Tax Reform*, 71 MINN. L. REV.913, 936 (1987) (in 1985, "[t]he lobbyists' payments exceeded by over fifty percent the $32.66 million that United States taxpayers paid as salaries to the 535 senators and representatives. The payments take many forms, including campaign contributions, speech and personal appearance honoraria, and in-kind benefits").

majority of (if not all) legislatures and legislators would have to agree to harmonization for it to become the law of the land,[55] the path towards adoption would be anything but smooth.

Even assuming national legislatures continue to have a role in determining tax rules under a harmonized system, their power in such a world would be spread very thinly. This would make lobbying very expensive, perhaps too expensive relative to expected benefits for many current participants. The issue of cost goes beyond simply the sheer number of legislatures and legislators that a lobbyist would have to persuade under a harmonized regime to make intervention worthwhile, though that would be part of the problem. Additional costs and difficulties will be imposed by the variety of political traditions and alignments such lobbyists would have to work within. Many likely would decide to abstain from the process entirely, to the detriment of national legislators.

As tax issues would not lose their importance, other actors, other lobbyists, would undoubtedly take the place of those that dropped out. Thus a legislature as a whole (as well as individual legislators) would, on average, retain its preexisting level of power in a tax-harmonized world. However, that world would be considerably different, involving new players and new issues, often with uncertain ramifications for preexisting supporters. Nationally-based politicians may be wary of the appearance created when forming the necessary relationships with non-nationals over tax issues; to put it bluntly, domestic constituents with adverse interests on other issues may be suspicious of such relationships. Given that, on average, legislatures and legislators will gain no additional power from the move to a harmonized tax base, the considerable disruption in established political relationships may seem too high a price to pay.

Of course, what is true "on average" may not be for individual legislatures and legislators. Undoubtedly, some will attain relatively more power while others will become less influential. Some legislators and legislatures may be willing to bet that they will come out ahead, in terms of power, as a result of the changes. But at least in the United States, there is little evidence for the proposition that politicians crave change and risk;[56] their behavior when structuring redistricting plans suggests the opposite.[57] And

[55]Even if adopted in the form of a treaty obligation, harmonization would require the assent of two-thirds of the sitting Senators. U.S. Constit., art. II, § 2,cl. 2.

[56]Note that legislators and legislatures would have to be risk-preferers to favor tax harmonization, since the expected returns (looking solely from the influence perspective) of the harmonization bet are the same as those from the status quo.

[57]*See* Daniel H. Lowenstein and Jonathan Steinberg, *The Quest for Legislative Districting in the Public Interest: Elusive or Illusory*, 33 U.C.L.A. L. REV. 1, 67 (1985) ("Politicians are much more likely to be risk-avoiders than risk-seekers); *id.* at 68 & n. 167 (example of risk-averse legislators sacrificing potential party gains for personal electoral safety).

unless a majority[58] of legislators believe that they personally, or their legislature as a whole, will be better off, they will opt for the status quo.

But the most important impediment to legislative acquiescence in a harmonization scheme comes from the probability that any such scheme would provide for the establishment of a new, international organization for the consideration of tax legislative proposals. In short, it would remove this area of responsibility–and political opportunity–from the purview of the preexisting legislatures and entrust it to a newly formed institution.

It would be hard to overstate the unwieldiness of a decision-making procedure requiring concurrent majorities of the legislatures of all the harmonizing countries, or even a majority of such countries. Such a procedure would be significantly more unwieldy than the European Union's current procedure for dealing with tax proposals, already the subject of considerable complaint.[59] And, of course, the hope would be to encompass even more countries in the harmonization scheme, making such a procedure even more problematic. Some method would be found to reduce the number of active decision makers to a reasonable number.[60] Even if those decision makers were drawn from current legislative bodies (and more likely they would be chosen for technical expertise) a significant number of current legislators could expect to be frozen out of the new process, and the political benefits entailed by that process. Again, some individuals may think they have a reasonable shot at these new positions, but it would require mass delusion for the required majority of legislators to be so optimistic.

Still, one might argue that as long as national legislators and legislatures retain control over the determination of tax rates, the virtual elimination of their influence over the definition of the income tax base is relatively unimportant. After all, as stated earlier, to a large extent tax rate and tax base decisions are economically interchangeable; any change in taxable income caused by a re-definition of the tax base can be offset by a corresponding change in tax rates. However, legislators find it much harder to vary tax rates than tax base definitions because the former are so much easier for constituents to

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[58]Or a supermajority, in the United States, in the case of treaty-effectuated harmonization. *See supra* note 55.

[59] The current procedure requires unanimous approval in the EU Council of Ministers, a council composed of one representative from each of the fifteen member countries. *See* Joe Kirwin, *EU Commissioner to Recommend Shift in Focus from Harmonization to Tax Barriers*, 26 DAILY TAX REP'T G-1, G-1 (February 7, 2001).

