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Competition and Evasion: Another Perspective on International Tax Competition

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Competition and Evasion: Another Perspective on International Tax Competition

JULIE ROIN*

TABLE OF CONTENTS

INTRODUCTION ........................................ 544

I. CONSTRUCTIVE VERSUS DESTRUCTIVE COMPETITION ............... 545
   A. THE CASE AGAINST COMPETITION ..................... 549
      1. Race to the Bottom ............................ 550
      2. Tax Competition as a Race to the Bottom ....... 552
   B. REVISITING LOCATIONAL EFFICIENCY ................. 554
      1. Income Taxes as Benefits Taxes ................. 555
      2. Garbage in, Garbage out? ....................... 562
         a. The Monetarization of Non-Monetary Benefits .. 562
         b. Winner’s Curse ................................ 564
         c. Agency Costs ................................. 565
   C. REALLOCATION OF THE REDISTRIBUTIVE BURDEN .......... 568
      1. Taxes as Rents ................................ 570
      2. The Incidence Issue ............................ 575
      3. Lessons from the Consumption Tax Literature .... 579
      4. Redistribution and the Foreign Investor .......... 580

II. POLICY IMPLICATIONS .................................. 586
   A. TAXATION OF THE FOREIGN INCOME OF U.S. COMPANIES ..... 586
   B. TAXATION OF FOREIGN COMPANIES .................... 590

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543
INTRODUCTION

Though the problems plaguing the patchwork of rules governing the taxation of income generated through cross-border transactions and by transnational taxpayers long predate current trends in economic globalization and financial innovation, both trends have greatly exacerbated their effects. If nothing is done, some fear the evisceration of the tax bases of developed nations, and with them, the ability to provide the social programs necessary for their preservation. Others express less overwhelming but still serious fears about the preservation of tax capacity.

But what to do? Several of the most prominent reform proposals advocate movement toward the goal of tax coordination or tax harmonization, typically at the level of the corporate income tax in an attempt to prevent "destructive tax competition." This Article argues against this approach for two reasons. First, the Article questions the normative basis for such a strategy on both economic and political process grounds. Second, the Article argues that such harmonization efforts will not succeed; like most cartelization strategies, long-term survival is problematic, and even the likelihood of short-term survival is questionable. Finally, the Article suggests a different

1. See generally Michael J. Graetz & Michael M. O'Hear, The "Original Intent" of U.S. International Taxation, 46 DUKE L.J. 1021, 1108-09 (1997) (arguing that inherent conflict between the goals of an international taxation system makes "compromises between these principles inevitable...[making] the tax law governing international transactions subject to routine complaints...").

2. See, e.g., Reuven S. Avi-Yonah, Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State, 113 HARV. L. REV. 1573, 1578 (2000); Communication from the Commission to the Council: Towards Tax Co-ordination in the European Union, A Package to Tackle Harmful Tax Competition, EUR. PARL. DOC., COM(97)495 final at 2, ¶3 (noting that tax competition "reduces the room for manoeuvre to meet other Community objectives, such as the protection of the environment") [hereinafter Tax Co-ordination in the European Union]; ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, HARMFUL TAX COMPETITION: AN EMERGING GLOBAL ISSUE 14 ¶23 (1998) (stating that tax competition "may hamper the application of progressive tax rates and the achievement of redistributive goals") [hereinafter HARMFUL TAX COMPETITION].


4. See infra text accompanying notes 20-24 (discussing Organization for Economic Co-operation and Development (OECD) and European Union reform proposals).
solution, one which ultimately depends on effective tax collection at the individual resident level.

Of course, individual residents cannot be taxed effectively if they can hide their income from foreign investments. This Article argues that reform efforts should be redirected away from concerns about tax competition and toward methods for improving transnational access to usable tax information. Although there has already been some movement in this direction—in part because suppressing tax competition also requires obtaining better tax information—this Article contends that it should become a primary rather than secondary goal of tax reform efforts.

I. CONSTRUCTIVE VERSUS DESTRUCTIVE COMPETITION

Private firms compete by lowering prices, raising the quality of goods or services they provide, or some combination of the two. Consumers invariably benefit from such competition. Either they get the same product with money to spare, are enabled to purchase an item formerly beyond their means, or go home with a better product. Conversely, the absence of competition created by either a natural or constructed monopoly (a cartel) typically harms consumers by raising prices, restricting access to, or lowering the quality of the goods involved. This consumer-based definition of harm serves in many jurisdictions as the justification for enactment of antitrust and other procompetition legal regimes.

There is much less consensus regarding the desirability of intergovernmental competition. Though one school of thought, building on a path-breaking article written by Charles Tiebout,5 argues that competition for residents makes governments more efficient and more responsive to the needs and desires of their residents,6 another argues that given the special nature of public goods, competition leads to a destructive "race to the bottom."7 Believers in the second scenario advocate the formation of international, governmental agreements prescribing minimum standards of governmental

behavior—agreements that would be viewed as "cartels" if reached by private parties.

The latest battleground in the fight between these two views of intergovernmental competition lies in the area of "tax competition." Tax competition occurs when one country seeks to entice investment within its borders (and possibly enhanced tax revenues) through the expedient of reduced business taxation. That is, the competing country tries to make investments within its borders relatively more attractive by reducing its tax claims on any income generated from such investments, thus raising the investors' post-tax returns. This can become an iterative process, in which other countries attempt to forestall potential investment and revenue losses by dropping their own tax rates on businesses and income thought to be at risk. Whereas some view tax competition as leading to beneficial pressure on inefficient governmental extractions and spending, as well as the efficient location of business activities, others believe that the new competitive equilibrium will result in an unduly and unhealthily low level of governmental expenditure or an unhealthily high level of reliance on more distortionary revenue sources.


9. This Article focuses on international tax competition. However, tax competition between states and localities in the United States generates similar concerns; an extensive literature discusses them. E.g., Dan A. Black & William H. Hoyt, Bidding for Firms, 79 AM. ECON. REV. 1249 (1989); Peter D. Enrich, Saving the States from Themselves: Commerce Clause Constraints on State Tax Initiatives for Business, 110 HARV. L. REV. 377 (1996); Clayton P. Gillette, Business Incentives, Interstate Competition, and the Commerce Clause, 82 MINN. L. REV. 447 (1997); Oates & Schwab, supra note 7; Daniel Shaviro, An Economic and Political Look at Federalism in Taxation, 90 MICH. L. REV. 895 (1992); John Douglas Wilson, Theories of Tax Competition, 52 NAT'L TAX J. 269 (1999).


11. See Jacob A. Frenkel et al., International Taxation in an Integrated World 206 (1991) ("We conclude that if the two countries are not coordinated with the rest of the world and cannot effectively tax their residents on their income from capital invested in the rest of the world, then competition among the tax authorities leads to a full exemption from tax for the mobile factor ").; Hufbauer, supra note 10, at 31; Bruno S. Frey, Intergovernmental Tax Competition, in Influence of Tax Differentials on International Competitiveness 89, 89 (1990) ("In equilibrium, the tax rate on capital in each state will be driven to zero because each one will compete for that tax base."); Peggy B. Musgrave & Richard A. Musgrave, Fiscal Coordination and Competition in an International Setting, in Influence of Tax Differentials on International Competitiveness, supra, at 59, 68-69.


13. See, e.g., Sinn, supra note 3, at 6-7; Avi-Yonah, supra note 2, at 1578.
The United States traditionally has taken a dim view of tax competition. Its tax credit rules prevent U.S. taxpayers from enjoying the benefits of earning low-taxed foreign income; such taxpayers must pay the U.S. Treasury any difference between foreign taxes paid with respect to such income and the tax that would have been paid if the income had been earned in the United States. Nor has the United States been willing to waive its “capital export neutral” rules by treaty with selected countries. The Senate routinely rejects treaties containing “tax-sparing” provisions.

By contrast, most European nations have historically seemed untroubled by the prospect of tax competition. They traditionally have maintained territorial tax systems, taxing only income earned within their national borders. As a result, only the country of source taxed most of the foreign income earned by European residents; those residents reaped the economic benefits of low or absent source taxation. And so, too, did the source countries, in the form of increased investment.

In recent years, European and other developed nations have been moving closer to the United States’ attitude toward tax competition. Rather than following the U.S. lead of eliminating the benefits to be gained from low tax rates...
through increased residence taxation, however, these nations are trying to encourage low-taxing source countries to raise their tax rates. Both the European Union and the OECD have taken preliminary steps toward eliminating tax competition at its source through mandated “harmonization” of income taxes imposed on business income. At present, both organizations focus particular ire on governments that maintain preferential “ring-fenced” tax regimes aimed at foreign investors as well as those that facilitate tax base erosion through artificial income allocation rules or noncooperation with other tax authorities. However, the ultimate goal of advocates of tax harmonization is more comprehensive. A substantial literature exists extolling the benefits of a global regime under which all countries would be forced to conform their tax bases to a uniform model while maintaining tax rates within a narrow, pre-

20. The Organization for Economic Co-operation and Development (OECD) is an organization of twenty-nine countries. Although it includes some developing countries and transition economies, most of its membership consists of developed countries.


22. See ECOFIN Council, supra note 21, Annex 1, ¶ B (labeling as “potentially harmful” all tax measures “which provide for a significantly lower effective level of taxation . . . than those levels which generally apply in the Member State in question”); HARMFUL TAX COMPETITION, supra note 2, at 27 (labeling “‘ring fencing’ of regimes” a “key factor[] in identifying and assessing harmful preferential tax regimes for the purposes of this report”).

23. See ECOFIN Council, supra note 21, Annex 1, ¶ B(4); HARMFUL TAX COMPETITION, supra note 2, at 30-31 (listing “artificial definition of the tax base” and “[f]ailure to adhere to international transfer pricing principles” as among factors “that can assist in identifying harmful preferential tax regimes”).

24. See HARMFUL TAX COMPETITION, supra note 2, at 27 (labeling “[l]ack of effective exchange of information” a “key factor[] in identifying and assessing harmful preferential tax regimes for the purposes of this report”).
specified range.\textsuperscript{25} The more complete the harmonization required, of course, the less room would exist for tax competition.

Before these steps toward tax harmonization move beyond the preliminary state, it is worth revisiting the question of the desirability of tax competition in general. This Article does just that, and comes to conclusions that are at odds with the present trend of tax policy. Part I.A outlines the case that has been made against tax competition. Parts I.B and I.C explore and rebut many of the assumptions underlying that case. Part II discusses the ramifications of these findings for U.S. tax policy.

A. THE CASE AGAINST TAX COMPETITION

Though competition's winners tend to praise the process, its losers rarely do. Their disrupted lives and expectations often blind them to the benefits enjoyed by consumers; even socially beneficial competition, when seen from their perspective, is destructive. The advent of the automobile was undoubtedly viewed as an unmitigated disaster by manufacturers of buggy whips, and likely the communities within which they were located as well. But there is general agreement that, under certain circumstances, competition can be destructive even when viewed at the societal level (taking the interests of both consumers and producers into account). This occurs when the proverbial "race to the bottom" intersects with the "prisoners' dilemma." The proponents of tax harmonization believe that tax competition lies within one such intersection, that such competition inexorably results in tax levels set at unsustainably or undesirably low levels on some income items. Their arguments have two prongs. The first is that the allowance of tax competition will have few if any effects on actual investment allocation decisions so that the efficiency gains from such competition are minimal at best.\textsuperscript{26} The second is that to the extent efficiency gains are created through the reallocation of capital, they are outweighed by the social losses incurred as a result of falling tax revenues or reliance on second-best tax measures enacted to prevent revenues from falling.\textsuperscript{27} Each of these arguments is explored in more detail below.


\textsuperscript{26} See, e.g., Avi-Yonah, supra note 2, at 1644-47; Enrich, supra note 9, at 391-93 (discussing tax competition between U.S. states); Janet Stotsky, \textit{Summary of IMF Tax Policy Advice, in Tax Policy Handbook}, supra note 25, at 279, 282 (noting that "[t]he IMF maintains a widely held view that tax incentives of all sorts have proved to be largely ineffective").

\textsuperscript{27} See, e.g., \textsc{Harmful Tax Competition}, supra note 2, at 16; \textsc{Wallace E. Oates}, \textit{Fiscal Federalism} 143 (1993) (1972); Avi-Yonah, supra note 2, at 1624-25; Musgrave & Musgrave, supra note 11, at 69-70.
1. The Race to the Bottom/Prisoners' Dilemma Conundrum

In a sense, all competition involves a "race to the bottom" in the nonpejorative sense that the dynamics of competition push producers toward lowering prices or increasing the quality of the products they sell at the original price. Producers of fungible goods cannot afford to price their goods higher than similar ones offered by competitors; informed customers would simply shift to alternative sources of supply. Moreover, assuming expandable capacity, producers benefit from reducing prices below those offered by their competitors (as long as their marginal price does not drop below marginal costs); they attract more customers and earn higher profits. In fact, it is precisely this "race" that generally generates the benefits associated with the competitive process. That is, this race leads to the production of (and only of) goods actually desired by consumers, to their production and sale at the lowest possible cost, and therefore to the satisfaction of the greatest possible amount of consumer desire.

Along the way, some firms are hurt. Inefficient producers (that is, those with costs in excess of other producers) suffer; such producers will sometimes fail to cover their costs and will eventually be forced out of business unless they can reduce those costs. It is worth noting that, when dealing with a fungible product, at the final stage of the competitive process, all the surviving producers will be selling the product at the same price; customers will not be able to choose among them based on price. The beneficial effects occur before this final stage, in the struggle for survival. Competition forces inefficient firms to close or to become more efficient. Only if they do the latter do they reach the final stage, and then they deserve to prosper with the others. The absence of price competition at the end stage, in short, does not signify the futility of the competitive process but instead evidences its effectiveness, at least when dealing with commodities traded in the private sector. It is the process, rather than the particular end result (which may indeed involve a choice among "equals"), which induces allocative efficiency.

This contest, this race to the bottom (of the average total cost curve, we might say), then, generally benefits consumers and society alike, although it can harm individual competitors. It leads to social harm only if competition leads to prices that are unsustainable in the long run—or, in short, to an economic version of the "prisoners' dilemma."

In the classic prisoners' dilemma, two individuals are taken into custody and separately interrogated in an effort to get them to confess. In the absence of a confession, the prosecutor can obtain only misdemeanor convictions that would result in one-year sentences for each individual. If only one confesses and implicates the other, the prosecutor is willing to offer the confessing individual a plea bargain leading to a six-month sentence; the other prisoner will be convicted of a felony and sentenced to ten years in prison. If both confess, they
will each be convicted of a felony but receive five-year sentences.\textsuperscript{28} Given the absence of a mechanism for binding cooperation, intelligent prisoners would confess. In economic terms, confession is the “dominant strategy.” It allows for the possibility of a six-month sentence while foreclosing the disaster of a ten-year sentence. However, from the prisoners’ point of view, the result of following this course of action is sub-optimal, for it leads to extra jail time.\textsuperscript{29} Each is worse off than if they had been able to agree beforehand not to confess.

Of course, the fact that the prisoners may be worse off as a result of their “dilemma” does not necessarily prove that it hurts society as a whole. After all, if the prisoners are factually guilty of the felony, the “right” result for society may be that each spends five years in jail (because society appears to believe that the proper punishment for an unrepentant felon of this type is ten years). The case for social harm requires further explication. It is two-fold. First, one of the basic premises of the U.S. justice system is that defendants are innocent until proven guilty by the government. The government’s inability to prove the defendant’s guilt in the absence of their confession suggests that this burden has not been met, and that the defendants should be treated accordingly. To some extent, this ties into the U.S. rule against forced testimony and self-incrimination. However, it is also linked to the second argument for societal harm: the fact that the dominant strategy remains dominant for innocent defendants. The prisoners’ dilemma can lead to the imposition of five-year sentences on innocent individuals as well as guilty ones because the incentive to plead guilty falsely is as cogent as the incentive to truthfully plead guilty. No prisoner can be sure that her fellow prisoner will refuse to cooperate. After all, a system incapable of definitively proving the guilt of guilty individuals may be equally incapable of establishing the innocent as innocent (or as truly guilty only of misdemeanors); an innocent individual thus may regard giving a false confession as necessary insurance against a ten-year sentence. False imprisonments resulting from false confessions harm both the individuals immediately and the larger society. They are particularly reprehensible in a society which supposedly believes it “better that ten guilty defendants go free than one be unjustly convicted.”

Moving from criminal law to markets, what constitutes a purely economic “prisoners’ dilemma”? Surely not the situation in which producers’ prices are forced down to marginal cost. Although the producers’ interests are harmed in such a scenario (they would prefer to earn “monopoly profits”), competition is

\textsuperscript{28} See, e.g., R. DUNCAN LUCE & HOWARD RAFFA, GAMES AND DECISIONS: INTRODUCTION AND CRITICAL SURVEY 94-97 (Dover 1989) (1957); PETER C. ORDESHOOK, GAME THEORY AND POLITICAL THEORY: AN INTRODUCTION 206-10 (1986).

\textsuperscript{29} Oreshook, supra note 28, at 207.

\textsuperscript{30} It is perhaps worth noting at this juncture that to economists, the problem posed by monopolies stems not from the distributional questions raised by the enrichment of monopolists but rather that because the monopolized goods have been mispriced, fewer of these goods will be produced and sold to consumers, eliminating valuable consumer surplus. E.g., PAUL A. SAMUELSON & WILLIAM D. NORDHAUS, ECONOMICS 582-83 (13th ed. 1989).
supposed to lead to this consumer-friendly result. Harmonization of prices at some low level is often desirable, rather than harmful. When, then, is there harm—when does economic competition lead to social harm? One example may be a situation in which several competitors bid against each other (or expand capacity) until prices fall so low as to make each business unprofitable. If both businesses fail, the public may be left with no suppliers of a desirable good or service; if only one survive\s, it may begin acting like a monopoly, again to the detriment of the public. And in the case of overcapacity, the harm lies in the waste of resources implicit in the production of goods or services that must be sold for less than their marginal cost. The larger society, as well as the individual actors, pays a cost for this competition. Other examples of prisoners' dilemmas arise in situations where one competitor's actions give rise to external, uncompensated effects (“externalities”). For example, jurisdictions acting individually may not enact antipollution regulations that would make doing business within their borders more expensive if the pollution affects mostly residents of other jurisdictions, but may be willing to do so if the other affected jurisdictions reciprocate by enacting similar rules.

2. Tax Competition as a Race to the Bottom/Prisoners' Dilemma Conundrum

In a simple world consisting of a single jurisdiction, that jurisdiction would choose its tax system and its tax levels based on its residents' (or its leaders') evaluation of the social needs and desires of the populace. Perfect lump-sum taxes aside, these taxes will introduce some level of distortion into the economy. An income tax system may encourage some to enjoy leisure rather than work to produce taxable income; a property tax may discourage investment in the types of property it impacts, and so on. All workable taxes lead to avoidance opportunities and tactics, many of which are socially useless or worse. But the residents or the leaders of the country are allowed to weigh the advantages and disadvantages of each alternative and choose the one that accords most closely with their tastes.

The introduction of other jurisdictions fundamentally changes the considerations a jurisdiction must take into account when setting tax rates. In addition to the internal social consensus, it has to worry about the possibility that its investors will be lured away by lower-tax jurisdictions. When one substitutes “the government” for producers, “taxes” for prices, and “investment” for consumers, the potential for countries to compete for investors based on low tax rates is clear. A “race to the bottom” in tax rates can develop as a result of tax competition. Indeed, a seminal economic model purports to prove that a self-
interested small country should eliminate its business income tax (at least to the extent it applies to mobile business capital) to maximize investment attractiveness and social welfare.34

Once such a race begins, no country can remain unaffected. A country may act as if nothing has changed, preserving its pre-existing tax structure to maintain a semblance of continuity in the obvious distribution of the tax burden. However, the appearance of stasis will be misleading. As lower-tax jurisdictions attract more and more business, demand for labor in high-tax jurisdictions decreases, creating downward pressure on wages in those jurisdictions. This decrease in wages may be just as painful (economically) to the workers in such jurisdictions as would a tax increase necessitated by a decrease in corporate income taxes.35

For a race to the bottom to be destructive rather than beneficial, however, the bottom that is reached must be “too low” in some objective sense, rather than just different. What does “too low” mean when dealing in the context of government and taxes? Advocates of tax harmonization appear to regard any departure from the level and distribution of the tax burden set in the noncompetitive world as unduly low.36 In their view, globalization of the economy should not impact the social consensus reached regarding the level and funding sources for governmental services. This argument is often buttressed by attacks on specific revenue sources. Increases in the individual income tax, it is claimed, will unduly distort both individuals’ labor-leisure tradeoff and business investment decisions.37 Advocates of tax harmonization additionally argue that the substitution of residence-based income taxation for source-based income taxation is unworkable.38 And, of course, there is the (often) unstated assumption that income taxes are preferable to other tax mechanisms.

This privileging of the status quo is further justified by the argument that there are no particular gains, either to individual countries or to the world as a whole, that will be generated by transferring revenues from governments to producers. Proponents of tax harmonization contend that because the race to the bottom will result in equivalent tax rates in every country, in the end state, no country would offer investors a “better” tax deal relative to the others and thus

34. Sam Bucovetsky & John Douglas Wilson, Tax Competition with Two Tax Instruments, 21 REGIONAL SCI. & URB. ECON. 333, 338-41 (1991); see also FRENKEL ET AL., supra note 11, at 206 (concluding that tax competition between two countries not coordinated with the rest of the world leads to tax exemption for mobile factor).
35. See TANZI, supra note 25, at 138-39.
36. See, e.g., Musgrave & Musgrave, supra note 11, at 69-70; Wilson, supra note 9, at 296. This occurs in large part because the models on which such conclusions are based assume that all regions are identical and therefore choose the same tax rates, thereby “isolating” inefficiencies in the overall level of public good provision from the efficiency and equity issues concerning differences in tax rates and public good levels across regions. Wilson, supra note 9, at 275.
37. See, e.g., Avi-Yonah, supra note 2, at 1578.
38. See, e.g., TANZI, supra note 25, at 87-89; Alberto Giovanni et al., Introduction to Studies in International Taxation 1, 2 (Alberto Giovanni et al. eds., 1993); Joel Slemrod, Comments, in TANZI, TAXATION IN AN INTEGRATING WORLD, supra note 25, at 141, 144.
none could attract additional investment amounts. Instead, investment decisions would be based on whatever nontax factors were determinative before the tax competition started. The sole consequence of the race to the bottom would be the transfer of revenues from governments to investors.

There is little question that in some respects, real world events have behaved in accordance with the dire predictions of opponents of tax competition (advocates of tax harmonization). Nominal income tax rates have fallen worldwide, for example. However, in many respects, events have confounded these predictions. Effective tax rates on business income have remained fairly stable despite declines in nominal rates, and far above zero. The question is why such discrepancies exist—is it just that too short a time period has elapsed since the competition began, that we have yet to reach the disastrous long-term equilibrium that has been forecast but will be reached at some time in the future? Or is there reason to believe that the analysis just described, the case against tax competition, is incomplete or faulty in particular respects? If the latter, what consequences should this have for the reform proposals that have been proffered?

In Parts I.B, I.C, and I.D, I revisit the assumptions underlying the critique of international tax harmonization, and find them deficient in many contexts. Part II looks at the policy implications of accepting the legitimacy of tax competition. Finally, Part III considers the steps that can be taken to prevent tax competition from devolving into a cover for tax evasion.

B. REVISITING LOCATIONAL EFFICIENCY

One of the tenets of the tax harmonization argument is that competition will force all jurisdictions to lower their tax rates to the same low (or zero) levels, such that no country will offer investors a “better” tax deal relative to other countries. Thus, tax competition transfers wealth from national treasuries to taxpayers without having the beneficial effect of directing business activities away from “buggy whip” jurisdictions and toward “better” locations. However,

39. See, e.g., Frey, supra note 11, at 89.
40. See Avi-Yonah, supra note 2, at 1577.
41. See LUCY CHENNELS & RACHEL GRIFFITH, TAXING PROFITS IN A CHANGING WORLD, 42-43 (1997). For a different interpretation of this data, see Avi-Yonah, supra note 2, 1620; see also Slemrod, supra note 8, at 306 (claiming that no evidence exists showing a movement of world, corporate tax rates toward zero).
42. See Avi-Yonah, supra note 2, at 1646 (illustrating how tax incentives can “cancel each other out”); Slemrod, supra note 38, at 145-46.
43. See supra text accompanying note 39; see also TANZI, supra note 25, at 138 (“Some would argue that competition would tend to equalize the rates . . . .”); Avi-Yonah, supra note 2, at 1647 (“[T]he developing country is likely to find itself forced to offer subsidies merely because other countries offer them . . . .”). Alternatively, they contend that tax differentials “distort” investment incentives, dismissing without consideration the possibility that tax differentials reflect underlying economic or political realities. See, e.g., Avi-Yonah, supra note 2, at 1604 (stating that tax differentials create a “deadweight loss from a global efficiency perspective”); Slemrod, supra note 8, at 287 (discussing work of Musgrave, Tanzi, and Bovenberg).
with very few exceptions, no such homogenization of tax rates has taken place. Nor, I argue, should such homogenization be expected because the homogenization argument assumes that governments, countries, and industries are essentially fungible when in fact they are not. One of the ways in which it does this is by assuming that additional investors impose no costs on and provide equal benefits to every jurisdiction. Once these simplifying assumptions are deleted, the outcome projected by critics of tax competition becomes quite unlikely. Instead, one would project exactly what is seen—many different countries offering different packages of government services and tax obligations and investors choosing among them to find the best “fit.” We encourage the development of such options when it comes to consumer choice; no reason exists to conclude it is undesirable in the government/investor context.

1. Income Taxes as Benefit Taxes

We are not accustomed to thinking about the income tax in general, and the tax on corporate income tax in particular, as a benefits tax. The reason for this is obvious; the nature of the tax base makes the correspondence between any particular taxpayers’ tax costs and tax benefits loose at best. Nonetheless, it would be a mistake to do as many economists do and to pretend that tax payments constitute net losses to their payers. The fact of the matter is that corporate income taxes raise considerable revenue, revenue that helps pay for the costs of benefits which directly and indirectly benefit the business payers in those jurisdictions.44 Or, to express the same thought differently, governments would be incapable of financing all of those benefits without the financial contribution of these tax receipts.45 As a result, one cannot understand or appreciate the motivations of investors or governments in a competitive (or even a noncompetitive) world without recognizing that there is a linkage between these tax receipts and the governmental services provided to business taxpayers. It is of course clear that the linkage is not complete; because of the nature of the tax base (and the budget process), the taxing mechanism may have the effect of redistributing costs to other businesses, or to resident individuals. Indeed, that may be part of the reason for choosing such a taxing mechanism to

44. Even proponents of tax harmonization have begun to recognize the linkage between taxation and benefits. See, e.g., Avi-Yonah, supra note 2, at 1626-27 ("[S]ource-based corporate taxes...are much closer to the benefits taxes Tiebout described than is generally recognized."). Others have done so in a back-handed manner, by realizing that tax harmonization would be meaningless unless accompanied by expenditure controls, see Frey, supra note 11, at 96, and still others remain torn on this issue. Compare PETER ANDREW HARRIS, CORPORATE/SHAREHOLDER INCOME TAXATION AND ALLOCATING TAXING RIGHTS BETWEEN COUNTRIES 117 (1996) ("There is no reason to suspect that the benefits of incorporation in any way relate to the amount of corporate income derived. Rather, it may be suggested that the relationship is an inverse of corporate income derived."), with id. at 472 (arguing against use of standard foreign tax credit because it "penalise[s] countries which provide low levels of production services reflected in low source income tax rates").

45. Corporate tax revenues account for approximately eight percent of total tax revenues in OECD countries, and significantly larger proportions of revenues in other regions of the world. See Avi-Yonah, supra note 2, at 1619 tbl.2.
begin with.\textsuperscript{46} However, above all, the point of such taxes is to raise the money necessary to pay the public's bills for the operation of its government—a government that is supposed to operate for the benefit of all those living and operating within its borders by providing public goods.

Though some may believe that the very nature of a public good is inconsistent with the concept of "marginal cost," that clearly is not the case. A good becomes a public good both because of its joint enjoyment (one fighter plane protects many citizens) and because of the inability to constrain access to it. That is, once the good is available to any, it is effectively available to all. However, this says nothing about whether the good's cost differs depending on whether usage is by few or by many. A road, for example, may be a public good in that restricting its use, once it has been built, to those who have financed it becomes extremely difficult; engineers nonetheless can estimate the marginal cost in terms of wear and tear imposed by additional traffic. Similarly, a police force is a public good within a particular area; however, as more people or businesses move into an area, the size of the force must increase to maintain the same level of police protection. The cost of many other (imperfect) public goods also increases with usage.\textsuperscript{47} Even the demands on the "social safety net" may increase along with investment. Living conditions deemed tolerable when widely shared may be deemed intolerable when viewed in proximity to much higher living standards enjoyed by others associated with the investment inflow.\textsuperscript{48}

\textsuperscript{46} A country interested only in receiving payment for benefits provided would impose user fees. However, a country’s decision to rely on income taxation rather than user fees should not necessarily be read as equivalent to an adoption of a redistributive agenda. Under current law, many countries allow taxpayers to offset residence-based taxes due on foreign source income with taxes paid to foreign countries. Such offsets typically are limited to amounts collected as income taxes. \textit{See}, e.g., I.R.C. §§ 901, 903 (West 2000) (limiting credit to "income taxes" and taxes imposed "in lieu of" income taxes). \textit{See generally} Glenn E. Coven, \textit{International Comity and the Foreign Tax Credit: Crediting Nonconforming Taxes}, 4 FLA. TAX REV. 83, 127 (1999) (arguing that current interpretation of such taxes is too narrow given lack of rationale for restriction). Countries routinely structure their tax systems (or their tax treaties) to enable foreign investors to take advantage of such residence country relief. \textit{See} Charles I. Kingson \& Cynthia A. Blum, \textit{International Taxation} 565 (1998); Joseph Isenbergh, \textit{The Foreign Tax Credit: Royalties, Subsidies, and Creditable Taxes}, 39 TAX L. REV. 227, 254-55 (1984) (describing how Indonesian tax system revised pursuant to "three cornered negotiations among the taxpayer, the Service, and the Indonesian government"); id. at 262 (describing reaction to release of regulations defining "creditable taxes" in 1980).

\textsuperscript{47} Of course, some public goods (like some private goods) are "lumpy" in nature, and some are lumpier than others. One policeman may adequately police one house or twenty, with a second officer being unnecessary until the twenty-first house is built, and a third being unnecessary until the forty-first is built, and so forth.

\textsuperscript{48} Oil companies have been learning this lesson the hard way in countries such as Nigeria, where they have been forced to provide extra-legal benefits to local residents upset by disparities in relative living standards. \textit{See} Norimitsu Onishi, \textit{Deep in the Republic of Chevron}, N.Y. TIMES, July 4, 1999, § 6, at 26. Closer to home, the relative (as opposed to objective) nature of poverty has been cited as the justification for revising the federal government's (monetary) definition of poverty. \textit{See} Louis Uchitelle, \textit{Devising New Math to Define Poverty}, N.Y. TIMES, Oct. 18, 1999, at A1; \textit{see also} Klaus Vogel,
The distinction between public goods and zero marginal cost goods (or services) is important because its existence undercuts the conclusion that a "smart" country would reduce its tax levy on imported capital to zero. A country does not improve the welfare of its residents by attracting new investments that impose higher financial demands on the social infrastructure than the government will recoup in tax payments. Thus, competition should not push tax rates on the marginal investor down below the rate needed to generate enough revenue to offset the costs imposed by the investment. The floor is marginal cost rather than zero.

Beneficial tax competition could not exist if every jurisdiction faced the same marginal cost of providing services and, hence, the same floor on tax rates. Under those conditions, competition would simply push tax levels down to that common floor, leaving the investor to choose between alternative locations based on their nontax characteristics. However, there is little reason to believe that countries' marginal costs are equivalent. As a result, beneficial tax competition can (and does) exist.

In the first place, residents of different countries may have different preferences regarding the mix between publicly and privately supplied services that affect the level (and thus the cost) of maintaining their public sectors. These differences may reflect differences in underlying philosophy or concerns about the relative competence of their public or private institutions, or some combination of the two. For example, the government provides (and funds through taxation) the health care system in most European nations. The United States does not. Postsecondary education is publicly financed in many countries, but much less so in the United States. Obviously, a government needs more revenue, generated by higher tax rates, adequately to perform more functions. Businesses should be indifferent between paying for services indirectly, through taxes, and directly, through self-provision, as long as the service is provided at equivalent cost. That is, they should be indifferent between a high-tax country providing higher services and a low-tax country which does not, assuming they assign a value to the services the government provides equivalent to their tax cost. But firms, like individuals, may have different preferences for government services. Some may want roads, but be indifferent to higher education; others may want both and still others neither. Allowing countries to reduce tax

World-Wide vs. Source Taxation of Income—A Review and a Reevaluation of Arguments, in Influence of Tax Differentials on International Competitiveness, supra note 11, at 117, 143.

49. Residents rarely if ever vote directly on the question of appropriate tax rates. Instead, the rates (and other parts of the tax system) are put into place by government officials. As with any agency relationship, room exists for strategic misbehavior. The consequences of such misbehavior—and strategies for dealing with it—are detailed infra Part I.B.2.c.

50. This assumes, of course, the absence of legal rules that make one form of provision more desirable. That is not always the case. For example, a foreign investor from a tax credit country may prefer services to be provided at the governmental level, and paid for through taxation, because foreign taxes would be creditable against its home country tax while its expenditures for identical services would be merely deductible. See supra note 46.
rates to cover only their particularized marginal costs allows them to search for investors sharing their preferences regarding the amount and quality of government services and to avoid both the undersupply and oversupply of such services.

The calculation of the marginal costs of a particular investment would be incomplete if it focused entirely on the cost of providing explicit government services. Everyday experiences show that the social impact of a given investment also varies widely from jurisdiction to jurisdiction. Physical differences, social tastes, and economic conditions also have an impact on the social costs and benefits of locating a particular investment in a particular country. One suspects, for example, that the net social benefits of opening an automobile assembly plant in Estonia are not exactly equal to the benefits of opening the plant in Germany. Where such variations exist, a neutral observer can identify some locations as preferable to others from a social perspective. And most importantly for purposes of this Article, tax burdens can be used as an instrument for communicating and effectuating information about such preferable locations.

Some jurisdictional variations may be due to normatively neutral physical differences. The siting of an industrial plant in an area already subject to substantial traffic congestion, for example, may impose substantially more costs than its siting in an uncongested area. Whereas in the first location, residents will either have to suffer an increase in the frequency and intensity of traffic jams (and the consequent time losses) or the disruption and expense of building new roads, in the second location, the additional traffic created by the plant may be barely noticeable and certainly not burdensome. An activity that generates unpleasant (but ultimately harmless) odors within a half-mile radius may be unattractive if located near a residential development, but relatively unobjectionable if located near farms (such as pig farms, themselves notorious for emitting noxious odors). It would be ridiculous to pretend that such differences should have no effect on the siting of business investments. Although sometimes it would be possible for these social concerns to be communicated outside the tax system—communities could organize protests by concerned residents, for example—it is often much cheaper and easier to use the tax system to deliver the message. Indeed, potential investors may pay more heed to a governmental offer of a tax cut (or imposition of a tax increase!) than to protesters, who may be regarded as representing a fringe interest rather than widespread sentiment.

51. Investors are often loathe to invest across the former Iron Curtain (as well as in many lesser-developed nations), fearful of official (and unofficial) corruption, the absence of a work ethic among workers, and the like. The ability to attract and retain a major investment such as an automobile assembly plant would send other potential investors a reassuring signal on all these counts. Further, employment options for potential workers may be less desirable in Estonia than in Germany, so that the gains enjoyed by newly hired Estonian workers would exceed those enjoyed by newly hired German workers. It is worth noting, however, that the integration of East Germany makes this question closer than it once was.
Other variations may be attributable to differences in taste. A country with a large Islamic population may not want a pig farm or processing plant, even if the plant's products are routinely exported to non-Islamic countries. They may be equally uncomfortable hosting back-room operations of a bank or other finance company that charges or pays interest. No pharmaceutical company is likely to build a plant in Italy for the manufacture of RU-486. Such enterprises could, of course, be forbidden through regulation. But what if a jurisdiction wanted to take a less draconian stance, and allow such activities if, and only if, they made a substantial financial contribution to the community?

Some differences in taste can be more accurately ascribed to wealth differentials. Just as few wealthy suburbs would countenance the placement of a prison in their midst whereas depressed rural areas may find them attractive, few wealthy countries would seek (as some developing countries do) to attract noisy factories paying subsistence wages. And whereas the already-employed residents of western Germany may not be particularly eager for the opening of a new automobile assembly plant because of concerns about the influx of new people with different backgrounds, congestion, and possible pollution, residents of southern Italy may be thrilled to attract such a plant. Such examples belie the contention made by advocates of harmonization that the social losses to the jurisdiction that would have received an investment in the absence of tax competition always equally counterbalance the gains of the jurisdiction that attracts an investment through tax competition, and thus both should be ignored.52

Though we may decry the wealth differentials underlying the differences in tastes that make for differential losses and gains, until we undertake to remedy the wealth disparities it seems quite hypocritical to deny the residents of poorer jurisdictions the right to do what they can to improve their lots (in their opinion). While it is undoubtedly true that poor jurisdictions would be better off receiving investment and higher tax revenues, forbidding tax competition may simply result in the location of the investment in a high-tax jurisdiction, leaving the poorer jurisdiction with nothing.

Though eagerness or the lack thereof for particular investments may be expressed by things other than tax rates, once we acknowledge the legitimacy of

52. Harmonization advocates generally contend that tax rates will be homogenized at or near zero, so that tax considerations will play little if any role in the final locational decisions, see supra note 11 and accompanying text, and identify the harm as the general diminution of tax revenues and thus governmental spending. This may be because economists dislike making interpersonal utility comparisons. Discussions of misallocated investment are found more often in the context of state and local tax competition and, especially, enterprise zones. See Franklin P. James, The Evaluation of Enterprise Zone Programs, in ENTERPRISE ZONES: NEW DIRECTIONS IN ECONOMIC DEVELOPMENT 236 (Roy E. Green ed., 1991) (claiming that enterprise zones "distort the location choices of new establishments"). Of course, one person's distortion can be another person's redress of an existing inefficient situation. See Mildred Wigfall Robinson, Empowerment Zones and Enterprise Communities Under the Omnibus Budget and Reconciliation Act of 1993: A Promising Concept with Some Modifications, 11 J.L. & POL. 345, 366 (1995).
interjurisdictional competition, one needs a justification for ruling out any particular method of obtaining an advantage. There is no reason to believe that tax competition will have worse side effects than the other forms such competition would take. In the automobile assembly plant example, the investment may be drawn to Estonia rather than Germany through differences in environmental regulations rather than lower tax burdens. Of course, the resulting pollution may end up wafting over Germany or generally contributing to the greenhouse effect; and it is hard to see how the affected jurisdictions can combat such externalities. By comparison, tax competition seems a relatively benign method of competition. The only spillover effect of tax competition is the attraction of an investment away from another location—an effect which such other jurisdictions may counter by making a similar tax offer if the investment is “worth” it. (And if it does not, its failure to act will prove that the investment is more valuable to the other jurisdiction.)