[60]The details of such an arrangement would doubtless be the focus of some dispute. Though one could look at the organizations of the European Union as models, it is unclear whether they would be regarded as models for good or ill. Their "democracy deficit" has been widely criticized. *See* JOHN H, JACKSON, WILLIAM J. DAVEY, ET AL., LEGAL PROBLEMS OF INTERNATIONAL ECONOMIC RELATIONS: CASES MATERIALS AND TEXT 193 (3d ed. 1995).

monitor. Hence the opportunities for delivering special favors–and receiving the accompanying recompense–will decrease despite the economic equivalence of the two measures. And perhaps just as importantly, they know it.

It has been almost fifty years since critics first contended that the tax code was particularly susceptible to special interest legislation.[61] These critics claimed the technical nature of most tax legislation made it quite difficult to determine both the identity of benefitted parties and the amounts being conferred on them, all but eliminating the possibility of effective monitoring by outside voters in all but the most extreme cases.[62] "Pursuing this idea to a logical conclusion,"[63] when one of these critics, Professor Stanley Surrey, became Assistant Secretary of the Treasury, he suggested a procedural change to increase the visibility of spending through tax provisions. Professor Surrey advocated including a "tax expenditure budget," detailing all provisions giving "special" treatment to particular transactions or activities, in the annual federal budget.[64]

Professor Surrey eventually won his battle,[65] but he may have lost the war. The effect of the tax expenditure budget is debatable. Although Congressional staff members have used this budget as a source of revenue-raisers,[66] in recent years the amount of such expenditures has been increasing.[67] Indeed, some have contended that the tax expenditure

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[61] *See, e.g.*, Walter J. Blum, The Effects of Special Provisions in the Income Tax on Taxpayer Morale, in Joint Committee on the Economic Report, Federal Tax Policy for Economic Growth and Stability, 84th Cong., 1st Sess. 251, 252 (1955), *cited in* Boris I. Bittker, *Accounting for Federal 'Tax Subsidies' In The National Budget*, 22 NAT'L TAX J. 244, 244 (1969); Walter W. Heller, *Some Observations on the Role and Reform of the Federal Income Tax*, in House Committee on Ways and Means, Tax Revision Compendium 181, 190 (1959), *cited in* Boris I. Bittker, *supra*, at 244-45.

[62] *See, e.g.*, Walter J. Blum, *supra* note 61, at 244; Walter W. Heller, *supra* note 61, at 244-45.

[63] Boris I. Bittker, *supra* note 61, at 245.

[64] Boris I. Bittker, *supra* note 61, at 245.

[65] The Congressional Budget and Impoundment Control Act of 1974 requires promulgation of an annual tax expenditure budget. 2 U.S.C. § 640(c)(3).

[66] Sometimes too much so, in the view of some commentators. *See* Victor Thuronyi, *Tax Expenditures: A Reassessment*, 1988 DUKE L. J. 1155, 1172 - 73, 1181 (1992) (decrying tendency to repeal tax expenditure provisions fulfilling "important subsidy functions" without providing an alternative subsidy mechanism outside the tax system).

[67] *See* Mary L. Heen, *Reinventing Tax Expenditure Reform: Improving Program Oversight Under the Government Performance and Results Act*, 35 WAKE FOREST L. REV. 751, 784 (2000) ("Relatively few tax expenditures identified in the budget since 1974 have been eliminated from the tax code. In recent years, tax expenditures have proliferated."); Gene Steurle, *Some Thoughts on the Status of Tax Expenditures* , 68 TAX NOTES 485, 485 (1995) (tax expenditures rose from 55.2 percent

budget has done more harm than good by alerting various special interest groups to the possibilities offered by tax legislation.[68] In addition, the tax expenditure budget fails to include the full range of tax favors.[69] It still remains the case that few people understand the arcana of tax law, and as a result, Congress retains the ability to manipulate base definitions for political ends.

At least, it has more flexibility in manipulating tax base definitions than in changing tax rates. Sections 68 and 55(d)(3) of the Internal Revenue Code, which "phase-out" various itemized deductions and personal exemption amounts as adjusted gross income grows, are often described as surreptitious rate increases.[70] Inasmuch as such furtive rate changes create extraneous difficulties such as "bubbles"–places where tax rates drop as income rises and other horizontal equity problems[71]--Congress would not employ such mechanisms unless it believed that they (and by extension other tax base manipulations) were less visible or salient to the average voter than straightforward changes in tax rates. That is, Congress must have believed that such base manipulations would have fewer political repercussions than outright increases in tax rates, even though the financial impact on most taxpayers would be the same. Congress may be deluded in this regard[72] (and we will undoubtedly find out in the event a tax base harmonization proposal becomes law), but there is no particular reason to doubt its political acumen on this point. And that same political acumen will lead it (and probably other legislatures as

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of income tax revenue in 1991 to 59.9 percent in 1995); Christopher Bergin, *Spending Through the Code – The Top Ten Tax Expenditures*, 78 TAX NOTES 795, 795 (1998) ("Not only does the tax expenditure budget continue to grow, it's growing at a fairly strong rate....The growth also illustrates that spending through the tax code has become a popular pastime again in the '90's with Washington politicians....").

[68]*See, e.g.*, Lee A. Sheppard, *The Role of the Earned Income Tax Credit After Welfare Repeal*, 72 TAX NOTES 1594, 1594 (1996) ("Unfortunately, disclosure of the cost of the tax goodies flowing largely to the rich has not been enough to kill them; open pricing seems only to have resulted in a more efficient auction of congressional favors.").

[69]*See* Gene Steurle, *supra* note 67, at 486. Its (inherently) noncomprehensive nature of the tax expenditure has been a focus of criticism since its inception. *See, e.g.,* Boris L. Bittker, *supra* note 61, at 249; Victor Thuronyi, *supra* note 66, at 1166-67.

[70]*See, e.g.*, Glen E. Coven, *Congress As Indian-Giver: "Phasing-Out" Tax Allowances Under The Internal Revenue Code*, 6 VA. TAX REV. 505, 526 (1987) ("the purpose that underlies these phaseouts was political deceit"); James Edward Maule, *Getting Hamr'd: Highest Applicable Marginal Rates That Nail Unsuspecting Taxpayers*, 53 TAX NOTES 1423, 1429 (1991) ("vote-seekers use smoke and mirrors to fabricate pipe dreams that sound appealing").

[71]*See* Glen E. Coven, *supra* note 70, at 516 & 530.

[72]Opinions are divided on this issue. *Compare* Glen E. Coven, *supra* note 70, at 531 *with* James Edward Maule, *supra* note 70, at 1429.

well) to reject proposals for tax base harmonization even more forcefully than proposals for tax rate harmonization.

Politicians gain power from their ability to distribute funds as well as their ability to decide how to raise them; theoretically, tax base harmonization could increase tax revenues sufficiently to counterbalance losses in other sources of political power. It seems that the potential for access to additional revenues spurred some countries to agree to the EU proposal for harmonizing income tax rates on capital income. The United Kingdom, for example, began supporting the proposal only after it was modified to make it easier for home countries to receive the taxes levied with respect to foreign interest income derived by their residents.[73] Other countries also became more enthusiastic after the addition of a revenue-sharing provision.[74] But tax base harmonization will not necessarily provide governments with enough additional revenue to fully compensate their politicians for the concomitant losses of political control.

Though some additional tax revenues will be raised by foreclosing arbitrage opportunities, the amount that will be gained is uncertain. Most arbitrage transactions, like tax shelter activity in general, are largely hidden from view to prevent attracting the attention of regulators and legislators who might look for ways to foreclose them. It is possible that the amount of revenues at stake would not justify the social costs of harmonization.[75] However, even if the revenue benefits of harmonization outweighs its costs at a social level, the cost-benefit analysis at the legislature or individual legislator level may be different. Put simply, control over the tax base definition gives a legislature the power to benefit a few at the expense of the many, with concomitant side benefits for its members. Those side benefits may lead legislators to ignore evidence of the desirability of harmonization.

The biggest beneficiaries of arbitrage are multinational corporations; most of the additional revenues raised by foreclosing arbitrage opportunities would be collected from this relatively small group of taxpayers. These taxpayers, already a potent political force in many national jurisdictions, would undoubtedly fight such attempts to increase their tax burden. And they may well succeed, given that amounts which may be huge from the perspective of each affected taxpayer are likely to prove insignificant on a per capita basis for the much larger class of taxpayers as a whole. The situation fits perfectly within the

[73]*See* Joe Kirwin, *EU States Agree to Long-Term Framework For Cross-Border Tax on Savings Income*, 120 DAILY TAX REP'T (BNA) GG-1, GG-2 (June 21, 2000) (UK insistent on change in focus from "harmonization" to avoidance of "tax evasion").

[74]*See* Bengt Ljung, *EU Nations Still Deadlocked on Savings Tax Following Meeting of High-Level Tax Group*, 95 DAILY TAX REP'T (BNA) G-5 (May 16, 2000).

[75]As stated earlier, I remain agnostic on the question of the social desirability of tax base harmonization. *See supra* page 2 .

classic political choice model of concentrated minority interests facing a dispersed majority. And even if the dollars involved were shown to be quite large–large enough to look significant to a dispersed majority–that majority (rightly or wrongly) may assume that the lion's share of funds collected through the elimination of arbitrage would be recycled to the large multinationals in some other form, rather than redounding to their personal benefit. In short, even if their collective interest outweighs the losses that would be suffered by multinationals, the general public may not pressure their political representatives to adopt harmonization.

Of course, state and other subnational legislatures would have suffered comparable losses of power from deciding to conform their tax bases to a national definition. And while some subnational legislatures had no choice in the matter, states of the United States were and remain free to design their tax systems however they choose, and for the most part, have chosen not to take advantage of that power. Every state except Alabama, Arkansas, and Mississippi uses federal taxable income as the starting point for the determination of state corporate income tax liability.[76] What explains their acceptance of a diminished stature and power? And would that explanation apply to national governments considering the adoption of international harmonization proposals?