Further, in some circumstances, tax concessions may be the only way to make such distinctions salient. Some social preferences may be hard to signal. What if the only concern was congestion, or a desire for spin-off businesses, or a fear (or desire) that the political climate may change with an influx of newcomers or a change in the current residents’ economic status? Having the flexibility to calibrate tax rates in accordance with the jurisdiction’s desire (or lack thereof) for an investment makes such preferences more salient to all involved, and increases the likelihood that they will (as they should) affect actual investment decisions. Far from being a zero-sum or even negative-sum game which succeeds only in transferring money from public treasuries to private wallets, tax competition provides a mechanism for forcing the internalization of social preferences and valuations that might otherwise be ignored to the detriment of all.

This is not to say that such differences in social impact and valuations exist between all jurisdictions with respect to all investments. Several jurisdictions may find a particular investment equally desirable (or undesirable). Tax

53. Indeed, high-tax, high-service countries may find low-service-demanding businesses as attractive as do many low-service, low-tax jurisdictions. Unfettered tax competition allows these high-service countries to compete for these low-service oriented businesses by offering “targeted tax breaks”—tax reductions limited to those businesses or investors plausibly claiming a willingness to move to low-tax, low-service, jurisdictions. Proponents of tax harmonization find such targeted tax breaks particularly reprehensible (both the OECD and EU proposals would outlaw them), but do so on grounds that their recipients receive a “windfall.” See Avi-Yonah, supra note 2, at 1627. However, no “windfall” results if the recipients (and their income-producing activities) in fact receive no benefit from the generally prevailing high level of services, nor are the other residents of these high-tax jurisdictions hurt because such recipients impose no additional costs on them. From the source country’s perspective, that is, the only issue is whether its tax or legislative authorities do a good job of identifying low-service businesses from imposters (who would like to combine high services and low taxes). This issue is discussed further infra Part I.b.2. An issue that could be raised by proponents of tax harmonization (but has not been) is whether it is “fair” or “right” or “efficient” for high-service countries to undercut the opportunities available to low-service countries in this way. Anyone attempting to answer this question would presumably have to grapple with the literature on price discrimination.
competition between such jurisdictions is indeed a zero-sum game (if one is willing to privilege general tax rates; for a reason not to, see Part I.c of this Article); if these jurisdictions can identify and creditably bind themselves, it may make sense for them to eschew such mutual competition. However, they would still have to reduce their tax levies to compete against other jurisdictions. That competition is not destructive because it is necessary to determine whether those other jurisdictions in fact value the investment more highly than the harmonized group. In short, once again, the most impressive efficiency gains are generated in the process of deciding which jurisdictions should be under consideration in the final round of bidding rather than in deciding between the contestants who survive to the final round. It is unfair to judge the efficacy and desirability of such competition by the "efficiency" of the allocation in the final round without first looking to see how many less desirable locations were ruled out earlier on.

In sum, advocates of tax harmonization overstate their case by implicitly assuming the fungibility of governments and jurisdictions. Countries are not like bushels of corn, indistinguishable from one another. Instead, they vary along many different dimensions, some of which are quite important to investors. As a result, instead of leading to a pure "race to the bottom," tax competition has and is likely to continue to result in market segmentation, as investors and countries look for good partners. Just as we believe that society benefits from the availability of Chevy Cavaliers, Camrys, Lexuses, and Porsches, so too can it benefit from the diversity of governmental and tax regimes encouraged by tax competition—benefits that would be lost under a strict form of harmonization.

At least in an ideal world, then, tax competition can create locational efficiencies. But how close is this world to that ideal world? That is, how good are governments at making the judgments required to set tax rates at close to marginal cost? That distressingly practical issue is confronted next.

54. One may view the recent attempts by the European Union to harmonize tax rates as attempts to do just this—maintain a high "European Union" rent. One could imagine other groups of countries forming similar cartels, but (and this is important) coalescing around a different set of tax rates reflective of the rent extractable by that particular group of nations. One of the pitfalls of "regional" (as opposed to universal) harmonization is that even countries with rents in common may differ in other respects; harmonization may prevent them from expressing those differences in a meaningful manner, leading to differences in investment patterns (that is, the pattern of investment may be different under a harmonized regime than would be the case under a competitive regime). Although the higher taxes collected on the investment that remains may compensate jurisdictions that lose investments due to harmonization, full compensation cannot be guaranteed. Some countries may be net losers under a harmonization scheme. Although (if the grouping is economically justifiable) the net winners should be able to make these losers whole out of their harmonization gains, it may be impossible as a practical or political matter to determine the amounts of money particular countries should be making and receiving to ensure a fair (and sustainable) result. Yet the absence of such compensatory payments may make even regional harmonization unsustainable. It is worth noting that harmonization has come closest to being effected in the European Union, a pre-existing international grouping which subsidizes its poorest members. Such existing cross-subsidies may ameliorate the need to provide compensatory payments directly related to harmonization concerns.
2. Garbage in, Garbage out?

For tax competition to allocate investments to the "right" location, tax differentials must reflect real differences in marginal costs of providing services, as adjusted for net social costs and benefits. Otherwise, the differentials represent mere noise in the decisionmaking process, having a random rather than systematically beneficial (or detrimental) effect on investment decisions. The expressed fear is that competition will drive tax rates far below any reasonable conception of marginal cost; unmoored from this factual constraint, tax competition fails to direct investment to the most "deserving" jurisdiction. As humans are prone to error, it is inevitable that some mistakes will be made, including occasional dramatic ones. The concern is that such errors will occur frequently enough to warrant foregoing the efficiency possibilities made possible by tax competition. This section evaluates some of the common arguments for the impossibility of such measurements.

a. The Monetarization of Non-Monetary Costs and Benefits. One rarely hears expressions of concern about the determination of marginal costs when analyzing private market transactions. Generally speaking, observers feel that private markets are capable of setting prices for the inputs of marginal cost, lending a definiteness and precision to the valuation process. Comfort with the underlying factual constraints on pricing decisions makes it easy to believe that consumption decisions based on those price differentials increase economic efficiency. This comfort level decreases markedly when one turns to the markets for governmental services. Part of this discomfort stems from difficulties inherent in attaching monetary values to costs and benefits not generally traded in the marketplace. Engineers can estimate the marginal cost of wear and tear on local roads caused by additional usage generated by the opening of a new plant. Other costs, such as the loss of productivity caused when such traffic generates traffic jams, however, may be more difficult to estimate and still others, such as the cost of the aggravation caused by such jams, even harder still. Decreases in comfort and convenience that do not rise to the level of health hazards are quite difficult to express in monetary terms because such items, not being regularly sold or traded, lack reliable market benchmarks.

Equally difficult to value for the same reason are the costs (or benefits) of changes in culture caused by increases or decreases in business investment. Although industrialization generally increases living standards as measured in economic terms, it may also disrupt indigenous cultural patterns and religious practices as well as create previously unknown disparities of wealth. Some or most of the population may find these effects unacceptable even though the general population may be better off if only market indicia (such as annual income) are taken into account. One of the benefits of tax competition is that it allows jurisdictions to take such cultural preferences into account when setting their tax rates; a jurisdiction with anti-growth sentiments may set tax rates almost punitively high. On the other hand, much room exists for error, for over-
or underestimating the importance of changes in culture relative to more easily (and definitely) monetarized items. Although assigning a monetary value makes comparisons on a common scale possible, the comparisons are useless if that value fails to reflect accurately the relative preferences of the affected individuals, and accurate reflection is difficult because people are not used to assigning values to such ephemeral or personal concerns.

At least in countries with democratically elected governments, feedback mechanisms may limit the damage wrought by valuation errors. Voters can vote out of office representatives viewed as "giving away the store" (offering potential investors too good a tax deal) or as chasing beneficial businesses away by refusing to offer a good enough deal. In many cases, tax rates can be changed for future years, limiting the damage created by early misestimates. Moreover, it is worth noting that such valuation issues are delegated to governmental agencies and elected officials all the time in the context of legislation regarding explicit spending programs. Officials and agencies prioritize projects, set budgets, specify performance requirements, and perform a host of like functions for programs funded by their jurisdiction's treasury. The valuation decisions required for the intelligent design of a tax system vary in neither kind nor scope from those required to perform these functions. There is no particular reason to believe that government officials will deal less well with these decisions. And having trusted them in one context (despite their problems), it seems rather odd to conclude that they are incapable of performing identical functions in the other.

One caveat to this optimistic view of the possibilities of public and/or political oversight of these decisions is a question as to the availability of information about the existence and effect of these special tax regimes. An oft-noted critique of tax concessions relates to their secrecy or lack of "transparency." Many concessions appear to be granted not by statute, but through private deals worked out with tax administrators. While business and privacy reasons may justify the general rule against disclosure of tax returns and tax liabilities, there seems to be no reason for hiding the rules under which such liabilities are to be calculated, including information regarding variations between these rules and those applicable to other taxpayers. Additionally, responsibility for determining the amount of tax concessions is often delegated to revenue officers, raising further concerns about the accountability of elected officials to the process. For political oversight to work properly, the body politic must be able to see what decisions are being made in their name and have some degree of control over the decisionmakers. Without information, no effective oversight is possible. Lack of transparency, then, should be disfavored, though

55. "Lack of transparency" is listed among the "key factors identifying tax havens" in the OECD Report on tax competition. See HARMFUL TAX COMPETITION, supra note 2, at 23 (Box 1). It is considered a "potentially harmful" feature under the European Union's Code of Conduct. See ECOFIN Council, supra note 21, at (B 5).
perhaps not for the reasons generally proffered by proponents of tax harmonization.

Finally, whatever the flaws in the valuation process, it hardly seems that leaving them out of the cost-benefit analysis altogether—pretending that social costs and benefits do not exist or have a value of zero—should be the preferred solution. To do that guarantees error while the other approach only allows for the possibility of error while guaranteeing some public discussion of the issues. And yet, that is what tax harmonization could do. It could force all jurisdictions to impose similar income tax burdens regardless of material and sociocultural differences. Such uniformity would guarantee that some jurisdictions will overcharge and inefficiently deter investment while others will undercharge and perhaps be the site of investments the populace neither needs nor wants. The case for harmonization thus resembles nothing so much as an example of the (impossible) best being the enemy of the (possible) good.

Proponents of tax harmonization point to more specific valuation concerns as well. One much-discussed flaw of some competitive processes is the tendency toward a “winner’s curse.” Its application to this context is discussed in the next section.

b. Winner’s Curse. The absence of determinate benchmarks of “marginal cost” makes mistaken pricing decisions possible. Though one might think such errors would be random, leading to excessive prices in one instance and insufficient prices in another, some worry that the “winner’s curse”\(^5\) will lead to systematic undertaxation of affected investors. The argument goes as follows: In an auction format, the winners are those that bid most aggressively. In the tax context, this is the jurisdiction that imposes the lowest effective tax rate. Because jurisdictions should be willing to lower their bids to the rate that will allow them to recoup the marginal costs of hosting the investment, the nominal winner should be the jurisdiction with the lowest marginal cost. However, because determining the amount of some key determinants of marginal cost involves guesswork, the winner is really the jurisdiction that guesses it will have the lowest marginal cost. As the lowest cost projection, this guess is an outlier—and like all outliers, likely to be wrong. And indeed, both field studies and experimental data show that auction winners often find out that they have overpaid.\(^6\)

This is the “winner’s curse”; in all too many situations, in retrospect, winners wish that they had not won. There is concern that if tax rate “auctions” were allowed, the winner’s curse phenomenon would prevail, leading to systematic undertaxation of affected firms and revenue losses by participating govern-


\(^6\) See Gillette, supra note 9, at 453-54 (describing anecdotal evidence of winner’s curse in interstate and private auctions; references to experimental studies); Barry Lind & Charles R. Plott, The Winner’s Curse: Experiments with Buyers and with Sellers, 81 Am. Econ. Rev. 335, 336 (1991) (stating that the winner’s curse is “a general phenomenon exhibited by most agents”).
ments. Even worse, locational decisions might be determined not by relative net costs and benefits of the investment but by the degree of over-optimism exhibited by jurisdictions' representatives. This possibility seems particularly frightening because experimental evidence hints that this curse may be difficult to correct.58 One way to overcome the problem is to prevent such auctions—such competition—from beginning through the imposition of harmonized rates.

However, the actual processes involved in competing for investors do not match the procedures which give rise to the winner's curse. The paradigmatic procedures for generating the curse—the procedures followed in most of the experimental literature—involves multiple bidders making sealed bids in a one-step auction.59 Techniques for attracting business investment tend to be quite different. Often, only a few bidders are involved, due to operational business constraints. Perhaps more importantly, the "auction process" is a multi-step one. The first salvo generally involves the promulgation of general, and generally published, tax rates (which may, of course, be revisited over time). Additional rounds of individualized negotiations may ensue. When multiple bidders do exist, parallel negotiations with several jurisdictions are common, as the investor seeks the best possible deal. The information disclosed by an investor seeking to play each jurisdiction off against others can aid those others by providing a baseline against which to judge its own estimate of the investment's value.60 Aberrant projections should provoke re-evaluation of the reasons behind the discrepancy: Do they reflect differences in net social cost, or the questionable resolution of uncertain facts? At the very least, such cross-comparisons should prevent most wildly aberrant bids from being made.

In sum, as the procedures through which tax competition takes place look more like open markets and less like auctions, fears that the winner's curse will systematically contaminate pricing decisions lose their force. And again, the alternative being proffered, harmonization, hardly guarantees accuracy.

Another alleged source of inaccuracies in tax "bids" comes from the conflict of interest that exists between the public officials or political leaders responsible for determining and making bids and their constituents or subjects.61 For the reasons discussed in the next section, this mismatch of interests between agents and principals may lead agents deliberately to misprice tax levies.

c. Agency Costs. The discontinuity between the interests of principals and their agents is a well-known problem; unfortunately, it is one that is easier to diagnose than to cure. This is at least as true in the governmental context as in

58. See Gillette, supra note 9, at 454 ("[T]hose subject to the effect learn little from their mistakes."); Lind & Plott, supra note 57, at 336.
59. See Gillette, supra note 9, at 455-56.
60. One problem may be that investors may lie about the deals offered by other jurisdictions, hoping to finagle a better one. However, the success of such lies depends on the secrecy of the other countries' tax regimes; if a transparency rule is in place, such strategic behavior becomes much more difficult.
61. See Avi-Yonah, supra note 2, at 1628.
private ones. When it comes to setting tax policies, constituents' only interest is accuracy. They, after all, will be ultimately responsible for funding (or living with the consequences of non-funding) any revenue shortfalls created by the undertaxation of marginal investors, just as they will have to live with the presence or absence of the investments attracted or deterred by the tax rates set by their polity. Public officials and political leaders, like managers of corporations, have additional interests which may conflict with their constituents' interests and their obligations to those constituents.

One such interest (in many jurisdictions) is being re-elected.\textsuperscript{62} Depending on the method of campaign funding extant in a jurisdiction, this may lead officials to over-respond to those promising funds for a re-election campaign, typically the investors seeking tax concessions and sub-groups of constituents particularly apt to benefit from the potential development.\textsuperscript{63} However, the over-response need not be directly tied to funding concerns. Lobbying efforts organized by those directly benefited by the proposed investment may prevail over disorganized opposition because the officials involved misconstrue this disorganization (typically expressed in the form of silence or inaction) as support or disinterest.\textsuperscript{64} The apparent lack of opposition may be rationalized in the official's mind by the enormity of the benefits provided by the investment (an amount calculated, of course, by its biased and often inaccurate supporters). Moreover, even those who recognize the true nature of the silence may decide that their best interests will be served by disregarding the opposition; if the opposition voters believe the stakes too small to bother organizing an effective opposition, the stakes are also probably too small materially to affect voting behavior in the next election.

The tendency to cater to the desires of an unrepresentative few may stem from desires even less savory than the imperatives of winning the next election. Officials may view their power to engage in tax negotiations as an opportunity to engage in financial self-help, essentially selling tax concessions (and development opportunities) for personal gain.\textsuperscript{65} Such diversions of public resources into private pockets not only leave the other residents bearing the financial burdens attributable to the increased investment, but may lead to the inefficient location

\textsuperscript{62} It is an axiom of political science and theory that legislators' primary, but not sole, concern is winning reelection. See Lynn A. Baker, \textit{Conditional Federal Spending After Lopez}, 95 \textit{COLUM. L. REV.} 1911, 1941 n.147 (1995) (listing sources).


\textsuperscript{64} See generally JAMES BUCHANAN & GORDON TULLOCK, \textit{THE CALCULUS OF CONSENT: LOGICAL FOUNDATIONS OF CONSTITUTIONAL DEMOCRACY} (1962).

\textsuperscript{65} Again, mandating transparency in such arrangements should reduce opportunities for misbehavior. Nothing short of perfect law enforcement, however, would be capable of eliminating them. But this is a problem not limited to tax incentives, and no particular reason exists to believe it worse in this context than others where agents continue to have discretion.
of such investment. The price set for such concessions by a profit-maximizing official probably will not be the same as the amount of taxes conceded, as it will be determined by what the official thinks the taxpayer will be willing to pay rather than reflecting the social costs inflicted on the jurisdiction. Indeed, if the amount of the bribe equals the difference between what the tax should have been (based on marginal cost considerations) and what it is “negotiated” down to, the investor would be indifferent from an economic standpoint as between paying the proper amount of tax and paying the bribe. Fear of embarrassment should the arrangement be made public, if not discomfort with the immorality and illegality of the bribery, should tip the balance toward the payment of the full tax levy under such circumstances. Bribes are most attractive, in short, when they reduce total expenditures, not when they substitute for an equal amount of legal ones.

Tax harmonization would reduce, if not eliminate, such opportunities for official misconduct by making it much more difficult for politicians to use tax rates as a bargaining chip in negotiations with investors (as would an internal rule against such tax breaks)\(^6\); it is unclear, however, whether harmonization is capable of reducing the overall amount of official misconduct or its less virulent cousin, interest group politics, both of which can lead to the misallocation of investment. Instead of disappearing, official misconduct may merely mutate into other forms with similar economic effects. In lieu of tax breaks, officials may be able to offer potential investors cash subsidies or the provision of valuable (and not generally available) governmental benefits that could become the focus of corruption. For example, a jurisdiction may condemn land to build roads and other infrastructure that just happens to benefit a newly built factory (and which otherwise would have been paid for by the factory owner). Nor does ensuring that tax monies flow into a jurisdiction’s treasury guarantee that such funds will be spent wisely—or even by the jurisdiction. Officials may simply siphon tax monies raised because of harmonization from the national treasury. Although it was once thought that tax expenditures were more susceptible to political skullduggery because they lacked visibility, recent events and scholarship have thrown this former truism into disrepute.\(^7\) And, of course, harmonization would rule out any possibility of obtaining efficiency gains in countries not troubled by such problems.