Several factors were (and to some extent remain) unique to the state situation. First, the federal income tax pre-dated most state income taxes. Several states had limited versions of a corporate income tax prior to the introduction of the federal income tax.[77] However, the first general state income tax pre-dated the federal income tax by only two years, while other states held off until after the advent of the federal income tax in 1913.[78] Not only did this mean that state legislators (and legislatures) had no preexisting political or emotional commitment to an independently developed set of tax rules, but they also lacked the opportunity to become familiar with the political benefits associated with control over income tax rules. It is easier to give up a potential gain than to lose a benefit one already possesses.[79] Moreover, the potential for political gain at the

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[76]*See* JEROME R. HELLERSTEIN, ET AL., *supra* note 51, at 407.

[77] *See* EDWIN R.A. SELIGMAN, ESSAYS IN TAXATION 219 (1931) (listing instances of state taxes on net earnings or income of corporations).

[78]"[E]xperiments with state income taxation up to the year 1911...[were] utterly insignificant and unsuccessful..." EDWIN R.A. SELIGMAN, THE INCOME TAX 419 (2d ed. 1914); *see also* JEROME R. HELLERSTEIN, ET AL., *supra* note 51, at 402 (Wisconsin "inaugurated the modern era of income taxation" by enacting a corporate and personal income tax in 1911)

[79]*See* Amos Tversky & Daniel Kahneman, *Rational Choice and the Framing of Decisions*, in RATIONAL CHOICE: THE CONTRAST BETWEEN ECONOMICS AND PSYCHOLOGY 67, 74 (Robin M. Hogarth & Melvin W. Reder, eds. 1986) (describing loss aversion and endowment effects); Cass R. Sunstein, *Switching the Default Rule*, 3 (Chicago John M. Olin Law & Economics Working Paper No. 114, 2d Series 2001) (describing endowment effect in employment context). RICHARD THALER,

state level may not have been as large as that which exists at the national level. Much more money is at stake in the definition of income for federal tax purposes than for state income tax purposes simply because the rates of state income tax are significantly lower than national income tax rates. At present, Iowa levies the largest corporate income tax, with rates ranging up to 12 percent, while the District of Columbia has the highest rate of personal income tax, 9.5 percent.[80] By contrast, federal income tax rates range from 15 to 39.6% for individuals with corporate rate ranges from 15 to 35 percent.[81] Potential taxpayers pay less attention as the dollars at stake decrease. Finally, because the number of dollars collected through the tax is so much smaller at the state level, administrative costs (and the potential for savings by decreasing them) loom as a larger consideration from the governmental standpoint. The closer the state tax base to the federal tax base, the more the state can rely and free-ride on the federal administrative efforts.

But as state income taxes have become a more significant source of state revenues, some of this voluntary harmonization has begun to dissipate. The first defections took the form of revisions in the formula used to apportion the income of interstate businesses among the several states. Historically, states apportioned income for tax purposes among themselves by applying a three-factor ratio to the interstate income. One-third of the income was apportioned in accordance with the ratio of the company's in-state to total sales, another third in accordance with the ratio of the company's in-state to total payroll, and the last third in accordance with the ratio of the company's in-state to total property. However, Iowa (a state with many consumers but few interstate producers) decided to apportion income using a superficially neutral one-factor test and basing the allocation solely on sales. The Supreme Court upheld its right to do this in 1978.[82] Other states have since followed suit, strategically picking variations on the original formula.[83]

More recently, states have experimented with different methods for increasing the amount of income subject to apportionment under their chosen formulas. Some experimented with the inclusion of foreign source income in the apportionable base while others broadened their definition of "unitary business" and income attributable to such a

QUASI-RATIONAL ECONOMICS 169, 184-86 (1993); Daniel Kahneman, Jack Knetch, & Richard Thaler, *Experimental Tests of the Endowment Effect and the Coase Theorem*, in BEHAVIORAL LAW AND ECONOMICS 211 (Cass R. Sunstein ed. 1999).

[80] *See* STATE TAX GUIDE, ALL STATES (CCH) ¶ 10-050 (listing 2000 tax rates).

[81] I.R.C. §§ 1, 11.

[82] Moorman Mfg. Co. v. Bair, 437 U.S. 267, 275 (1978).

[83] *See* Bharat N. Anand and Richard Sansing, *The Weighting Game: Formula Apportionment as an Instrument of Public Policy*, 53 NAT'L TAX J. 183 (2000).

business to reduce the amount of income reportable only to the corporation's state of incorporation.