A more serious agency problem arises when the adversely affected party is not a member of the same political jurisdiction. It is one thing to assume that the political system works, more or less, to police against the indiscriminate reduction of tax burdens to the detriment of the local fisc, and another when the financial burden falls on a foreign fisc. One aspect of some (but not all) of the

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66. It would not, however, have any impact on arrangements centered around tax administration—the use of discretion in determining the stringency of the administration of those rules.

67. See Zelinsky, supra note 63, at 1166 (arguing that tax institutions in the United States are better monitored by the public than many other governmental committees).
targeted tax schemes tax harmonization proponents rail against is that they confer anonymity on their beneficiaries, thereby enabling those beneficiaries to escape residence as well as source tax. For example, the United States generally requires bond registration as a condition of granting the debtor’s interest deduction. However, it allows corporations to deduct interest paid on untraceable bearer bonds that are sold to foreign persons. Residence taxes become voluntary taxes (with few volunteers) given the impossibility of an effective audit. While countries should be allowed to trade off their own tax revenues for increased investment, no efficiency rationale suggests that a similar privilege should be accorded to trades of the revenues of other countries. Tax harmonization advocates misidentify the problem by focusing on the source country’s attempt to attract investment by offering a tax exemption; the real problem is the source country’s collusion in taxpayer attempts to evade residence country tax. The solution to this problem lies not in the harmonization of source tax rates, but rather in requiring better disclosure of foreign earnings to the country of residence.

In summary, then, reasons exist for concluding that opponents of tax competition have significantly understated the locational efficiency gains that it may create, thus overstating their case for tax harmonization. Tax competition is not a negative-sum game, either from the perspective of participating countries or global welfare as a whole, when viewed from a strictly economic perspective. Even if one accepts the general idea that tax competition will lead to improvements in investment patterns, however, one may remain concerned that this benefit will be substantially offset if not overwhelmed by a side-effect of tax competition: lower tax revenues from traditional sources, necessitating either reduced government budgets or a shift of the tax burden to other sources. The extent to which such reductions and shifts will exist, and the nature of the problems they will and will not create, are discussed in the next section.

C. REALLOCATION OF THE REDISTRIBUTIVE BURDEN

No one has a theoretical or moral objection to reducing prices for commercial goods to their marginal cost of production. Reducing tax burdens to the level required to recompense the jurisdiction for the costs of hosting the taxpayer (or its income) is more problematic, however, because most tax systems are designed to achieve some degree of redistribution. That is, few tax systems seek to

69. Id. § 163(f)(2)(B).
70. See infra Part III.c. Some of the targeted tax schemes abhorred by tax harmonization advocates may disappear if source countries lose the ability to leverage their revenue losses with those of the investor's country of residence; unleveraged schemes may not attract enough additional investment to be deemed worthwhile, especially considering the difficult classification problems such regimes entail. See Harris, supra note 44, at 456 (arguing that the form of repatriation does not affect the benefits derived by business income so that source tax systems should not distinguish between them). Again, though, both the problem and the solution would be traceable to tax evasion rather than tax competition.
match perfectly governmental sources of income with governmental expenditures; most include subsidies (in the form of tax levies lower than marginal cost) for poorer members of the polity, subsidies that by definition must be paid for by its richer members. Indeed, belief in the desirability of such redistribution may be at the heart of a jurisdiction’s decision to use an income tax.

Tax competition undermines countries’ abilities to redistribute the burden of governmental expenses through corporate income taxes. Owners of capital that can easily be moved to lower tax jurisdictions will not pay redistributive levies; they will take their capital to those low-tax jurisdictions. Because much income-generating capital is (or can be construed by its owners as) mobile in this fashion, tax competition reduces the amount of revenue derived from the corporate income tax that can be directed to redistributive purposes.  

Affected governments are left with two alternatives: reduce redistributive government expenditures or find another source of revenue to make up the shortfall created by tax competition. Proponents of tax harmonization argue that neither of these alternatives is acceptable. Neither tax competition nor globalization should have any effect on a society’s taste or need for redistributive expenditures. Thus, any reduction in government revenues that causes a reduction in such expenditures moves the society away from its “socially optimum” level of redistribution. Nor is it easy to preserve redistributive expenditures by using other revenue sources to bring revenue levels up to the pre-competition level. Increasing the marginal rates of other taxes increases the inefficiencies associated with those taxes. These inefficiencies may deter jurisdictions from fully compensating for the revenue shortfalls. Moreover, even if enough revenue is raised from these alternative sources, the increase in inefficiencies may leave the society worse off.

71. This is the underlying concern of many proponents of tax harmonization. See, e.g., McLure, supra note 25, at 20 (claiming that owners of capital can move their capital to lower tax nations without the fear of a superceding government structure to ensure redistribution); Sinn, supra note 3, at 6.
72. See, e.g., Avi-Yonah, supra note 2, at 1639 (explaining that increasing other taxes besides income tax is not an alternative in many countries); Musgrave & Musgrave, supra note 11, at 69 (asserting that capital movement to low-tax jurisdictions results in free-rider problems and inefficient government services).
73. The likely reduction of governmental services was first forecast in the 1970s by an economist exploring the consequences of inter-local tax competition. See Wilson, supra note 9, at 269. This economist predicted that “[t]he result of tax competition may well be a tendency toward less than efficient levels of output of local services.” Oates, supra note 27, at 143. However, these initial explorations assumed that the state started at an optimal size, an assumption that has been questioned by later academicians. See Wilson, supra note 9, at 296; see also Avi-Yonah, supra note 2, at 1578 (arguing that the need for a social safety net increases with globalization).
74. The term “inefficiencies” encompasses a variety of economic distortions, such as affecting the labor-leisure trade-off, incentives to develop land, and others. See Avi-Yonah, supra note 2 at 1578 (listing types of inefficiencies).
75. Economists generally prescribe “many small taxes” on grounds that the deadweight loss of a tax “increases geometrically with the rate of tax.” See Russell Krelove, The Theory of the Second Best, in TAX POLICY HANDBOOK, supra note 25, at 62, 63.
76. See Avi-Yonah, supra note 2, at 1634.
Even if true, these arguments do not necessarily justify tax harmonization. After all, such harmonization would have the counterbalancing effects of eliminating the locational efficiencies enabled through tax competition. The question becomes which of these effects is more substantial. The next sections of this Article indicate that proponents of tax harmonization have overstated the seriousness of their redistributive claims just as they have understated the benefits to be gained from tax competition. The question thus becomes much closer than they would have us believe.

The harms associated with the “breakdown” in the redistributive process have been exaggerated in several respects. First, opponents have overestimated the amount by which corporate tax revenues’ contributions to redistribution will be reduced by tax competition. Second, they have in some respects underestimated the amount of revenue shortfalls that can (will) be recouped without creating additional social burdens. Third, they have ignored the substantial economic literature arguing that the distributional differences between a tax which explicitly taxes only labor income and one which explicitly taxes both labor and capital income is small to nonexistent. Fourth, and finally, they may have made a mistake in privileging the precompetition corporate tax rates to begin with. Each of these points is discussed in greater detail below.

1. Taxes as Rents

Marginal social cost serves as a floor on the amount of tax revenues a jurisdiction will require from an investor; it is not, however, necessarily a ceiling. Again this characteristic flows from the heterogeneity of jurisdictions. Not all businesses can be located in all locations, at least for an equal cost. Some businesses may be particularly well suited for particular jurisdictions because of the location of natural resources, transit connections, or marketing considerations. In such situations, countries can try to appropriate some of the economic value from investors through higher tax rates. An archetypal example of this phenomenon can be found in the history of income taxation of oil revenues derived in various Middle Eastern countries. But this is just the most blatant example of a more widespread phenomenon. As long as the additional taxes do not exceed the special benefits of the jurisdiction, investors will not leave the jurisdiction. These additional revenues, amounts by definition in excess of the costs imposed by the payer on the jurisdiction, can be used to achieve the government’s redistributive goals.\footnote{\textit{See} Christiansen et al., \textit{supra} note 32, at 16.}

Obviously, not all jurisdictions have the ability to extract rents with regard to all activities, and some may have no such power. Further, the favorable attributes that give rise to rents may be shared by several countries, and competition between those countries could dissipate potential rental revenues. And it is unlikely that enough rents exist to allow countries to forestall all revenue losses
due to tax competition. Nonetheless, the presence of such rents may explain why many countries, especially developed countries, have been able to retain a substantial corporate tax levy.

Finally, it is worth noting that these rents may be the only portion of corporate tax revenues available for redistribution even under a harmonized tax system. Rules against tax competition do not prevent jurisdictions from trying to attract favorable investments. All they do is push such competition elsewhere. One obvious "elsewhere" is increased governmental expenditure on goods or services that benefit such investors. Government money may be used to create desirable infrastructure (such as water, sewage purification facilities, or roads) which the investors might otherwise have to fund on their own. The more such money is funneled into benefits for investors, the less it is available for redistribution to others.

Limits on tax competition can be reinforced with limits on countries' ability to refund such taxes surreptitiously by providing the taxpayers with specific benefits. However, evidence derived from other contexts shows that it might be impossible to enforce expenditure limits in any meaningful way. As a practical matter, one cannot distinguish between expenditures on infrastructure meant to encourage "economic growth" in general and those meant to benefit the particular investors that end up using the infrastructure so created. At most, selective self-censorship may be required to prevent impermissible motivations from becoming apparent.

The United States has tried to backstop attempts at tax discrimination through controls on associated expenditures in two rather disparate contexts. In neither has the attempt been very successful. The first area involves interstate competition. The Commerce Clause of the Constitution prohibits states of the United States from imposing discriminatorily high taxes on interstate (as opposed to intrastate) commerce or taxpayers. However, it did not take long for states to realize that they could achieve the same economic effect by coupling a facially nondiscriminatory tax with a discriminatory spending program. To date, the Supreme Court has struck down only one such scheme. In that case, West Lynn Creamery, Inc. v. Healy, the state levied a charge on milk dealers based on the

78. This is particularly true given that jurisdictions must not only have the ability to extract such rents, but also know that they have this ability. Potential taxpayers will not be forthcoming with such information and indeed, will undoubtedly seek actively to mislead jurisdictions in an effort to receive more favorable tax treatment. These difficulties have led some to predict that few rents will be collected outside of jurisdictions with (obvious) natural resource advantages. See Bovenberg, supra note 12, at 2; Christiansen et al., supra note 32, at 18. But see Tanzi, supra note 25, at 119; Michael Keen, The Welfare Economics of Tax Coordination in the European Community, in The Economics of Tax Policy 189, 211 (M. Devereux ed., 1996).

79. Proponents of tax harmonization are slowly coming to realize that it must be accompanied by some undefined form of "expenditure control." See, e.g., Frey, supra note 11, at 96 (arguing that the "benefit side must be considered simultaneously"); Musgrave & Musgrave, supra note 11, at 113.

80. This rule has been applied under the rubric of the "dormant Commerce Clause." See Enrich, supra note 9, at 424-25.

volume of their sales of milk products in Massachusetts. The funds raised by the tax were then used to pay local milk producers a subsidy, also based on volume, but in an amount greater than the in-state producers’ initial tax payments related to the milk produced by local firms. As a result of these cross-payments, the local milk producers effectively paid no tax and received an additional financial subsidy paid out of milk taxes levied on foreign milk producers. The Court found that no legal difference existed between a discriminatory tax scheme which exempted in-state producers or products and one in which the tax was first levied and then rebated through a spending program, “eschewing formalism for a sensitive, case-by-case analysis of purposes and effects.”

However, the Court’s case-by-case analysis appears far from “sensitive.” In West Lynn Creamery itself, the Court went out of its way to note that “direct subsidization of domestic industry does not ordinarily run afoul of the negative commerce clause” and that, in fact, “it is undisputed that States may try to attract business by creating an environment conducive to economic activity, as by maintaining good roads . . . .” Moreover, other cases make clear that the Court will not disturb facially neutral tax statutes designed to fall primarily on out-of-state taxpayers. These positions can be defended by pointing to the fact that the Court is an “institutionally incapable and politically inappropriate body for determining the appropriate level of a tax.” However, they leave open the possibility that states will (and in all likelihood do) couple facially neutral (but practically discriminatory) taxing schemes with subsidies for in-state businesses and residents, to effect tariff-like economic protectionist designs. As long as the legislature refrains from directly linking the tax and subsidy programs—by, for example, having the tax proceeds go to general revenues out of which all state expenditures and not just the discriminatory subsidy are paid, or formally de-linking the amount of the subsidy from the proceeds generated by the tax—the Court seems unwilling to step in.

82. Id. at 191. The entire amount of the fund was distributed on a monthly basis to Massachusetts producers, with each such producer receiving “a share of the total fund equal to his proportionate contribution to the State’s total production of raw milk.” Id. Out-of-state producers received nothing.
83. The Court discounted the significance of the fact that the tax payments were made by milk dealers while the “rebates” were paid directly to dairy farmers, concluding that this payment scheme “merely reinforces the conclusion that the pricing order will favor local producers” because it eliminated any possibility that “the dealers might not use the funds to increase the price or quantity of milk purchased from Massachusetts dairy farmers.” Id. at 197 n.14.
84. Id. at 197.
85. Id. at 201.
86. Id. at 199 n.15.
Similarly superficial adjustments appear to inoculate collusive schemes between foreign governments and U.S. taxpayers to take advantage of the United States' foreign tax credit rules. U.S. taxpayers are supposed to obtain such credits only for taxes actually paid or accrued to foreign governments; such credits are not supposed to be granted for amounts rebated to the taxpayer by the foreign government or paid in return for "specific economic benefits" received from the foreign government. Although the Internal Revenue Service has taken the position that rebates can take the form of subsidies, its regulations target only those schemes as blatant as the one in West Lynn Creamery—that is, schemes in which the amount of the tax and subsidy are directly linked. Nor is there any evidence that it has attempted to extend the disallowance rules beyond this narrow subset of situations. Enforcement of a related regulation disallowing credits for taxes paid to gain access to a "specific economic benefit" has been similarly limited in scope; the regulation seems to have been enforced only in situations where the taxpayer received access to governmentally owned mineral or petroleum reserves.

90. Id. § 1.901-2(a)(2)(ii)(B).
91. Id. § 1.901-2(e)(3)(i) provides:

General rule. An amount of foreign income tax is not an amount of income tax paid or accrued by a taxpayer to a foreign country to the extent that

(A) The amount is used, directly or indirectly, by the foreign country imposing the tax to provide a subsidy by any means (including but not limited to, a rebate, a refund, a credit, a deduction, a payment, a discharge of an obligation, or any other method) to the taxpayer, to a related person (within the meaning of section 482), to any party to the transaction, or to any party to a related transaction; and

(B) The subsidy is determined, directly or indirectly, by reference to the amount of the tax or by reference to the base used to compute the amount of the tax.

92. A LEXIS search of the regulation generated relatively few cases or rulings, most of which related to various forms of "net" interest payments and a Brazilian program under which that government rebated taxes withheld on interest income to the associated debtors. None dealt specifically with infrastructure improvements. Similar factual situations presented in the domestic context could generate an analogous argument: The Service could contend that the value of infrastructure improvements granted "free of charge" by host governments should be treated as an offset against deductions allowed for state and local taxes paid to the hosting entities (that is, to consider such taxes as payments for the infrastructure items, requiring deferral of the deductions involved). Interestingly, although the Service attempted to deny taxpayers a basis in such free improvements in several cases, it does not seem to have raised the offset point. The Service lost the cases at issue; courts uniformly upheld taxpayers' right to depreciate the full cost basis of such improvements, analyzing the transfers as "gifts." E.g., Chicago, Burlington & Quincy R.R. Co. v. United States, 455 F.2d 993, 1002 (Ct. Cl. 1972). Even its ability to enforce its regulation in "net loan" situations has been called into question. The Court of Appeals for the Federal Circuit recently held the 901-02 regulations to be an invalid attempt to construe a statute in a manner different from a prior definitive court ruling. See Bankers Trust New York Corp. v. United States, 225 F.2d 1368 (2000).

94. At least, all the private letter rulings, published rulings and cases generated through a LEXIS search involved some extractive context; none alluded to governmental programs providing infrastructure or other benefits. Of course, there is no way to know what is happening in the field, but it is worth

HeinOnline -- 89 Geo. L.J. 573 2000-2001
The experience outside of the United States gives no additional grounds for optimism. GATT has long imposed restrictions on subsidies that operate to increase exports or decrease imports.\textsuperscript{95} However, implementation of those restrictions has proved unsatisfactory because "[t]he search for a standard for restraining domestic subsidy policies ... has proven ... difficult."\textsuperscript{96} Although GATT panels have agreed that certain tax subsidies targeted specifically at imports violate the rule,\textsuperscript{97} they have thus far proved largely unwilling to rule against "upstream" subsidies.\textsuperscript{98} Moreover, the rules allow recourse only against "specific" subsidies; a considerable amount of litigation has ensued over the meaning of that term without generating any clear answer.\textsuperscript{99} The rules have been limited in this fashion precisely because of a general reluctance to interfere with "benefits and services ... that governments routinely provide to their population at large."\textsuperscript{100} Other scholars have expressed skepticism that such distinctions are workable.\textsuperscript{101} If they are not, all that harmonization is likely to do is to push competition into spending programs rather than taxing provi-

\textsuperscript{95} Noting that the Internal Revenue Manual, the guidebook for examining agents, does not suggest such programs as an item of inquiry while it does specially reference "gross-up net loans" of the type seen in Brazil. \textit{See Internal Revenue Serv., Market Segment Specialization Program Guideline: Commercial Banking, Chapter 7, Gross-Up Net Loans: International Tax Issues} (July 1997), available at 1997 WL 1138369.

\textsuperscript{96} For reasons to be suspicious of any system's ability to do a good job of policing impermissible subsidies, see Isenbergh, supra note 46, at 247 ("The question of who enjoys a subsidy is the mirror image of that of the incidence of a tax.").


\textsuperscript{98} See, e.g., PPG Indus., Inc. \textit{v.} United States, 928 F.2d 1568, 1576-77 (Fed. Cir. 1991) (upholding ITA ruling that domestic subsidies must benefit only a specific enterprise or industry); Armco Inc. \textit{v.} United States, 733 F. Supp. 1514, 1525 (Ct. Int'l Trade 1990) (holding that continuing export of specific good by parent company was subject to countervailing duties when wholly owned subsidiary claimed subsidy on export); Certain Softwood Lumber Products From Canada, United States-Canada Free Trade Agreement Binational Review Panel, Panel No. USA-92-1904-01, Report of Dec. 17, 1993 (holding that government action that "acts to limit the availability of a program" is indicative of specificity, but not determinative).


In the absence of any reason to believe that subsidies delivered through spending programs are procedurally preferable to tax provisions, harmonization will have few if any distributive (or rather, redistributive) consequences.

The difference between the amount of corporate tax revenues available for redistribution in a tax competitive world and in a tax harmonized world, then, may not be as significant as proponents of tax harmonization believe because the economic impetus underlying such competition will likely move into the area of governmental expenditures. Governments will compete on the basis of services provided to businesses rather than the amount of tax collected from them. In neither case will funds be made available for social programs. In short, harmonization of taxes will have little effect in the absence of harmonization of governmental expenditures, a policy with few if any supporters. Fortunately for the supporters of governmental redistribution, however, the next section of this Article argues that the initial burden imposed by tax competition—both in terms of revenue total and the replication of the redistributive burden—may be lower than has been feared.