At present, though, states have not significantly departed from federal rules regarding the calculation of taxpayers' overall income. To a large extent, this may be because they can achieve their distributional and revenue ends without straying far from the federal base. And however much the affected taxpayers dislike the implicit tax increases contained within adjustments to the base allocation methods, they seem to prefer (or the state legislators think they prefer) the use of such methods to tinkering with the federal base calculation rules.[84] Concerns about administrative costs may increased taxpayer (and voter) enthusiasm for uniformity in income–as opposed to income allocation–calculations, just as they do the government's. The relatively small number of tax dollars at stake could be more easily overwhelmed by the costs of complying with (or lobbying for) multiple disparate tax systems.

By contrast, there is little reason to believe that taxpayers will be particularly supportive of international tax base harmonization plans. As explained in the next part, this stems from two features peculiar to the international context: first, the costs imposed by such plans will be far more salient, if not excessive in fact, than the benefits many taxpayers will derive from them, and second, even those taxpayers deriving obviously significant administrative benefits will have to weigh those benefits against the equally obvious possibility of losing special benefits received under current tax rules.

2. Sources of Taxpayer Hostility to Uniformity

As explained in Part I, tax base uniformity has the potential for conferring both benefits and costs on taxpayers. On the benefit side, taxpayers save administrative costs and avoid the possibility of inadvertent double (or multiple) taxation. On the cost side, taxpayers lose favorable arbitrage opportunities. At first glance, these costs and benefits may appear equivalent, counterbalancing one another sufficiently to make taxpayers relatively indifferent to tax harmonization proposals. However, such indifference is unlikely for two reasons. First, not all taxpayers will reap administrative gains, while all will suffer some transition costs. Second, taxpayers face not only the loss of arbitrage opportunities, but also the possibility of losing favorable tax rules inscribed in current statutory law. Together, these factors suggest that base harmonization proposals are more likely to engender substantial taxpayer opposition than support.

a. Administrative costs.

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[84]*See* JEROME R. HELLERSTEIN ET AL., *supra* note 51, at 406 ("The prime force responsible for the very wide conformity of the state corporate net income tax base to the federal corporate income tax base ... has been pressure from taxpayers for easing compliance and auditing burdens.").

Any move towards tax base harmonization will entail substantial transition costs because a harmonized definition of taxable income undoubtedly will differ significantly from most if not all current national systems. Taxpayers and their advisors will have to become familiar with the new rules, methods for transitioning between the old rules and the new ones will have to be worked out, employees responsible for implementing the new rules will have to be retrained and computers re-programmed. Though taxpayers (at least in the U.S.) expect to have to endure some tax disruption on a regular basis, the scope of this disruption–and thus its costs --may dwarf their prior experiences. Transition costs, of course, are just that, and such one-time costs may be recouped over time as taxpayers begin to realize their savings from uniformity. However, not all taxpayers will realize administrative savings because many will never realize income that would have been subjected to multiple taxing jurisdictions. Put simply, many if not most taxpayers never were and never will be "international" taxpayers in the sense of earning income outside their country of residence. These taxpayers will face administrative costs rather than reaping administrative benefits from any harmonization plan.[85] And as discussed earlier, the non-administrative benefits that would accrue to these taxpayers as a result of tax harmonization are both hard to quantify and far from salient.

This distinguishes the situation from that facing proponents of intra-national tax harmonization. With few exceptions, the group of national income taxpayers was (and remains) coterminous with that of sub-national income taxpayers. As a result, the vast majority of taxpayers affected by intra-national tax base harmonization were people or institutions subject to tax in two (or more) jurisdictions; hence, that same vast majority benefitted from, and politically support the continuance of, the intra-national harmonization.[86] They were in a position to see the silver lining in the cloud of up-front transition costs. Moreover, at least in the United States, those up-front costs were relatively minor since most taxpayers had never been subject to a state income tax to begin with.

By contrast, relatively few taxpayers in the United States derive income from foreign sources. While the amount of foreign source income and the number of taxpayers

[85]These costs may be sufficiently large to outweigh the gains available from harmonization. The move to put the United States on the metric system foundered on similar considerations; studies concluded that the transition costs facing domestic producers engaged in solely domestic businesses outweighed the benefits for domestic producers with international connections. *See* Michael Chapman, *Metrics: Mismeasuring Consumer Demand*, CONSUMERS RESEARCH (Feb. 1994), *reprinted in* 140 CONG. REC. S. 4500 (April 11, 1994) (1978 GAO study found substantial costs, uncertain benefits from metrification). But the purported gains from tax base harmonization stem from more than administrative savings; even if on balance, harmonization will result in higher rather than lower administrative costs, the gains from eliminating arbitrage may overwhelm the administrative losses. Again, the point is not to press the case for tax base harmonization but to point out structural, non-meritorious obstacles to its adoption should it prove to be worthy of such.

[86]*See id.*

claiming foreign tax credits for such income have both grown dramatically in recent years,[87] their number is still small in comparison to the total number of U.S. taxpayers. Only .14 percent of corporate returns, and 2.39 percent of individual returns, claimed foreign tax credits in 1997 and 1998, respectively.[88] The percentage earning foreign income may be higher in other jurisdictions, but it is far from a universal characteristic of taxpayers in any jurisdiction. Hence, a significant number of taxpayers will fail to derive an obvious personal benefit from tax base harmonization in the form of decreased administrative costs. Although they may not bear significant costs if the relevant portions of the harmonized rules do not vary significantly from preexisting domestic rules, it is hard to believe that they will become ardent (or even quiet) supporters of tax base harmonization.

And some, those facing significant transition costs without any appreciable offsetting benefit, will become political opponents of the change. Though one can plausibly argue that even this latter group of taxpayers will benefit indirectly from tax base harmonization–perhaps through higher government revenues generated by decreased arbitrage or tax expenditures or through general increases in economic efficiency--such long-term and impersonal (and far from guaranteed since there is no way to be sure what the government will do with the extra revenue) benefits lack the saliency of immediate up-front transition costs.

It also bears mentioning that the EU's recent agreement on international rate harmonization burdens only taxpayers earning foreign income. The harmonization scheme may subject income earned outside a taxpayer's country of residence to increased taxation at source, which in turn may either lower after-tax returns or complicate home country tax calculations for affected taxpayers. It has no direct effect on taxpayers earning solely domestic income, though the additional revenue generated by implementation of the plan may produce indirect benefits.

Finally, the taxpayers likely to reap the greatest administrative savings from tax base harmonization have the most to lose on the arbitrage side; on balance, they may oppose rather than support harmonization. Nor will they be the only taxpayers who may

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[87]*See* Jeff Curry, Maureen Keenan Kahr, and Sarah E. Nutter, *Individual Foreign-Earned Income and Foreign Tax Credit, 1996*, in DEPARTMENT OF THE TREASURY, INTERNAL REVENUE SERVICE, 19 STATISTICS OF INCOME BULLETIN 130, 138 (1999) (between 1991 and 1999, the foreign source gross income of individuals grew 67.8 percent and the number of individual returns claiming a foreign tax credit grew by 140.8 percent); Nick Ward, *Corporate Foreign Tax Credit, 1996: An Industry and Geographic Focus*, in DEPARTMENT OF THE TREASURY, INTERNAL REVENUE SERVICE, 20 STATISTICS OF INCOME BULLETIN 180, 181& 182 (Figure A) (2000) (from 1992 through 1996, foreign-source taxable income reported on corporate returns "jumped" 90 percent while number of corporate taxpayers claiming foreign tax credits rose by 20%).

[88]*See* DEPARTMENT OF THE TREASURY, INTERNAL REVENUE SERVICE, 20 STATISTICS OF INCOME BULLETIN 266 (Table 1) & 281 (Table 13).

end up paying higher taxes following harmonization. Any diminution in legislative power over tax base definition will affect those used to being at the receiving end of legislative largesse. Tax base manipulation has been an effective method of delivering subsidies to particular interest groups. Who these groups are –and the precise nature and amount of such subsidies–undoubtedly varies from jurisdiction to jurisdiction. All of those recipients will understandably be concerned that they will lose their "special deals" in the harmonization process.

b. Revenge of the tax expenditure addicts.

Although taxpayers are victims of the lack of harmonization, many are also its beneficiaries. They have convinced their national legislatures to enact special tax rules which lower their effective tax rate. These special rules (which may or may not be desirable from a social standpoint) may not survive the harmonization process. Whether harmonization would leave any particular taxpayer better or worse off would depend on whether that taxpayer would derive greater benefits from harmonization than they would lose from the elimination of special tax benefits provided by a preexisting national regimes. But from the perspective of a given taxpayer, what matters most is whether it thinks it will be better off with or without harmonization.

Taxpayers may overestimate their likelihood of being at the losing end of a harmonization-induced revision of the tax base. To make a definitive calculation of harmonization's impact, a taxpayer would have to know what definition of taxable income would prevail under the harmonized system. Given that this information may not be available at the time taxpayers need to take a stand on the harmonization issue, the stand they take will depend on their projection of what the final rules will look like. Taxpayers may be optimistic and believe that their special benefits will be continued, or at least survive in truncated form. However, grounds also exist for making more pessimistic projections. After all, the impetus for harmonization comes largely from reformers generally opposed to special tax deals, and drafting of the harmonized statute will likely be handled by a new and unfamiliar international agency. Further, many tax deals confer benefits precisely because they are national rather than international in scope, or help one industry and not another. Universalizing them would eliminate the competitive advantages they confer and thus their value to taxpayers. And it defies belief to think that all tax deals incorporated in every countries' tax code will survive; the resulting code would be too complex. Taxpayers benefitting from the tax laws as currently configured may not wish to re-open issues previously settled in their favor. They may, in short, be risk averse.