2. The Incidence Issue

One of the recurring contentions of advocates of tax harmonization is that without such harmonization, an unwarranted amount of the redistributive burden will be placed on labor. At its most extreme, the argument contends that tax competition will force countries to switch from income tax systems to consumption tax systems. This shift in the location of the tax burden allegedly will have two undesirable consequences: first, it will further distort the leisure-labor tradeoff for workers, and second, it will induce producers to substitute capital for labor in the production process. But will such a change in distributional patterns actually occur?

102. Interestingly, one explanation for the European Union’s recent interest in tax harmonization (as well as the particular provisions contained in the proposed “Code of Conduct”) is that it is a necessary complement to the Union’s internal rules against the provision of certain types of investment subsidies. As was noted to me by Professor Paul McDaniel of NYU School of Law, some of its members regard special tax regimes as the equivalent of government subsidies—hence the focus on disallowing “ring-fenced” regimes while tolerating generalized rate reductions, such as have been adopted in Ireland.

103. For a discussion of this point, see supra text accompanying notes 66-67. Although the conclusion that tax subsidies are better monitored than direct subsidies may be an artifact of the peculiar institutional set-up of the United States and hence not generalizable, it at least proves the perils of generalizing the opposite conclusion.

104. See TANZI, supra note 25, at 138; Avi-Yonah, supra note 2, at 1576.


106. TANZI, supra note 25, at 3; Avi-Yonah, supra note 2, at 1634.

107. See Stotsky, supra note 26, at 177, 179 (discussing effect of payroll tax, which is a tax on labor income).
Discussions of distributional issues are always problematic because of the incidence question. No one has devised a method for determining whether and to what extent the economic burden of a tax remains on the payer or is shifted to another. This problem is especially evident in the context of the corporate income tax because of the truism that "corporations don't pay tax, only people do." That is, because a corporation is an artificial entity, the real burden of the tax must fall elsewhere. But where? Possibilities include shareholders, workers and other suppliers, and customers.

Under conditions of long-term equilibrium, where corporations price their products to wring every last cent out of potential consumers and all production factors are also in long-term equilibrium, a corporate income tax constitutes a tax on the owners of capital. Decreases in that tax, then, decrease the tax burden placed on those owners. Although other taxes can be used to extract similar amounts of revenue from these owners, few are available when the owners of that capital are foreign to the taxing jurisdiction. In the worst case scenario envisioned by opponents of tax competition, all owners of capital will routinely invest outside their countries of residence, thus avoiding tax on income generated from that capital. As income from capital increasingly avoids taxation, the only income left subject to taxation would be labor income.

How different is that from what currently happens, however? Again, it boils down to a question of incidence. What does it mean to say that a tax "falls" on owners of capital (or anyone else)? The real question is what would happen with the money that goes to the government rather than the owners of capital. With less money, investors may invest less, with corresponding effects on economic growth and the demand for labor—leading to an implicit tax on labor in the form of lower wages. Unless, that is, the government spends the tax revenues it collects in a way that similarly increases the demand for labor. It may or it may not.

More importantly, however, no one contends that the real world has reached a stage of "long-term equilibrium." And once that unrealistic equilibrium assump-

108. See Avi-Yonah, supra note 2, at 1647 ("Unfortunately, even after decades of analysis, no consensus exists on [corporate income tax's] incidence."); Russell Krelow, Concepts of Tax Incidence, in TAX POLICY HANDBOOK, supra note 25, at 35 ("[T]he ideal incidence analysis demands data on the universe of tastes and technologies in the economy, an impossible goal.").
109. See Harris, supra note 44, at 114 ("[T]here is no consensus on the incidence of the corporate tax."); Russell Krelow, General Equilibrium Incidence of Taxes, in TAX POLICY HANDBOOK, supra note 25, at 39, 42; Dan R. Mastromarco, What's So Fair About a Tax on Income?, 85 TAX NOTES 217, 225 (1999) ("Whether forward incidence is the correct way of viewing these taxes or not has been the subject of endless speculation for tax policy economists.").
111. Wealth taxes are another means of taxing capital.
112. See Christiansen et al., supra note 32, at 16.
113. Mastromarco, supra note 109, at 225.
tion is relaxed, the incidence of the corporate tax becomes quite unclear. Consumers of the goods produced by the corporation may bear some or most of the burden of the tax if producers used the tax as an opportunity to enact a price increase they could have enacted—but previously would not have because of uncertainty as to whether it would have been tolerated by its customers. Enactment of such a tax (or the imposition of a tax increase) may provide producers or vendors with the public relations cover for a desirable (in the eyes of the seller) price movement. Consumers may be more willing to accept higher prices when provided a cost justification for them than if the vendor is perceived as trying to appropriate the last penny from them. Reducing or removing the tax creates the opposite pressure on prices, and could lead to consumer gains in the form of lower prices rather than directly benefiting the producers.

Alternatively, in situations where suppliers had been collecting rents in the form of labor rates in excess of their marginal reservation points, or royalties due to scarcity of their product, the tax may have a greater effect on the amount of those rents. The amount of the tax (in excess of benefits received) would reduce the net benefits provided by such labor or suppliers, thus depressing the amount of wages collected or prices received. A competition-induced rollback of the tax may translate into higher earnings by those laborers or suppliers rather than higher after-tax profits by the tax-paying corporation.

In the latter case, the normal operation of the pre-existing tax regime may well restore a portion of both revenues and distributional features of the original, precompetition tax regime. Additional monies flowing into the hands of the suppliers in the form of income, or customers in the form of smaller deductions for business purposes, should be subjected to tax in their hands. Of course, even if the entire amount of the tax decrease attributable to tax competition flows into the hands of such suppliers and customers, and the suppliers and customers are taxed at the precompetition corporate tax rate, the country will not fully recoup its lost tax revenues (because it will collect only its tax rate times the taxes lost). Further, many customers may purchase the items outside the context of a business, in which case the price drop would have no effect on their taxable income or tax revenues collected.

Additional offsetting revenue may be raised by increasing tax rates on those residents aided by competition-induced tax decreases. The fact that these interests are richer as a result of tax-competition-induced tax rollbacks may allow

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114. See Horst Claus Recktenwald, Tax Incidence and Income Redistribution: An Introduction 234 (1971) ("Incidence theory cannot give a simple and definite answer because economic and fiscal phenomena are closely linked in an interdependent and complicated manner.").


116. Id. at 42-43 (exploring the effects of using different assumptions when applying incidence model); John Whalley, Lessons from General Equilibrium Models, in Uneasy Compromise: Problems of a Hybrid Income-Consumption Tax 15, 24 (Henry J. Aaron et al. eds., 1988) ("In some of the other policy areas where applied general equilibrium models have been used, it has become apparent how important these market structure assumptions are . . . . ").
more room for tax increases on them than standard analysis allows. Proponents of harmonization argue that fully offsetting rate increases are unlikely and that overall government revenues will go down. This argument is based on standard models, which assume that tax rates are set where the marginal costs of raising the rate equals the marginal benefits of the associated revenue gains. Decreasing receipts from one tax may justify an increase in another tax under this model because the decrease would effectively “defund” a highly valued expenditure. However, because the social costs of increasing the second tax are assumed to remain the same as before the decrease in the second tax, the marginal costs associated with increasing the second tax will likely increase the marginal benefits associated with the expenditure before it has been completely “re-funded.” As a result, the second tax will not be raised enough to provide a full offset for the decrease in revenue caused by the decrease in the first tax.

It is unclear, however, why one should assume that the social costs associated with particular tax increases should be assumed to remain the same in the face of changes in taxpayers’ income. If one believes that the tax increases can be focused on individuals or businesses that have benefited from tax competition, the opposite assumption seems plausible. Some of the social harms associated with higher levels of taxation may be due not to the marginal rate of tax per se, but rather to the effect of that marginal rate on particular taxpayers—and that effect may be different when the economic position of the taxpayers changes. A taxpayer may expend fewer resources avoiding the effects of a tax increase when that increase is associated with an offsetting decrease in another tax. If only the form of taxation shifts, rather than overall tax burden, taxpayers’ resistance to the upward shift may be moderated. Further, from a political standpoint, it may be easier to “sell” a targeted tax increase if it can be linked to a corresponding tax decrease.

Shifting from a corporate tax that hides the tax burden to one which does not may have larger political implications and advantages. The difficulties inherent in discerning the incidence of the corporate income tax may lead voters to misapprehend the tradeoff between a given level of governmental expenditures and tax obligations—or to assess incorrectly the compatibility of the design of the tax system (and the distribution of its obligations) with their political preferences. By increasing the transparency of the tax system, such a shift may generate more intelligent or informed political decisions. Whether such decisions will lead to increased or decreased tax burdens on capital income vis-à-vis labor income remains to be seen.

117. At least one harmonization supporter acknowledges that harmonization schemes may succeed in shifting only the apparent incidence, not the economic incidence, of the tax burden. E.g., Tanzi, supra note 25, at 138-39.
118. As does whether such a distinction truly exists. See infra text accompanying notes 119-27.
Further, it is questionable whether such a shift, if it occurred, would be meaningful in distributional terms. Most commentators believe it would not, for the reasons discussed in the next section.

3. Lessons from the Consumption Tax Literature

Opponents of tax competition have expressed the fear that such competition will lead to the elimination of tax on income generated by mobile capital, leading to an unfair and inefficient concentration of the tax burden on labor income.119 Meanwhile, a number of economists and academicians (and even a few politicians) have been advocating the replacement of the income tax with various forms of a consumption tax.120 The major difference between an income tax and a consumption tax lies in the latter’s explicit and purposive exclusion from the tax base of income generated by capital.121 One of the lessons to be drawn from the debate over the desirability of consumption taxes is how little is at stake in the choice between an income tax and a tax that exempts returns from capital, either explicitly (by having a base limited to wages) or by allowing an up-front deduction for the entire amount of capital investments.

Little purpose would be served by recapitulating the entire, extensive literature analyzing the differences and similarities between consumption and income taxes.122 It is sufficient to note that “over the last fifteen years, commentators have chipped away at the standard analysis of a consumption tax as repealing the existing (positive) tax on all forms of (new) capital investments.”123 Instead, they now agree that consumption taxes treat only two elements of the return on capital—real riskless return and inflation premia—more favorably than does an income tax.124 Studies of historic rates of return show the “real riskless return” to be almost vanishingly small,125 while most scholars dispute the desirability


122. This literature is “vast.” DAVID A. WEISBACH, IRONING OUT THE FLAT TAX, 52 STAN. L. REV. 599, 603 n.8 (2000) (listing sources).


124. See id. at 541-42.

of taxing inflation premia to begin with. Indeed, so small are the differences between the consumption tax base and the income tax base that economists now agree that virtually all of the "efficiency gains" claimed by proponents of consumption taxes can be attributed to the one-time tax on accumulated capital created by the transition from an income tax to a consumption tax system. The systems are very similar in effect—whether viewed in terms of economic efficiency or distribution—on an ongoing basis.

This analysis suggests yet another reason to regard the fears of opponents of tax competition as overblown. Exempting capital income from tax appears to be a more significant change than it really is. Even should the "worst case" scenario develop, with countries forced to switch their income tax systems to consumption tax systems, the consequences would be far from devastating.

Despite the opportunities described for recouping significant amounts of the tax revenue lost to tax competition, and the virtual identity between income taxes which purport to tax capital income and consumption taxes which do not, some real changes in the distribution of tax revenues may occur. In particular, taxes paid by foreign investors to source countries may decrease. Less money may be redistributed from them to residents of the source country. As the next section suggests, however, this is far from an unmitigated evil.

4. Redistribution and the Foreign Investor

Though there is general agreement on the need for redistribution of income through the tax system, there is substantial disagreement over the extent of redistribution that should take place. This disagreement exists within as well as between jurisdictions. Within a jurisdiction, such disagreements are mediated through its political system. That is, the disparate views of its members are aggregated through the political mechanisms accepted within the jurisdiction, and the resulting "consensus" is implemented by its legal and governmental agencies. One of the objections to tax competition is that it will disrupt this societal consensus about who should bear the redistributive burden, resulting in the substitution of an inferior redistributive scheme. This argument has one very serious flaw: It privileges the consensus that would exist in a harmonized world (by assuming that moving away from it would be detrimental) without giving any basis for this privilege. And indeed, closer examination reveals that harmonization may lead to systematically biased tax rules.

In a world without international investment, where all the residents of a jurisdiction live and work within the jurisdiction, one can reasonably conclude that both the level and distribution of tax burden represent considered judgments as to the best level of public expenditures and the appropriate distribution of the burden for those expenditures. This does not mean that the decisions made by the polity must be the decisions preferred by every member of the

126. See id. at 391.
127. See Bankman & Fried, supra note 123, at 565-66.
polity; differences in economic and social circumstances, as well as political beliefs, undoubtedly lead to a variety of views on such matters. However, the whole point of the political process is to aggregate these views to reach a collective “consensus” according to which the society can function. And when the same individuals are the beneficiaries of and the financiers for the public expenditures, one can be reasonably certain that any decisions made, while perhaps not defensible in terms of some independently defined “rightness,” at least seem correct to the members of the polity. Each member has the same right to participate in the decisionmaking process and to express views about the overall levels, as well as their particularized share, of burdens and benefits.

The addition of international investors, investments, and customers makes for a more complicated situation because it engenders possibilities (real or imagined) for externalizing tax burdens. That is, residents of a jurisdiction may attempt to shift the costs of their governmental programs onto foreigners (or their home countries, if the foreigners come from tax credit countries). Foreigners present tempting targets for disproportionate taxation because they often lack opportunities for formal participation in electoral processes and because their status as outsiders renders them less sympathetic to those with such opportunities.

No one likes to pay taxes; everyone likes to be on the receiving end of government expenditures. Those two facts are together responsible for much of the perceived incoherence of modern political rhetoric. Whether elected or not, governmental leaders prefer happy constituents and often willingly abet their delusion that governmental programs can be costless. The delusion becomes more realistic when the apparent burden of financing governmental expenditures falls on foreigners. Shifting the cost of government onto people who do not count in the political calculus is exactly like shifting the costs of pollution onto neighboring property owners; not only does the resulting cost distribution seem unfair, but one is fairly certain that the overall amount of such pollution (or the cost of the government) tends to rise over time.

Foreigners, whether they be customers or investors, often do not count in the political calculus. The point is not that foreigners may not benefit from the governmental services provided by their tax dollars. The same can be said of many domestic taxpayers to the extent of the portion of their taxes serving

128. Substantial dispute exists about whether such a concept can exist, as well as disputes over its source if it does exist.
129. See supra Part I.c.2.
130. Charles Kingson detailed the anti-American sentiment underlying French and German decisions as to whether and how to integrate their corporate-level taxes and other tax decisions. See Charles I. Kingson, The Coherence of International Taxation, 81 COLUM. L. REV. 1151, 1194-1209 (1981). The same problem exists with regard to nonresidents of states within the United States; states often seek to export their tax burdens to outsiders. See Shaviro, supra note 9, at 931-32 (explaining when and why taxation of nonresidents is politically appealing).
131. See Shaviro, supra note 9, at 927-28 (asserting that states which appear to export large portion of tax burden also have wastefully high level of government expenditures).
redistributive ends. Far more serious is foreigners' lack of formal and informal input into political decisions. The ultimate expression of such input (in democratic regimes, of course) is the exercise of franchise rights. Neither foreign nor domestic corporations can vote in their capacity as corporations; only natural persons have this privilege. The interests of most domestic corporations, though, should be reflected in the votes of their owners—domestic shareholders and, to a lesser extent, domestic employees. By contrast, many foreign-owned companies have relatively few domestic shareholders, while foreign investors are just that; in both cases, then, proxy voters are few and far between. Foreign customers have even less representation in the political process of the source country.

This comparative disability can extend beyond the loss of formal franchise rights. Nonresidents may be forbidden from trying to exercise informal influence through (for example) making political campaign donations. They may be largely shut out, in short, from all but the most indirect participation in the political process. Such formal bars may not stem attempts to influence governmental policy; the historical record is replete with examples of less-than-legal political maneuvers. However, their illegal nature makes them considerably

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132. U.S. law prohibits foreign nationals (including both nonresident aliens and foreign corporations) from making "any contribution of money or other thing of value, or to promise expressly or impliedly to make any such contribution, in connection with an election to any political office or in connection with any primary election, convention, or caucus held to select candidates for any political office ...." 2 U.S.C. § 441e(b)(2) (2000). However, resident aliens and foreign-owned U.S. companies may make such contributions, albeit subject to some restrictions. The Federal Election Commission prohibits foreign nationals from participating in or influencing a corporation's campaign contributions or PAC involvement. F.E.C. Advisory Op. 1992-16, reprinted in 2 FED. ELECION CAMPAIGN FIN. GUIDE (CCH) ¶ 6059 (June 20, 1992). Further, the subsidiary may use only the profits from its U.S. operations to make donations to state and local campaigns. See id. Finally, a foreign parent cannot provide (or reimburse) its domestic subsidiary for any funds expended on political contributions. See id. Many deem these restrictions insufficient, see Daniel Scott Savrin, Curtailing Foreign Financial Participation in Domestic Elections: A Proposal to Reform the Federal Election Campaign Act, 28 VA. J. Int’L L. 783, 818 (1988) (advocating change), but the several attempts to broaden the scope of the legislation have been defeated, see id. at 812 n.138 (recounting history of 1987 attempt to amend section 441(e)); Jeffrey K. Powell, Comment, Prohibitions on Campaign Contributions from Foreign Sources: Questioning Their Justification in a Global Interdependent Economy, 17 U. Pa. J. Int’L Econ. L. 957, 969-70 (1996) (detailing failed attempts to expand the scope of section 441(e)). Though these defeats may indicate that even foreign-based multinationals have political power, it is worth noting that this situation may not continue. There has even been some discussion of forbidding all corporate campaign contributions. See Matt Richtel, Entrepreneur Pushes Plan to Fix California Schools, N.Y. TIMES, Apr. 17, 2000, at A16 (reporting that California voters rejected proposition to ban campaign contributions); The 2000 Campaign: Ballot Questions, N.Y. TIMES, Mar. 8, 2000, at A27 (same).

The United States is not unique in limiting the financial influence of foreigners. Many countries, including Japan, India, Spain, Mexico, Russia, and China, have more stringent rules against foreign political donations. Powell, supra, at 971-72. Israel, Canada, and Germany have somewhat different, but still restrictive, provisions. Id. at 972. Moreover, even legal campaign contributions from foreign-connected individuals and corporations have been the focus of unfavorable press scrutiny and intimations of misbehavior. See id. at 973 (describing foreign money scandal in Great Britain); Jessica S. Horrocks, Campaigns, Contributions and Citizenship: The First Amendment Right of Resident Aliens to Finance Federal Elections, 83 B.C. L. Rev. 771, 771 (1997) (detailing controversy surrounding President Clinton's acceptance of funds from resident aliens).
riskier and less attractive, and presumably less often used than would be legal mechanisms.

Further, few voting citizens are likely to take nonresidents' interests into account when making decisions regarding overall levels of governmental spending and, particularly, the distribution of the associated tax burdens, unless forced to do so by some outside force. Whether conscious or not, xenophobia is a widespread trait; aliens are generally regarded as sufficiently "other" that their interests are not accorded the same degree of respect as those of most nationals. These disregarded interests include financial interests; people's propensity freely to spend the money of others is well known. To the political process, foreigners can be little more than "the man behind the tree."133

The lack of influence may be less acute in undemocratic regimes. To the extent such regimes are corrupt, foreigners may have more access to more cash than residents, and thus an unduly large effect on political outcomes (including tax rules). On the other hand, patterns of corruption may be sufficiently intricate that foreigners stand little chance of effectively purveying their resources. And cultural suspicion of outsiders may interfere, either because of fears that an appearance of favoring foreigners will lead to popular rebellion or because the leaders themselves hold xenophobic beliefs.