The role played by taxpayers' fear of losing existing tax benefits may be elucidated by progress (or lack thereof) of the International Accounting Standard Boards new project to "converge current international accounting standards into one global system."[89] The administrative advantages of convergence in accounting standards would be quite similar to those obtainable through tax base harmonization; however, changes in accounting standards have far less direct an impact on affected businesses than do changes in tax laws. The absence of such economic considerations may make agreement on a uniform accounting standard easier to reach (if it is in fact truly desirable) just as their relative absence undoubtedly aided the process of gaining support for intra-national base harmonization.

This sort of economic concern was largely absent in the intra-national context because fewer taxpayers had special tax deals in place at the state level to protect. Moreover, the outlines of the national code existed before harmonization was attempted. And though these outlines may have lived up to some taxpayers' worst fears, the fears of other taxpayers would have been allayed. Finally, the means for attempting to reinstate "missing" tax deals would have been more familiar (and thus interpreted as more accessible) to disfavored taxpayer groups than under international harmonization proposals. The threats naturally associated with harmonization, then, would have seemed compelling to a smaller subset of taxpayers.

It bears emphasizing that the amount of social gain or loss from base harmonization would not necessarily correspond to the number of taxpayers self-identifying as losers under, and therefore opponents of, a harmonized regime, nor of the amount of their losses. Many current tax rules are socially inefficient, perpetuated by exactly the same public choice phenomenon detailed in this article as affecting the tax base harmonization debate. The likelihood of eliminating at least some of these socially inefficient tax rules[90] strengthens the economic justification for harmonization even as it lowers its political viability. While the general public regards the benefits of eliminating these special provisions as remote and insignificant, their beneficiaries will take the political actions necessary to protect them.

III. The Task Ahead

This combination of highly motivated opponents and a generally apathetic public promises an uphill battle for adherents of tax base harmonization. Perhaps so uphill as to be Sisyphean. Yet dedicated adherents will be unsatisfied with this analysis and point to the fact that harmonization–even tax base harmonization–has been accomplished in some circumstances. Beyond the limited (because incomplete) example of intra-state income

[89] David Graber, *Global Accounting Standards Project Requires Converging U.S., IASB Systems*, 68 DAILY TAX REP'T G-1 (April 9, 2001).

[90] It is worth noting that not all special tax rules are socially inefficient; the case for harmonization is weakened to the extent it results in the elimination of "good" rules. Reasonable people can disagree as to the merits of particular rules, making overall judgments on the merits of harmonization difficult.

taxes, they may point to the European Union's success in harmonizing VAT tax bases as evidence that the public choice obstacles outlined in this article can be overcome, and the only issue is how.

Some of the paths towards harmonization simply are not viable in the context of national income taxes. VATs, like the previously discussed state income taxes, were relatively recent innovations at the time harmonization efforts began. At the present time, arbitrage-related revenue losses and distortions do not appear to be massive in scope. Of course, to some extent this is a chicken and egg problem; as previously recounted, it is very hard to determine how much behavior has been distorted by arbitrage opportunities because those profiting from them have an incentive (and the opportunity) to keep its benefits secret. The question is what options are left. That is the subject of this last section. It evaluates three possible approaches: pressing for incremental changes in the direction of harmonization through treaties, legislative and administrative rules; trying to achieve international recognition of the goal of tax base harmonization in the abstract, while leaving the details of harmonization for later discussion; or presenting a thoroughly thought out proposal for universal discussion and adoption. The question facing harmonization proponents is which of these strategies provides the greatest likelihood of success.

Some of the difficulties with following the first strategy have already been laid out. Incremental changes will almost invariably be retrospective in nature. Not only will this strategy provide taxpayers with an incentive to devise tax avoidance schemes that can flourish during the pre-change years, it sets the stage for a continued loss of revenues as those taxpayers profiting from such schemes band together as a political force to prevent their closure. Congress often shies away from enacting reforms which upset "settled expectations," no matter how unreasonable those expectations in the first instance.

However, this approach faces a deeper problem: how to rationalize advocating incremental changes in the direction of harmonization before harmonization has been accepted as a goal. Particularly if other reasons (national interest, administrative convenience, to mention just a couple) exist to support either the continuation of a preexisting rule or its evolution into a "non-harmonious" form, appeals to the "goal of harmonization" will likely fall on deaf ears. People do not generally allow an unacknowledged, controversial goal to trump a traditional goal supported by obviously laudable values.

Nonetheless, there may be some scenarios in which this approach is viable. Many tax rules are essentially random, and can be changed without harming any discernable interest group. Others may be of such limited effect–because so easily manipulated–that their substance should be a matter of indifference to taxpayers and affected governments.

At least one scholar would put the rules for allocating interest expenses in this category.[91] In such cases, taxpayers may present a united front in favor of a harmonized approach while legislators would have little to lose from acceding to their demands since there would be few opportunities to gain from proposing an alternative approach. It is even possible that the success of coordination in these instances would serve as an argument for coordination in other, more contested areas.

But such wider success likely requires gaining acceptance of the goal of tax base harmonization through other, more direct means. The real question here is whether to pursue acceptance in the abstract or in the context of adherence to a particular proposal. This is a difficult question, as its answer depends on a projection of how the relevant interests are likely to respond to uncertainty. The dilemma, stated simply, is this: is it better to be in a position of defending a known quantity, an elaborate proposal which dispenses with uncertainty and creates definite winners and losers, or to defend an abstract principle which has the potential to create gains or inflict losses, but whose winners and losers (as well as the amounts of their gains and losses) have yet to be identified? Stated in this fashion, the "answer" becomes clear: it depends on whether the relevant interests would predict greater losses than they would actually suffer under a specific harmonization proposal. The more optimistic taxpayers are, the more appealing the abstraction approach; the more pessimistic, the more attractive the elaborated approach.

There are, of course, intermediate approaches. A harmonization proposal need not consist of actual tax rules. It instead may consist of a proposed mechanism for the development of such rules. Possible mechanisms range from the sort of unelected commission used in the United States to determine the closure of military bases to the formation of a new, specially entrusted, elected, deliberative body. Either proposal would drive home the loss of legislative power, but would do little to directly offend taxpayers per se (except to the extent that they saw the new process as beyond their ability to lobby and influence outcomes). Such a truncated proposal may be the easiest to develop.

On the other hand, a procedurally based proposal may stand less chance of success than either of the more extreme approaches. It does, after all, drive home legislators' losses without assuaging any particular taxpayer's fears; hence, relative to a completely unelaborated proposal, it increases opposition without necessarily increasing support.

Yet, submitting a fully elaborated harmonization proposal has its own dangers. Once a proposal is floated, concerns about the merits of the particular proposal become inextricably intertwined with support (or not) for the abstract goal of harmonization. In addition to concerns about creating a group of identified and therefore vociferous losers, a more subtle problem intrudes. Advocates of tax harmonization may be tempted to garner

[91] Daniel Shaviro, *supra* note 20.

support by floating a so-called "Christmas tree" proposal–one that goes out of its way to cater to an enormous variety of special interests to forestall organized opposition. There is some evidence of just such behavior when other uniform laws were drafted. [92] While such a proposal may win more adherents than other possible approaches, such a proposal might spur a revolt by other taxpayers or tax experts, who could provide political cover for politicians generally disinclined to adopt harmonization proposals.

As well it should, of course. After all, the point of tax base harmonization is to improve income tax systems, to make them more efficient and more fair revenue collection mechanisms. It seems unlikely that universal acceptance of an inferior set of tax rules will be an improvement over the present practice of maintaining disparate national tax regimes.

This leads to one final point. The stronger the arguments in favor of harmonization, the less significant these public choice obstacles become. If harmonization proponents can show that vast amounts of revenue are at stake, politicians will accede to it. Politicians will trade a loss of power over tax policy for the additional power created by gaining access to vast amounts of new tax revenue; similarly, the general public may become sufficiently motivated to organize in opposition to the "tax expenditure addicts" if the amounts at issue are large enough. There are far too many instances in which uniform laws, such as the Uniform Commercial Code in the United States, have been enacted and international arrangements, such as the European Union, have been reached to argue that these public choice obstacles are insuperable.

Conclusion

The point is not that tax base harmonization cannot be achieved. If it is sufficiently desirable, it will be. The issue is what "sufficiently desirable" means. By outlining the various political obstacles to its adoption, the article seeks to make clear that harmonization will not occur whenever its social benefits outweigh its social costs. An additional–and likely quite substantial--margin will be required to overcome the countervailing selfish, but politically powerful, interests that will be arrayed against harmonization. One way to think of that margin is as the "public choice toll-charge," the price we pay for having a political system which allows legislators and legislatures sometimes to advance their own selfish interests at the expense of the public and which allows concentrated minority interests to profit at the expense of a dispersed minority interest. The lack of an obvious focal point, or model, for a harmonized tax code

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[92] *See* Larry E. Ribstein & Bruce Kobayashi, *An Economic Analysis of Uniform State Laws*, 25 J. LEG. STUD. 145-146 (1996) (uniform law commissioners have an incentive to maximize the number of adoptions, causing them "to be open to compromise and accommodate groups that could help or hinder adoptions"); Kathleen Patchel, *Interest Group Politics, Federalism, and the Uniform Process: Some Lessons From the Uniform Commercial Code*, 78 MINN. L. REV. 123 (1993) ("interest groups are one of the primary sources of support for the passage of the [Uniform Commercial] Code in the state legislatures").

provides an additional fillip in this already difficult situation. These are hardly new or unusual problems. They have been widely discussed in the context of domestic legislation. But their international applications, which surely go beyond tax base harmonization, are often ignored.

Whether this toll charge proves bothersome in the context of tax harmonization depends largely on whether it is being paid. Is it preventing a socially beneficial tax arrangement from being adopted? Here, one must finally confront the issue this paper has so carefully avoided: Would international tax base harmonization be socially beneficial? Would its benefits outweigh its costs, even if not by the margin needed for easy evolution, or its costs outweigh its benefits? But those are questions for another day.

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