The tendency to over-tax foreign investors and their enterprises relative to domestic entities has not gone unnoticed by the international community. One typical response is to include "national treatment" or "nondiscrimination" rules in bilateral investment and taxation treaties.134 These provisions are supposed to guarantee that businesses owned by residents of one treaty partner and operated in the other treaty partner are accorded the same legal treatment as wholly domestic businesses.135 Typically, they render invalid any regulations or tax responsibilities imposing greater burdens on foreign investors than on their domestic counterparts. However, the scope and meaning of these treaty rules are far from clear.136

Particularly when it comes to the tax area, special treatment of foreigners is often allowed because of practical or administrative difficulties in applying the domestic rules.137 And if the foreign business operates in an industry in which few if any local competitors exist, it might find itself subject to draconian

133. "Don't tax you, don't tax me, tax the man behind the tree" is a well-known tax aphorism. See The Long View on Tax Reform, 44 CONG. Q. WKLY. REP. 799, 799 (1986).
134. Nondiscrimination clauses were included in draft model tax treaties prepared by the League of Nations in the 1940s. See KEES VAN RAAD, NONDISCRIMINATION IN INTERNATIONAL TAX LAW 29 (1986). However, they were not widely accepted until after one was included in the 1963 OECD model treaty. See id. at 33-34. Most of the recently negotiated U.S. tax treaties contain some version of a nondiscrimination provision. See Sanford H. Goldberg & Peter A. Glicklich, Treaty-Based Nondiscrimination: Now You See It, Now You Don't, 1 FLA. TAX REV. 51, 51 n.1 (1992).
135. See AMERICAN LAW INST., FEDERAL INCOME TAX PROJECT, INTERNATIONAL ASPECTS OF UNITED STATES INCOME TAXATION II, PROPOSALS ON UNITED STATES INCOME TAX TREATIES 253 (1992).
136. See Goldberg & Glicklich, supra note 134, at 52.
137. AMERICAN LAW INST., supra note 135, at 255.
exactions written narrowly enough to affect only the one industry. Moreover, investors cannot claim even the meager protection provided by nondiscrimination provisions unless their country of residence has entered into a treaty containing such a provision with the country in which the investment is sited. Finally, what does equal treatment mean when it is only the collection side (tax obligations), and not the benefit side (government spending) that is protected? Domestic corporations and individuals may be happy to pay tax at a rate of fifty percent because they know that the government will spend the money collected on items that benefit them personally. Is it fair to say that foreign investors are being treated equally when they pay the same tax rate but are ineligible to receive the lion’s share of the benefits generated by governmental expenditures? To what extent can a tax be considered a tax when it is returned to the payer in the form of economically beneficial goods and services? In sum, treaty provisions provide inadequate protection at best against overtaxation.

Tax competition often provides more effective protection from discrimination against foreign taxpayers. Residents’ tendency to raise as much money as possible from foreigners whom they do not know and have no sympathy for can be tempered by the fear that if they levy too high a tax burden, those foreigners—and their tax dollars as well as employment opportunities—will leave for a more hospitable jurisdiction. Competition is no panacea; some jurisdictions are attractive enough on other grounds that foreign investors overlook discriminatorily high tax levels. They may have resource advantages, or a protected market, for example. In these cases, though, taxes are just a method for extracting monopoly rents which could just as easily be collected in some other form. The monopoly, not the tax system, is the problem (to the extent one exists at all).

Tax harmonization would remove the tempering effect of competition without substituting adequate protection for foreign investors in its place. Countries, for example, may comply with the harmonized rate standard for foreign investors while levying lower taxes on fully domestic investors. Alternatively, jurisdictions may tax all investors and businesses similarly, but provide special benefits to domestic businesses. In the worst case, of course, additional tax revenues generated by a formerly low-tax state will be wasted or, worse, stolen. A tax rate (and/or base) which seems nonexploitative and reasonable in some jurisdictions—perhaps enough to have it prevail as the “general standard”—may well be outrageous in the circumstances of another.

138. Some tax/subsidy schemes are incredibly blatant; others are less so. See supra text accompanying notes 79-99 (discussing some schemes).
139. Although I am unwilling to state that countries should be entitled to monopoly rents in an “ideal” world, it is at least unclear to me who (or what country) has a better claim to those rents in the current world.
140. Such discriminatory treatment may be disallowed as a result of tax treaties provisions, of course.
Nor is it clear that international investors will be able to protect themselves against these results through their input into the harmonization process. Their natural representatives in that process—the representatives from their state of residence—face conflicting loyalties. Though they may want to help domestic businesses with foreign operations because of the political influence of those businesses, they may not wish to protest too strongly against rules that have the twin effect of keeping some additional business investment at home (even if inefficiently) while providing opportunities for differentially taxing incoming investment.

Perhaps this does not matter, because even if they lose, these businesses will be represented in the decisionmaking process. Representation, of course, does not have to be synonymous with success. If the international businesses cannot make their case to their representatives sufficiently to overcome their opponents, perhaps they deserve to lose. Or perhaps there is an argument here about systematically flawed representation.

The interplay between harmonization and redistributive goals in source countries is thus quite complicated, much more complicated than is ordinarily thought. First, tax harmonization is much less likely to achieve the ends desired by its supporters than they believe. Competition for investment will be displaced (from taxation to expenditure programs), but it will survive. Raising revenues for redistribution through a corporate level tax is, aside from situations involving country-specific rents (in which case competition is not an issue in any case) simply not a realistic option. Second, even if harmonization "worked," its effects may appall its proponents. Limiting countries' ability to use tax incentives to attract investment, contrary to the wishes of harmonization proponents, may have the effect of making some poor countries poorer. Although such losses theoretically may be compensated for by foreign aid, there is little likelihood that such aid would materialize. The identity of the winners and losers, to say nothing of the extent of the gains and losses involved, would be sufficiently obscure to prevent a compelling claim of entitlement to compensation, and in the absence of such a claim (and perhaps even with it), there is little evidence pointing toward the development of a political push for increases in aid by donor countries. Meanwhile, the countries that profit from tax harmonization may "over-profit," in that their citizens, oblivious to the real costs imposed by corporate-level taxes ostensibly levied on foreigners, may choose a higher level of governmental services than they would if the costs of those services were more obvious to them.

If one accepts the argument that tax competition is inevitable and perhaps even desirable, the next question is what to do about it. That is, what policy or policies should be adopted by the United States to be consistent with the analysis of the corporate income tax as primarily a benefit tax? The practical implications of analyzing the corporate income tax as a benefit tax are the subject of the next Part.
II. POLICY IMPLICATIONS

The structural implications of allowing, rather than discouraging, tax competition are quite extensive. Although the U.S. rules for the taxation of foreign income of U.S. corporate taxpayers would obviously have to be revised, other tax rules would also be impacted. Changes in the rules for the taxation of foreign income of U.S. corporate taxpayers would have implications for the taxation of foreign income of noncorporate U.S. taxpayers, and for the taxation of corporate income in general. Finally, the United States may want to reevaluate its rules for the taxation of income earned in the United States by foreign taxpayers. Each of these issues is examined in turn.

A. TAXATION OF FOREIGN INCOME EARNED BY U.S. COMPANIES

Although the U.S. rules for the taxation of international transactions are complex, confusing, and to some extent internally inconsistent, for the most part they embody the government’s expressed belief in “capital export neutrality”—the belief that U.S. investors should pay the same amount of income tax whatever the source of their income. The lodestone of these rules is the foreign tax credit.\(^{141}\) The credit operates to deny U.S. taxpayers the benefits of incurring source taxes on foreign income at less than U.S. rates; to a lesser extent, it also operates to relieve taxpayers of the burden of excessive (when measured against U.S. tax levies) foreign taxation.\(^{142}\) Congress adopted the credit in an attempt to remove tax considerations as an element of business location decisions.\(^{143}\) To the extent the credit operates in accordance with this original purpose, it obviously undercuts (if not eliminates) beneficial tax competition. If one believes the corporate tax is a benefit tax and that tax competition is beneficial, the present tax credit system will have to be changed, if not eliminated in its entirety, to preserve the locational efficiencies generated by countries’ tax and benefit packages. The more challenging question is what should replace it.

There are two obvious alternative approaches to the treatment of foreign earned income and foreign tax. One is to treat foreign taxes as a deductible expense, and then subject the remaining income to tax in the United States at regular rates. Another would be to do as many European nations do, and exempt foreign-earned income from home country (in this case the United States) corporate-level taxation entirely. As it happens, both of these obvious alternatives are flawed. It is worth going through why they fail as acceptable alternatives because their failures point to the design of a preferable outcome.

Some economists have advocated allowing merely a deduction for foreign taxes when computing the home country tax liability for foreign earned in-

\[\text{\footnotesize{\cite{141}} See I.R.C. §§ 901-903 (West 2000).}\]
\[\text{\footnotesize{\cite{142}} See Roin, supra note 14, at 933.}\]
\[\text{\footnotesize{\cite{143}} See \text{STAFF OF JOINT COMM. ON TAXATION, 102d CONG., FACTORS AFFECTING THE INTERNATIONAL COMPETITIVENESS OF THE UNITED STATES} 5 (Comm. Print 1991). \text{But see} \text{Graetz & O’Hear, supra note 1, at 1021, 1027, 1039 (arguing intent due to concern about tax avoidance).}\]
come. They contend that a resident should be required to pay the same percentage of income to the state no matter where it was earned because it would maximize home country gains from home country capital. Although this original rationale does not resonate with a benefits tax analysis, another does. To the extent the foreign tax is merely a benefit tax, one might argue, it should not matter whether the taxpayer pays for the benefit directly or does so indirectly through a tax. For example, suppose a taxpayer needs a road to ship products from its factory. It has two options for getting that road built: It may build the road itself or it may pay higher taxes in return for the government's building of the road. Because its own road-building expenditures would be treated as deductions (and only deductions) for income tax purposes, the argument goes, in order to make the taxpayer indifferent between the two options, a deduction should be allowed only for the taxpayer's tax payments. To give it more credit than that against its U.S. income tax obligation would distort the incentives of both taxpayers and the foreign government, leading to a (possibly) inefficiently large governmental role. And under a deduction system, foreign governments would still be able to compete for U.S. investors based on relative tax rates. As long as marginal tax rates in the United States remain below one-hundred percent, taxpayers retain an advantage from investing in low tax jurisdictions relative to high tax jurisdictions (though not relative to investing at home in the United States).

The problem with allowing taxpayers only a deduction for foreign taxes is that it suggests that the U.S. government is entitled to apply its normal tax rates to the income that remains after the deduction has been taken. But if the analysis of corporate income taxes as benefit taxes is accurate, that would constitute overtaxation. Back to the road example. If the income had been earned in the United States, the U.S. government would have been responsible for building the road. The taxpayer would have paid for the road with its taxes, and would owe no additional taxes. When the income is earned abroad, the road has to be built in the source country, not the residence country. The taxpayer pays for this road, either directly or indirectly, through source country taxes.


145. Because (if one accepts the premise that the taxes involved are redistributive rather than payments for governmental services) this strategy advances the interests of the investor's home country at the expense of worldwide income and welfare, this policy, known as "national neutrality," is referred to as a "beggar thy neighbor" strategy. Overview of Present-Law Rules, supra note 14, at 47; Graetz & O'Hear, supra note 1, at 1043. One enduring political and economic question is why capital-exporting countries, generally not known for their altruism, failed to adopt such a nationalistically opportunistic system of taxation. See Keen, supra note 78, at 208. It has been suggested that maintaining a seemingly "friendlier" system for the taxation of foreign investment, like the credit, actually protects home country revenues by encouraging foreign countries to maintain higher tax rates. See id.

146. See Bird & McLure, supra note 105, at 235, 252 (making similar argument regarding personal labor income).
Why should it then pay another tax in the United States for roads it will never use (or as if the U.S. government had paid for the foreign road)? To put the same point another way, it is fairly obvious that the U.S. government provides taxpayers fewer benefits with respect to foreign earned income than with respect to domestically earned income. Only the domestically earned income benefits from the national infrastructure provided by the U.S. government. To act as if foreign income received the full measure of U.S. benefits as well as source country benefits discourages all cross-border earnings. This belief—that taxes paid to the foreign country of source relieve the U.S. government of part of its obligations to the taxpayer—was part of the intuition that lay behind the adoption of the U.S. foreign tax credit.

This leads directly to an argument for the exemption of foreign-earned income from U.S. taxation. If the foreign government provides the services that the U.S. government provides to U.S. businesses with funds raised by the corporate income tax (or the taxpayer does without such services or pays for them out of its own pocket), then the taxpayer should not pay any U.S. tax with respect to its foreign earned income. The foreign government would be fulfilling the role ordinarily served by the U.S. government. Although only a loose connection between benefits and services may be required given the nature of the tax (that is, based on income rather than a precisely calibrated user fee), the total absence of a connection should lead to forgiveness of the tax. And under an exemption system, investors would still be indifferent between paying for government services and self-provision; they could benefit from investing in low tax jurisdictions so that countries could signal the relative benefits of attracting such investments.

Although many governments ostensibly maintain exemption systems, most of them cheat around the edges\(^\text{147}\) (just as the United States has begun cheating around the edges of its tax credit system\(^\text{148}\)). To some extent, this “misbehavior” (if you can call it that) represents the opportunistic response to the operation of other countries’ tax systems; however, it also represents the intuition that home countries’ roles have not been completely displaced with regard to the foreign earned income of their residents (or their subsidiaries). Rather, the home countries continue to provide some benefits to taxpayers with respect to their foreign earned income. Home countries may intercede on their residents’ behalf.

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\(^{147}\) For example, they generally tax foreign-sourced interest and royalties income. Further, countries that integrate their corporate and personal income tax systems uniformly fail to credit foreign corporate taxes against the personal income tax levy, ultimately subjecting such earnings to two layers of tax instead of the one imposed on domestic profits. See Hugh J. Ault, *Corporate Integration, Tax Treaties, and the Division of the International Tax Base: Principles and Practice*, 47 Tax L. Rev. 565, 579 (1992) (describing effect of imputation systems on foreign sourced earnings).

\(^{148}\) The United States allows foreign tax credits to offset only ninety percent of a corporate taxpayer’s alternative minimum tax liability. I.R.C. § 59(a)(2) (West 2000). Moreover, it does not allow taxpayers to claim credits for foreign taxes paid at rates in excess of U.S. rates. See id. § 904.
in the event of trade disputes, or political or military instability. \textsuperscript{149} Although these benefits will be different in kind and in scope from those provided to taxpayers with purely domestic income, they may be substantial enough to justify some home country tax. \textsuperscript{150} Further, U.S. corporations may be expected to contribute to the redistributional social benefits decided upon by the nation's electorate. The process concerns that militate against their paying for such benefits in other countries do not exist in their home jurisdiction.

The amount of such a tax would be a matter of some dispute. \textsuperscript{151} What is crucial, however, is that the amount of this tax should not depend on the rate of tax being paid in the country of source, but should be payable in addition to whatever source tax has been levied. Not only is such an add-on tax necessary to maintain a rough equivalence between the benefits being paid for and those being received, but only such a tax would preserve the locational incentives provided by beneficial tax competition.

To some extent, this structure represents less of a philosophic change from the present system than first appears. Once one is willing to accept that tax rates often reflect differences in benefit levels, one can view the effect of this structure as adhering rather closely to the capital export neutrality ideal. However, the definition of "neutrality" is expanded to include governmental benefits. For the first time, the tax system will acknowledge that for many taxpayers, there is no economic difference between investing in high-tax, high-services jurisdictions and low-tax, low-services jurisdictions. Still, complete export neutrality will not be achieved because some taxpayers will prefer the low-tax, low-services jurisdictions (just as some will prefer the opposite), and they will be left better off under the new rules.

If such a taxing structure were adopted, some contested treaty issues—notably the ongoing tax-sparing debate—would be mooted. A "tax-sparing" clause in a treaty requires residence countries to treat source country taxes "foregone" by a source country as if they had been paid when calculating the amount of foreign tax credit allowed a taxpayer against residence country tax. Tax-sparing provisions preserve the investment attraction bought by the source country through its tax reductions. In the absence of a credit mechanism

\textsuperscript{149} For example, the U.S. courts sometimes accept suits concerning overseas activities when the parties involved are U.S. citizens. \textit{See} Neela Banerjee, \textit{Foreign Investors Win Court Order in Russian Oil Case}, \textit{N.Y. Times}, Nov. 24, 1999, at C4 (discussing case filed in New York State by U.S. investment group against Russian company over Russian business transactions).

\textsuperscript{150} One wonders, for example, whether the United States would have been as willing to help Chrysler Corporation if it had been the German Daimler-Benz-Chrysler corporation in the 1980s.

\textsuperscript{151} Strategic concerns may intrude into this decision. Now that foreign issues can be traded on the major U.S. securities exchanges, a growing number of U.S. companies have begun "expatriating," or reincorporating themselves as foreign companies in an effort to reduce their tax obligations. Practitioners routinely advise new companies to incorporate in tax haven countries rather than in Delaware. Such behavior will continue if the United States attaches significant burdens on U.S. corporations. The answer may lie in increasing the tax on individual residents' receipt (however defined) of corporate distributions.
designed to strip away this investment attraction, such a clause is unnecessary; source countries would glean the benefits sought under tax-sparing provisions from the normal operation of the residence country's tax regime.

However, some new issues would take their place. One technical issue is the treatment of income received by and from corporate (or personal) intermediaries—that is, taxpayers with substantial (usually interest) deductions associated with income received from foreign sources. To what extent will the foreign nature of the underlying income (and the tax treatment of such income) be passed on to the ultimate recipient? More generally, though, the imposition of relatively heavy (compared to other jurisdictions around the world) U.S. corporate taxes on U.S. corporations (whether on domestic or foreign income) may encourage corporations to "expatriate," or become foreign corporations, for tax avoidance reasons. Indeed, there is reason to believe that such behavior has begun to occur. The question is what can or should be done about this phenomenon. Any solution will implicate the rules for the taxation of foreign taxpayers with income generated in the United States. That is the subject to which we must now turn.

B. TAXATION OF FOREIGN COMPANIES

If U.S. corporations pay heavier income taxes than do foreign corporations, businesses will strive to avoid U.S. corporate status. This avoidance can take several forms. Existing U.S. corporations may seek to become foreign corporations. Under current law, expatriation transactions can be accomplished with minimal tax costs under certain conditions. Over time, though, the more important problem will be that most new business enterprises will be formed abroad, in lower-tax jurisdictions. The share of U.S. companies—and their share of worldwide income—will decline.

It should go without saying that foreign companies (whether or not "genuinely" foreign) should be forced to "pay their own way" when they earn


153. Indeed, practitioners routinely advise start-up companies to incorporate abroad. See Herman B. Bouma, The Tax Code and Reality: Improving the Connection, 85 Taxes Notes 811, 813 (1999). Recent changes in securities regulation (notably the opening of U.S. securities markets to foreign corporations) undoubtedly makes such behavior more attractive. However, one cannot lay the blame for this development at the feet of securities regulators; they rightfully worried that failing to open the exchanges would merely drive exchange operations to foreign jurisdictions willing to maintain open exchanges. If this fear proved true, erecting regulatory barriers would serve only to delay—not prevent—the expatriation problem.

154. Under U.S. law, the nationality of a corporation depends upon its place of incorporation, rather than the identity of its shareholders, or the location of its business operations or managerial headquarters. See I.R.C. § 7701(a)(4)-(5) (West 2000) (defining "domestic" and "foreign"). Thus, a corporation wholly owned by U.S. citizens, operated and managed in the United States, and whose shares are traded on the New York Stock Exchange may be, from a technical standpoint, a "foreign" corporation.
money in the United States. That is, companies that take advantage of the U.S. market or U.S. facilities should contribute their fair share toward the costs of maintaining the attractiveness of that market and those facilities. They should not be allowed to escape legitimate financial obligations through the careful structuring of their business transactions. Ensuring that this recompense takes place will require changing some time-honored tax rules and approaches to tax rules. ¹⁵⁵

This is not the place to detail which rules will need to change or the form those changes should take; that is the subject of another article. The only point worth making at this juncture is that “harmonizing” tax rates will not obviate the need for such changes. Any harmonization short of total uniformity will provide taxpayers with an economic motivation for strategic misbehavior, and affected countries could be expected to misbehave under a system of totally uniform tax rates.

“Paying one’s way” does not necessarily include paying the same tax on U.S. source income as would a U.S. corporation. A case may be made for imposing a lower tax on the U.S. income of foreign corporations than on the U.S. income of domestic corporations. Precisely because such corporations are foreign, the United States may legitimately refuse to extend the diplomatic and political protections that U.S. corporations are afforded when operating abroad. Moreover, a U.S. corporation may legitimately be held responsible for paying some amount toward the redistributive function of the U.S. government.¹⁵⁶ Exactly the same factors that justify the imposition of an add-on tax imposed with respect to the foreign income of a U.S. corporation, then, justify a corresponding downward adjustment in the rate of corporate tax payable on the domestic income of foreign corporations.

In sum, “ring-fenced tax regimes,” with preferential tax rates available only to foreign investors, are not necessarily evil. However, they may not be sustainable over the long term, as residents may seek to gain access to the preferential rates by carrying out their domestic investments through foreign corporations and “masquerading” as foreigners. Residents of a country, protected as they are by their national government and represented in the political process that led to the adoption of that government’s redistributive policies, should not be allowed the freedom to evade their legitimate tax obligations through such contrivances.

¹⁵⁵. Corporations should recompense jurisdictions for any costs that they impose. We are used to extracting such recompense in the form of income taxes; however, there is nothing inherently superior about that taxing mechanism. One of the advantages of the system advocated in this Article is that it would leave governments free to experiment with other taxing mechanisms that may be better adapted to their particular circumstances. The present rules, which credit only foreign “income taxes,” I.R.C. § 901 (West 2000), discourage the use of any other revenue-raising mechanism.

¹⁵⁶. Whether such payment obligations will be imposed is another story altogether. To avoid providing incentives for expatriation, the government may decide to substitute taxation at the individual shareholder level for corporate level taxes. See infra Part II.c.
The solution, then, may be best achieved through additional taxation at the individual, rather than the corporate level.

C. TAXATION OF DOMESTIC INDIVIDUALS

To an increasing extent, corporations are "multinational," simultaneously operating in many jurisdictions, with shares traded on the exchanges of several different countries and owners of those shares hailing from many parts of the globe. It is difficult to justify (let alone enforce) their paying redistributive taxes in any particular jurisdiction. There is far less uncertainty when it comes to the location of their owners (natural persons). And particularly in a world where corporations are largely exempt from paying redistributive taxes, it makes little sense to exempt their owners from such obligations in their home countries with respect to their share of the corporate income. Indeed, to do so would simply encourage cross-investment: Residents of each country would routinely invest through shares of corporations registered in another country, thereby avoiding any responsibility for paying redistributive taxes.

The solution is to subject individuals to tax in their home countries on their share of corporate income. This tax does not have to be imposed at the same rate as taxes on other types of income earned by the taxpayer; after all, a substantial portion of the "benefits" portion of the tax has been prepaid at the corporate level.\(^{157}\) Nor does the tax have to be imposed on a current basis; presumably, it could (but would not have to) be taxed under a realization principle, with some rate adjustment to compensate for the corresponding deferral advantage. Many variations are possible, and again, this is not the place to describe them all. Though the details will become important, the point to be made here is just one of general structure.

Although most of the foreign-sourced income earned by individuals is earned through corporations, some is earned directly. Direct foreign earnings should be taxed, like a domestic corporation's foreign earnings, at a reduced rate because the benefits portion of the tax should have been paid to the source country.\(^{158}\) Though this may create a discrepancy between the tax paid on direct foreign earnings and foreign income earned through a domestic corporation and then distributed to an individual, it will be no worse than the discrepancy that exists under present law. Our classical tax system currently subjects all corporate

\(^{157}\) Some portion of the redistribution tax may also have been paid if the corporation is a domestic one. Some complexities would be avoided by avoiding such a tax at the corporate level. However, this leads directly into the debate over the desirability of moving to an integrated system of corporate taxation, a debate in which I wish to avoid taking sides. It is worth noting, however, that the suggested approach could be coordinated with either tax system.

\(^{158}\) This tax could be levied on net income (that is, the amount of the foreign-generated income less foreign tax imposed) or on gross income (the amount of foreign-generated income prior to payment of the foreign tax). If one wants to be true to the characterization of foreign taxes as benefit taxes, the tax should be levied on net income.
income, foreign and domestic, to two levels of tax, one more than is imposed on income earned directly by individuals.

What will a system putting all these components together look like? How different will it be from presently existing tax systems? The answer depends in large part on whether the rearrangement incorporates integration.¹⁵⁹

In the absence of integration, changes may appear minimal. Domestic corporations would begin paying a small residence tax on their after-tax foreign-sourced income, a tax that would not be correlated to the amount of foreign tax payments made. Individual residents would treat distributions from both foreign and domestic corporations as they would any other corporate distributions. However, serious consideration should be given to changing the tax treatment of all corporate income, either by accelerating the time at which individual residents pay such tax or adjusting tax rates to take the time value of money into account.¹⁶⁰ Individual residents would pay tax on income received from foreign sources (other than corporate distributions) at a discounted rate.¹⁶¹

Should integration be included as a part of this overhaul, the system could operate much like current imputation systems. Corporate distributions would be includable in the income of individual recipients, but with an offsetting tax credit equal to the amount of domestic income tax that would have been paid had the entirety of such distributions been earned domestically.¹⁶² Current tax

¹⁵⁹. Integration of the corporate- and individual-level income taxes becomes more compelling once one thinks of the corporate income tax as a benefits tax. However, integration is not a necessary feature of the plan.

¹⁶⁰. Of course, some would regard the absence of integration as just such a rate adjustment. It is quite an inexact one, especially once the effects of section 1014 (basis step-up at death) are taken into account; whether its inexactness would be acceptable given the new interpretation of the corporate-level tax is open to question.

¹⁶¹. This assumes that the amount of foreign tax paid with respect to this income has not been reduced by treaty. If a treaty eliminates foreign-sourced tax entirely, the income should be treated as domestically sourced to recoup the cost that the residence country has presumably paid by foregoing taxation of domestically sourced income earned by a resident of the treaty partner. Such treaties involve a swap of tax bases. The more difficult issue is what to do if a treaty merely reduces rather than eliminates a particular income tax. One has to decide whether the intent was to eliminate overtaxation while retaining full source taxation (in which case the income should be treated in the country of residence as nontreaty foreign income) or whether there was a partial swap of tax bases (in which case the income should be treated as partially domestic, partially foreign). There is no ready answer to this question.

A related issue is how to handle foreign-sourced income exempt from foreign tax because of practical or other exigencies (such as foreign-sourced capital gains unrelated to a foreign business). One could (and in my mind should) regard such statutory exemptions as implicit treaty trades, and consequently treat such income as domestically sourced in the country of residence. This will again create line-drawing problems and possibilities for manipulation, particularly in the case of interest income.

¹⁶². Many commentators acknowledge that foreign earnings should be treated as domestic ones under an integration system, and that the unanimous practice of doing otherwise stems from revenue concerns. See Alvin C. Warren, Jr., American Law Inst. Fed. Income Tax Project, Integration of the Individual and Corporate Income Taxes, Reporter’s Study of Corporate Tax Integration 185 (1993) (“Most imputation countries that exempt foreign income treat such income as tax-preferred for purposes of the shareholder credit. The result is double taxation of distributed foreign source corporate income, ... a result that seems difficult to justify on policy grounds.”).
treaties would have to be revised to ensure that corporate residence countries would not have to issue foreign shareholders refunds of taxes paid to source countries.\textsuperscript{163}

III. THE IMPORTANCE OF INFORMATION AND THE ROLE OF TAX HAVENS

As many other commentators have noted, residence country taxation is a nice idea but hard to achieve.\textsuperscript{164} The primary impediment lies in residence countries' inability to obtain and process the necessary information from source countries. As a result, taxpayers routinely underreport their foreign-sourced income; the resulting tax differential then provides an incentive to earn money abroad rather than domestically.\textsuperscript{165} Effective residence taxation, in short, depends on effective intergovernmental exchanges (and processing) of information. The supposed inability to achieve such exchanges traditionally served as a justification for focusing on alternative approaches such as harmonization.\textsuperscript{166} This move to alternatives, however, is unwarranted. In the first place, the alternatives themselves cannot be implemented in the absence of effective information exchange; further, focusing reform efforts solely on informational cooperation rather than tax rate harmonization has significant policy advantages.

A. THE ROLE OF INFORMATION EXCHANGES IN HARMONIZATION SCHEMES

Some proponents of harmonization justify their proposals as a second-best approach to the problem of residence tax evasion, proposals more feasible than the (admittedly) first-best approach of residence country taxation.\textsuperscript{167} Their optimism, however, is misplaced; closer examination of harmonization proposals currently under consideration suggests that such proposals will fail to correct the problems at which they are aimed in the absence of greatly expanded information exchanges.

Consider two recent proposals, one promulgated by the European Union and another by Professor Avi-Yonah. The European Union proposal would allow countries to choose between levying a twenty percent withholding tax on interest income (which the host country can keep) or providing a tax information report to the investor's country of residence.\textsuperscript{168} Professor Avi-Yonah advo-

\textsuperscript{163} Alternatively, the credit for corporate-level taxes may be made nonrefundable.

\textsuperscript{164} See, e.g., Tarzi, supra note 25, at 136; Giovanni et al., supra note 38, at 1, 2.

\textsuperscript{165} To the extent taxpayers move actual business operations abroad to take advantage of lower tax rates, there is no problem. This is exactly the sort of behavior tax competition is supposed to encourage. Problems arise when taxpayers use foreign investments as a means of avoiding their residence-based redistributational tax burden and/or legitimate source tax burdens. The latter problem probably cannot be solved absent changes in source rules, which is the subject of another article.

\textsuperscript{166} See Avi-Yonah, supra note 2, at 1583-84; Bird & McLure, Jr., supra note 105, at 235, 240-44; Slemrod, supra note 38, at 141, 144.

\textsuperscript{167} See Tarzi, supra note 25, at 136, 140; Avi-Yonah, supra note 2, at 1668-69.

\textsuperscript{168} See Proposal for a Council Directive to Ensure a Minimum of Effective Taxation of Savings Income in the Form of Interest Payments Within the Community, Art. 8.1, Doc. 598PC0295 (98/C 212/09) COM(98)295 final—98/1093 (June 4, 1998); see also Joseph Kirwin, European Commission
icates a mandatory forty-percent withholding tax, refundable upon the taxpayer’s provision of proof that such income has been reported to the country of residence.169

The defects in the European Union’s plan are obvious,170 assuming, as seems likely, that host countries171 will opt for the withholding tax alternative. Under the regime, host countries rather than residence countries will collect the additional revenue. Not to put too fine a point upon it, no great redistributitional goals will be served by adding to the tax coffers of Switzerland and Luxembourg (though Switzerland and Luxembourg may be happy about such a development). The desired end can be achieved only if additional tax revenues end up in the hands of investors’ countries of residence. This will happen only if the host countries are forced to redirect the tax revenues to the countries of residence172 or if the withholding tax rates are set high enough to discourage

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Critical of UK Proposal for Information Sharing, Optional Withholding, 39 DAILY TAX REP., Feb. 28, 2000, at G1 (claiming British proposal focusing on information exchange unacceptable because it represents “a ‘clear rejection’ of the [EU] ‘coexistence model’ ”). Initial indications suggest that affected countries would elect the withholding tax alternative. Luxembourg and Switzerland are on record as preferring the withholding tax alternative. See Statements by Luxembourg and Switzerland, in HARMFUL TAX COMPETITION, supra note 2, at 74 (Annex II). However, that preference may be based on a presumption that many investors will be from traditional tax credit countries, in which case all haven investment might cease in the face of full disclosure. Under the taxing regime proposed in this paper, investors may still be attracted to a haven based on its low source tax rates.

The OECD has also been working on a harmonization proposal. Although (like the EU) it has targeted certain low-tax regimes for elimination, it also explicitly requires full information exchange. The OECD proposal seems to require information exchanges as well, indicating that harmonizers need not prefer a different approach. See HARMFUL TAX COMPETITION, supra note 2, at 33 (including secrecy provisions among identifiers of “harmful preferential tax regimes”); see also Sindhu G. Hirani, Guttentag Highlights OECD Priorities to Association of American Law Schools, 7 DAILY TAX REP., Jan. 11, 2000, at G2 (reporting that Guttentag said “bank secrecy has a high place on OECD’s agenda”).

169. See Avi-Yonah, supra note 2, at 1669.

170. They have also been pointed out by Professor Avi-Yonah. See id. at 1656-57.

171. It remains unclear whether the “host countries” levying the withholding tax would be the countries in which such income is economically earned, or would be the country in which the earning entity has been incorporated. If the latter, some of the problems discussed in the text will be aggravated. See supra text accompanying notes 151-53.

172. The EU is moving to do exactly that. In a series of meetings held in June of 2000, several countries proposed that those countries adopting the withholding tax alternative be forced to share their withholding tax revenues with the taxpayers’ countries of residence. See Bengt Ljung, EU NATIONS STILL DEADLOCKED ON SAVINGS TAX FOLLOWING MEETING OF HIGH LEVEL TAX GROUP, 95 DAILY TAX REP. May 16, 2000, at G5. In November, 2000, the EU finance ministers agreed on a revenue sharing plan requiring the national government collecting tax on accounts of nonresidents to give three-quarters of the levy to the member state where the nonresident lives. Joe Kirwin, EU FINANCE MINISTERS REACH ACCORD ON CROSS-BORDER SAVINGS INCOME LEVY, 229 DAILY TAX REP., Nov. 28, 2000, at G1. However, considerable confusion exists as to when or whether this legislation will go into effect. Luxembourg’s Treasury Minister stated that implementation was contingent on other, non-EU countries agreeing to implement similar taxation measures while Austria’s representative stated that the plan was conditional on the enactment of a controversial code of tax conduct. Id. Of course, such implementation cannot occur in the absence of knowledge of the investors’ home countries. Gathering and making that information available for audit would implicitly if not explicitly eliminate the supposed bank secrecy option provided by the original EU plan, thereby bringing it closer to the OECD’s mandatory disclosure plan. In the absence of such information collection and auditing, however, taxpayers would doubtless try to
cross-border investment. The first would eliminate host country incentives to participate in the rate cartel, while the second is obviously undesirable.

The Avi-Yonah plan takes a different approach, relying on investor self-interest to effect residence country taxation. Most taxpayers would prefer to pay a tax in their country of residence on net income over a forty percent withholding tax on gross income, and thus the assumption is that they would report and pay tax on their foreign earnings to their countries of residence. This may in fact occur if taxpayers have no other options, but they do if and to the extent source countries cannot adequately determine the legitimacy of taxpayers’ tax reporting or residency claims. For example, taxpayers may claim residency in, and accordingly report their income to, low-tax countries (or countries which maintain territorial systems of taxation). Given that countries have “sold” residency status in the past for tax purposes, one can easily envision the resurgence of such behavior should the Avi-Yonah plan be attempted. To combat such schemes, “real” residence countries must be able to obtain taxpayer information from source states. This would require the same sort of international information-sharing proponents of harmonization claim constitutes an insuperable barrier against effective residence taxation.

In short, the absence of effective information exchange dooms harmonization schemes as thoroughly as schemes of residence taxation. Thus, harmonization proposals are not true “alternatives,” at least in the way commonly conceived. Indeed, though it may be difficult to work out an effective information-exchange regime, it would be even harder to agree on a harmonization scheme that results in the desired redistribution because agreement could be limited to information exchange, with rate decisions left up to individual countries. The first step would be to gain universal acceptance of the principle that countries of residence have the right (though not necessarily the obligation) to tax their avoid the reach of the withholding tax—as well as any applicable home country taxation—by posing as nationals of a non-EU (or other participating) country. Finally, as another commentator has noted, if the withholding tax itself were imposed as the final tax, the regime would provide at best a partial corrective because it would be lower than the appropriate residence country tax for many taxpayers. See Avi-Yonah, supra note 2, at 1657.

173. Under the Avi-Yonah plan, source countries would be placed in the uncomfortable position of either rejecting many such proofs because of their nonverifiability, and running the risk of discouraging legitimate cross-border investment, or making only cursory verification attempts, which would allow many tax evaders to escape taxation at both source and residence country levels.

174. See Johansson v. United States, 336 F.2d 809, 812 (5th Cir. 1964) (holding that Swedish citizen was not a Swiss resident within the meaning of the U.S.-Switzerland tax treaty, despite acts by the Swiss government). More recently, the United States has struggled to prevent U.S. taxpayers from posing as foreigners when investing in U.S. bonds (by investing through foreign entities and foreign bank accounts) and thereby collecting such income anonymously and free of source tax. See Sindhu G. Hirani, IRS Issues Final Withholding Rules, Allows QIS in Non-Tax Treaty Countries, 95 DAILY TAX REP., May 16, 2000, at G1.

175. Some cases of dual- and even multiple-residence taxpayers will exist, necessitating rules and procedures for allocating the revenues involved. Moreover, rules and procedures will have to be developed to prevent countries from using the information-gathering process to oppress political enemies. This issue is discussed infra text accompanying notes 177-79.
residents' worldwide income. As this principle is less intrusive on national sovereignty than schemes to regulate permissible tax rates, it should be easier to promulgate.

B. SECRECY AND NATIONAL SOVEREIGNTY

Mandated tax uniformity (enforced by punitive sanctions, if available) is generally regarded as an intolerable infringement on national sovereignty. Whether rational or not, most countries consider the design of tax systems to be a national prerogative, and foreign influences thereon to be an intolerable intrusion.176 This same argument often arises in the context of bank secrecy and proposals for the exchange of tax information. However, such arguments lack much force in those contexts. It is one thing to argue that a country should be able to use the tools at its disposal—tools that impose costs on the local population—to attract investment and tax revenues. It is another to attract investment (or launder the profits generated elsewhere) by using tools that impose costs only on outsiders (including outside governments).

The most widely touted rationale for respecting bank secrecy and other restrictions on intergovernmental information exchanges, in fact, has not been the dictates of national sovereignty or the illegitimacy of residence country taxation,177 but, instead, the possibility that governments will abuse the information they obtain. Bank secrecy laws and laws forbidding cooperation with foreign tax authorities traditionally have been justified as a necessary protection against the ability of oppressive governments to strip members of political, racial or religious minorities of their assets under the guise of taxation or other laws.178 Switzerland’s protection of the assets of European Jews during the

176. Indeed, one longstanding objection to the United States’ use of a tax-credit mechanism is that it impermissibly interferes with source country taxing decisions by eliminating the effect of tax concessions granted by source countries. See Canute R. Miller, Third World Views of the Ends and Means of United States Tax Policy, in United States Taxation and Developing Countries 83, 88 (R. Hellawell ed., 1980); Stanley Surrey, Current Issues in the Taxation of Corporate Foreign Investment, 56 Colum. L. Rev. 815, 823 (1956) [hereinafter Surrey, Current Issues]. These complaints have been ameliorated by the allowance of deferral. See U.N. Centre on Transnat'l Corps., International Income Taxation and Developing Countries at 21-22, U.N. Doc. ST/CTC/56, U.N. Sales No. E.88.I.A.6 (1988); Surrey, Current Issues, supra, at 823. Deferral compromises the supposed capital export neutrality goal of the United States’s tax system; in actual operation, it is surprisingly close to the operation of systems maintained by countries espousing a belief in capital import neutrality. See Stanley S. Surrey, The United States Taxation of Foreign Income, 1 J.L. & Econ. 72, 75-77 (1958).

177. Some hostility can be traced to the perception that residence country tax systems have been designed specifically to neutralize host country tax incentives, thereby interfering with the host country’s economic sovereignty. See Miller, supra note 176, at 88. The design advocated in this Article would not have this effect.

Hitler era was routinely cited as the paradigmatic example of the beneficent quality of such behavior.\textsuperscript{179} Now that that particular canard has been laid to rest, the time has come to distinguish between secrecy that serves such meritorious ends and secrecy that instead contributes to various forms of tax and nontax related illegal and abusive behavior by governments, bankers and their clients.

The possibility—indeed probability—of oppressive and confiscatory taxation by residence countries (whether actual, purported or former) cannot be discounted.\textsuperscript{180} Such unwholesome policies have existed in the past, engendering legitimate fear that it will recur. Ironically, however, the untrammeled availability of secret accounts may encourage such distressing behavior. Such secrecy makes it altogether too easy for people to avoid such taxes, thus removing the economic disincentive (and political unrest) governments might otherwise suffer upon passing such unwise legislation.\textsuperscript{181} This encourages government by symbol rather than by substance; why not cater to public opinion and “soak the rich” (or some other unpopular group) if one can be assured that no such soaking will take place and the public will never know? Of course, often the public eventually discovers the deception, which leads to an even worse result: widespread contempt and disdain for the rule of law.

Moreover, the secrecy option may make the worst form of oppressive taxation—discriminatory taxation or expropriation—more likely. Tax rules which on their face penalize members of disfavored political, ethnic or religious groups are reprehensible, and presumably should and could not be enforced abroad because they violate basic human rights. However, secrecy laws abet the discriminatory application of facially neutral tax rules. The politically favored may be given advance warning of changes in tax rules, and allowed the opportunity to hide their money, leaving only the politically disfavored to bear the brunt of facially neutral tax rules. Moreover, the inability to obtain evidence of such disparate treatment impedes a disfavored citizen’s attempts to avoid enforcement of the tax by proving its discriminatory nature.

In addition to encouraging legislative “corruption” (that is, the passage of dishonest, symbolic, or discriminatory legislation), bank secrecy laws and tax


\textsuperscript{180} Individuals’ definitions of “oppressive and confiscatory” may differ.

\textsuperscript{181} The recent Russian money laundering scandal can be attributed, in part, to this dynamic. Russia and its subunits have enacted unrealistically high taxes, which, if enforced, would bring economic activity to a halt. The laws have not been enforced; instead, profits have been siphoned off to virtually untraceable accounts. In addition to undermining the collection of tax revenue (once the decision is made to siphon off profits, why not siphon them all off?), the process encourages corruption at every step of the process. See Celestine Bohlen & Michael R. Gordon, Russians Say Bank Scheme May Not Be What It Seems, N.Y. Times, Sept. 12, 1999, at A10; Benjamin Weiser & Lowell Bergman, U.S. Officials Say Bank of New York Transfers Involved Money in Russian Tax Cases, N.Y. Times, Sept. 15, 2000, at A18.
haven entities encourage corrupt administration and corrupt administrators. Most money laundering schemes require the cooperation of bank officials, customs officials, tax officials, business professionals, lawyers, and the like. Most are aware of the shady nature of their dealings, and ask for appropriate economic rewards. Further, some take advantage of the perilous legal position of their contacts to extort additional rewards; thieves cannot complain about the theft of ill-gotten gains. They may, however, resort to various forms of extra-legal sanctions which add to a general climate of lawlessness. Additionally, many of the corrupt administrators and politicians take advantage of the secrecy provisions to hide their own malfeasance.

The solution lies in drawing lines where none have been drawn before, that is, distinguishing between situations where secrecy can be maintained as a form of protection against political (or racial or ethnic) persecution and those where it serves less laudable goals. This will not be an easy task, as such lines are, inevitably, political in nature, at least in part. However, in reality such lines are already being drawn, and often on the worst possible grounds. There is nothing to be lost and much to be gained by regularizing and systematizing such decisions to the extent possible.

Making information available to residence countries rather than relying on various “second best” alternatives (which, as discussed above, are not true alternatives anyway) would have still another advantage: It would add to the transparency of tax systems, thus aiding the tax policy decisions made by both source and residency countries.

C. TRANSPARENCY

The major advantage of an information, rather than tax rate, requirement is that it encourages transparency and accountability with respect to both source and residence countries' tax regimes. One of the puzzles of tax law is why havens (as well as countries that do not regard themselves as havens, such as participants in the Eurobond market) have been allowed to "poach" on the tax bases of other countries with such impunity for so long. It is particularly mysterious given the degree of cooperation such poaching often requires from

182. See Cono R. Namorato & Scott D. Michel, International Criminal Tax Cases, 50 U. MIAMI L. REV. 617, 622 (1996) ("[]Individuals who engage in criminal activities commonly employ tax practitioners to devise means to conceal their unlawful income . . . "); Weiser & Bergman, supra note 181, at A18 (reporting judicial opinion concluding that Sobinbank, "one of the most politically connected financial institutions" in Russia must have had "knowledge or willful blindness" of money laundering and tax evasion scheme).

183. At least, not explicitly or openly. Many exceptions to secrecy laws have been made, not all of them laudable.

184. See, e.g., Alan Cowell, Swiss Used Nazi Victims' Money for War Payments, Files Revealed, N.Y. TIMES, Oct. 24, 1996, at A1 (reporting that Swiss government used bank accounts of Holocaust victims to pay debts owed to Swiss residents by Germany and Poland).
the "poached" country—cooperation that takes the form of treaty exemptions\footnote{Tax treaties usually reduce source-country taxation, entirely exempting certain income earned by residents of the treaty partner and reducing the tax rate on other income. Such reductions are envisioned as "trades" of revenue (what one country loses from noncollection of source tax, it picks up in the form of additional taxes collected on resident income). See 2 JOSEPH ISENBERGH, INTERNATIONAL TAXATION: U.S. TAXATION OF FOREIGN TAXPAYERS AND FOREIGN INCOME ¶ 36.2, at 316-17 (2d ed. 1990). In fact, the offsetting revenue collections often fail to occur due to imbalances in revenue flows, flaws in the system for calculating the tax due on residents' foreign income, or the residence country's failure to find out about the foreign income. See Roin, supra note 19, at 1799.} and the like. A surprising amount of tax avoidance behavior could be controlled by unilateral changes in tax rules or effecting changes in tax treaty relationships to restore withholding taxes on tax-base-depleting expenditures such as interest and royalties. That such alternatives have not been widely adopted suggests that issues other than "poaching" are involved.

One possibility is that much of the behavior currently being castigated does not constitute "poaching" at all, but represents instead a deliberately tolerated method of providing a tax reduction for certain groups of taxpayers. The impetus for allowing such reductions may spring from either source or residence country concerns. Source countries may tolerate or even encourage tax avoidance in an effort to attract investors; residence countries may tolerate or encourage tax avoidance to lower the tax burden on certain residents.\footnote{Europeans have long held rather mixed feelings toward taxation in general and income taxation in particular. Tax evasion was not considered a crime in some European nations until recently and the definition of criminal tax evasion remains quite restrictive. See Karzon, supra note 178, at 786 (discussing law of Switzerland). Further, countries have been quite reluctant to help other countries enforce their tax laws. See RICHARD L. DOERNBERG, INTERNATIONAL TAXATION 135 (3d ed. 1997). Tax crimes still are not covered by most extradition treaties. See Douglas J. Workman, The Use of Offshore Tax Havens for the Purpose of Criminaly Evading Income Taxes, 73 J. CRIM. L. & CRIMINOLOGY 675, 691 (1982); see also Namorato & Michel, supra note 182, at 623 n.37 (giving example of criminal assistance treaty excluding tax cases).} The current round of complaints by such countries may thus be disingenuous (and the defects in their proposals deliberate). If so, the secrecy surrounding these transactions is particularly troubling, for it indicates political failure in the source and/or residence countries. If the low tax rates made available through the use of tax haven countries are in fact desirable (on investment attraction or vertical equity grounds), then the polities involved should be able to provide openly for such rate reductions through domestic legislation.\footnote{As, for example, the United States did in 1984, when it largely repealed the withholding tax on interest income earned by foreign residents. See STAFF OF JOINT COMM. ON TAXATION, 98TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1984 392 (Joint Comm. Print 1984) [hereinafter GENERAL EXPLANATION] ("Congress believed that if tax-free access to the Eurobond market is important, such access should be direct.").} Their failure to do so, to rely instead on the distinctly inferior substitute of informal, uneven, and unpoliced self-help methods of tax reduction made available through the use of tax havens or tax avoidance devices, suggests a disconnect between those parties effectively making tax policy and those that are supposed to determine that policy.\footnote{Indeed, such a disconnect exists even with respect to the U.S. law just described. While the exemption decision was above-board and transparent from the source perspective, the law as} Such disconnects should not exist. As discussed
earlier,\textsuperscript{189} tax breaks should not be hidden. Public officials cannot be held properly accountable for their actions when those actions are hidden from public view, and accountability is a necessary corrective for inherent agency problems. If open tax reductions cannot be sustained politically, then the hidden version of those reductions, effected through the use of tax havens, should not be allowed either. Eliminating the secrecy surrounding such transactions would be a step in the direction of putting such policies to the necessary political test. Governments cannot reveal information they cannot obtain; they may be embarrassed into collecting and providing it when they can.

Alternatively, the current expressions of concern may reflect changes in political and/or economic conditions that warrant revising longstanding policies (made on source attraction or vertical equity grounds).\textsuperscript{190} Like all tax increases, however, those that result from cutting down on "poaching" may have unwelcome repercussions in the form of reduced internal investment. In a tax-competitive world, investors may decide to move their investments elsewhere rather than pay tax at the higher rate. From an individual country's standpoint, it makes economic sense to try to forestall such competition by arranging a pricing cartel among potential competitors. If those competitors truly are fungible, no great damage will be done,\textsuperscript{191} particularly if income transfers compensate inadvertent losers.\textsuperscript{192} However, as discussed in Part I, harmonization efforts should be limited (as the current proposals are not) to such fungible jurisdictions. And most importantly, their dependence on improvements in information

passed by the United States harmed an unrepresented party—potential investors' countries of residence—by enabling such investment to take place on an anonymous basis. Few countries have clean hands in the area of information exchanges. The United States, which has long taken the lead in attempts to encourage intergovernmental information exchanges, itself operates as a tax haven for foreigners because it exempted their portfolio interest income from source tax in such a way as to make residence taxation impossible. See Michael J. McIntyre, The International Income Tax Rules of the United States 2-51 (2d ed. 1992) ("The traditional policy of the United States has been to avoid serving as a tax haven for foreigners. The exemptions for interest on deposits and the exemption for portfolio interest are obviously exceptions to that policy."); George Gutman, IRS Foreign Information Returns Program, 62 Tax Notes 411, 412 (1994) (describing history of attempts to gain foreign information); Sindhu G. Hirani, International Tax Counsel's Office to Continue High-Profile, Ongoing Projects, 13 Daily Tax Rep., Jan. 20, 2000, at S20 (detailing current information exchange agreements and future prospects); Lee Sheppard, The United States as a Tax Haven, 24 Tax Notes 325, 325 (1984) (asserting that "Treasury has a foot in both camps; its tax conscience" and its desire to raise money cheaply).

\textsuperscript{189} See supra Part I.B.2.a.

\textsuperscript{190} See Robert Goulder, ABA Tax Section Meeting—Int'l Panels Discuss APAs, FSCs, Treaties, Compaq and NatWest, 86 Tax Notes 606, 612 (2000) (stating that Liechtenstein complains about tax haven label because "the country's tax laws and applicable rates have not changed appreciably in 50 years . . . . If [their] attraction has increased . . . the reasons are external . . . .").

\textsuperscript{191} The question becomes who enjoys the benefits of location-specific rents—source countries, residence countries, or taxpayers. As discussed supra note 139, I lack a theory capable of determining who "should" be entitled to these rents. It is worth noting once again though that even if the source country appears to collect the rents, it may end up transferring them to the investors through increased benefits.

\textsuperscript{192} See supra notes 53-54 and accompanying text. Even in that situation, of course, there is no guarantee that a tax cartel will generate favorable results for the participating jurisdictions. See id.
exchanges must not be overlooked. Absent such improvements, these schemes will become mere political window-dressing, perpetuating rather than cutting back on tax evasion.

Eliminating secrecy laws and designing an effective information exchange and processing capability will not be easy either politically or technically. Politically, such rules have powerful backers, including the wealthy individuals and corporations that make use of them. In addition, some of the countries that have used these rules to develop a tax-haven economy have developed a new line of defensive argument—that their economies will collapse if they cannot provide investors with secrecy-leveraged tax advantages. This argument is not as obviously appealing as the now largely discredited argument that they are needed as protection against oppressive and discriminatory taxation. Surely more productive, and less open-ended, methods of foreign aid can be designed.

Even with political support, difficulties will remain. However, it is too facile to conclude that secrecy havens cannot be shut down inasmuch as no one has ever made a serious effort to do so. Measures such as restricting deductions for payments to entities located in such countries, imposing withholding taxes on

193. Even in the United States, support exists for continued secrecy. In September of 2000, Representative Richard Armey sent Treasury Secretary Lawrence Summers a letter expressing his "deep concern" about the administration's support of the OECD effort to "stamp out tax competition." In particular, he wrote: "Likewise, it is not our job to tell other countries to dismantle their financial privacy laws. We should seek cooperation when investigating specific cases of wrongdoing, but this does not require the wholesale destruction of personal privacy." Armey Criticizes Administration for Supporting OECD Crackdown on Tax Havens, 2000 Tax Notes Today 177-10, WL 2000 TNT 177-10.

194. Interestingly, large corporate entities may be the least serious offenders under present conditions, because most are publicly traded. With share price dependent on profits, and executive compensation dependent (in many cases) on share price, most corporations remain eager to disclose the entirety of their profits on their financial statements. Residence country tax officials should be able to work backwards from those statements to discover omitted income. Private individuals and closely held companies, by contrast, have no independent incentive to reveal income sources.

195. The Netherlands Antilles used this argument in the early 1980s when Congress was considering repealing the withholding tax on interest income, and again in the late 1980s when Treasury seemed determined to terminate the United States-Netherlands Antilles tax treaty. It won the country a partial reprieve in both instances. Congress repealed the withholding tax on a prospective basis only (the repeal affected only interest paid on portfolio debt instruments issued after the 1984 date of enactment) because it "would result in a gradual and orderly reduction of international financing activity in the Netherlands Antilles and thus mitigate any economic hardship that the withholding tax repeal might indirectly impose on that country." General Explanation, supra note 187, at 393. Treasury also grandfathered the favorable tax treatment of certain pre-existing debt instruments when it terminated the treaty in 1987. See Announcement 87-76, I.R.B. 1987-35 (Aug. 31, 1987), reprinted in 155 Daily Tax Rep., Aug. 13, 1987, at J1.

Sympathy for European countries such as Switzerland, Luxembourg, and Monaco may be even greater.

196. A simple transfer of money from the treasuries of the residence countries to those of the haven countries would be cheaper if the only goal is to provide foreign aid. The recipient countries could use this money to encourage activity more productive than training people how to launder money.

197. As it stands, the residence countries have very little control over the amount of foreign aid being transferred to tax haven countries.
payments made to residents of tax haven countries, or disallowing financial transfers to financial institutions located in such countries have never been attempted. In addition to motivating source countries to adhere to such measures, residence countries may have to agree on a variety of technical specifications for tax information to make effective use of the information that is available. For example, some uniform method for identifying and cross-referencing taxpayers may be required. None of these moves will be easy, but none should be harder than those required to achieve effective harmonization, and the end result may be more acceptable to the countries whose participation is necessary. Finally, and perhaps most importantly, the reintroduction of source taxation may reduce their attractiveness in the first instance.

CONCLUSION

The basic structure of the rules for the taxation of income generated through international transactions has remained constant for more than thirty years. Taxpayers and tax-haven countries have learned all too well how to exploit them. There is little question that this architecture must change for the concept of an income tax to survive. The question is how.

At present, most calls for reform of the international tax system take the form of proposals to harmonize tax rates. They advocate the formation of international cartels to combat the supposed evils of tax rate competition. Only such cartels, they argue, can protect the tax mechanisms necessary to fund the social infrastructure of the modern welfare state.

This Article argues that the focus on tax rate harmonization is misguided. In part, its message is pragmatic. Tax rate harmonization will not work; competition based on taxes and expenditures is inevitable. In part, its message is a matter of principle. Source countries should remain free to use tax policies to attract business investment, just as residence countries should have the right to tax their residents to support the social services and social climate that they enjoy. The Article suggests how to construct a tax system that will allow both goals to be achieved, one in which tax rate harmonization plays little if any role.

At bottom, though, both the tax harmonization advocates and I agree on the larger principle that decisions about the extent and the distribution of the financial burdens of the modern welfare state should be made at the ballot box.

198. Both of these ideas are included in the list of "[topics for further study" found at the end of the OECD Report. See HARMFUL TAX COMPETITION, supra note 2, at 59-60. It may well be that the specter of such sanctions is responsible for the apparent success of the OECD's initial attempts to encourage traditional tax havens to "join the international effort to combat harmful tax competition." Robert Goulder, Six Tax Havens Agree to Cooperation with OECD, 87 TAX NOTES 1701 (2000) (stating that six governments signed letters of commitment to abide by international standards for "transparency, exchange of information, and fair tax competition" by the end of 2005). Many jurisdictions remain reluctant to change; indeed, several have suggested that they may challenge the proposed sanctions as impermissible "obstacle[s] to trade" before the WTO. See Lawrence J. Speer, OECD Announces Collective Approach for Negotiations with Suspected Tax Havens, DAILY TAX REP., Oct. 19, 2000, at G1-2.
rather than through individual consultation with the director of a brass nameplate bank. And that is where the advocates of tax harmonization do the most harm. By focusing on the (largely nonexistent) evils of tax competition, they detract attention from the real problem of tax evasion. This Article lays out some of the issues to be resolved before serious efforts to combat such evasion can begin. Their resolution will not be easy, but the alternatives are decidedly worse.