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Law Department

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Ian Roxan *

Abstract: Globalisation is a phenomenon that is said to have radically changed the international economy. It is said to have radically limited the power of national governments, particular in the field of taxation, in a world of highly mobile capital and flexible transnational corporations. To explore the extent of the effects of globalisation on taxation, this article discusses some ideas about how we should look at international tax policy in the face of the realities of globalisation, particularly in a world that includes developing countries, by considering the differences between different discourses on taxation, such as the economic, the legal, and the policy discourses. The policy discourse can offer new perspectives on the old question of the choice between source and residence taxation, makes it possible to understand them in terms of tax fairness criteria, and gives rise to a new criterion: the participation principle. Not only does the participation principle provide interesting approaches to some cases of concern to developing countries that have traditionally been viewed as source taxes, but the rise of digital goods do not simply shift the location of taxed activities. They can also offer creative opportunities for the developing world.

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THE PHENOMENON OF GLOBALISATION

THE NATURE OF GLOBALISATION

The phenomenon of globalisation as it developed at the end of the twentieth century is principally the result of two developments: the general removal of exchange controls by developed countries, and the growth of new technologies, particularly computer-based data processing and communications, such as the Internet, which has made virtually instantaneous global communication possible.[1] This extends not only to the pure processing and communication of information, but also to the transmission of goods through conversion into digital form – digitised goods.

These developments have interacted: global communications have made worldwide instantaneous financial transactions possible. This has made financial capital highly mobile. Global communications have also enabled transnational corporations to make rapid decisions on a global basis: not only can the decisions be communicated instantaneously, but the information needed to make them is also instantly available. In addition, the developments in data processing mean that large amounts of data can be easily analysed, another element needed for global decision-making. These developments have led to an increasing integration of the world economy. To a large degree, the actors in this integration have been the transnational corporations.

THE CONCERN ABOUT GLOBALISATION AND TAXATION

It has become conventional to take what may be seen as a pessimistic view of the effect of globalisation on taxation. This view explains that globalisation has increased the mobility of capital, so that investors can change the location of their investments very easily. As other barriers to international capital movements have fallen, differences in how countries tax the income from capital investments have become more important. This has engendered what is called 'tax competition'. In order to retain and attract capital investments, countries have to offer attractive tax regimes, that is to say lower effective tax rates. The pure theoretical argument is that globalisation has made capital so mobile that the effective rate of tax on income from capital is being driven down to zero. Of course, we may still see positive statutory rates of tax being charged on capital, but that will not prevent

[1] Globalisation is also used in the (earlier) literature to refer to earlier developments, such as the rise of transnational corporations. *See eg* J.G. Williamson, 'Winners and Losers over Two Centuries of Globalization' (NBER Working Paper no. 9161, 2002), at <www.nber.org/papers/w9161> (last visited 15 April 2011). R.S. Avi-Yonah, 'Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State' (2000) 113 *Harvard Law Review* 1573, 1575 points out that the development of world trade in the decades before World War I can also be seen as an episode of globalisation.

the effective rate of tax (the amount of tax collected on the true amount of income from capital) from approaching zero.[2]

SUMMARY

In this article I would like to examine three questions centred around this issue of the effect of globalisation on taxation. I am not trying to offer definitive answers, but I hope to clarify some of the issues and to suggest which questions are the most important. First, I consider how we should approach the design of international tax policy in general in this globalised world. I suggest that the key is to understand that international tax policy has its own perspective on international taxation, distinct from, for example, the economics of international taxation. Second, I look at whether it is possible to give a more sophisticated explanation of the role of tax competition in the context of policy. Finally, I would like to offer some thoughts on how, in light of these considerations, tax policy should respond to globalisation, particularly in the case of developing countries.

INTERNATIONAL TAX POLICY

TRADITIONAL CRITERIA – CEN AND CIN

Traditionally the evaluation of international tax policy has focused on criteria of economic efficiency, particularly the criteria of CEN and CIN.[3] Efficiency is important because an efficient economy will produce the greatest amount possible measured by value, given the resources available and the preferences of consumers.[4] In other words it results in maximising the value of world-wide production.

When we consider the taxation of capital, which is the principal factor of production affected by globalisation, the traditional approach seeks an efficient allocation of capital. In market economics capital is allocated by markets that involve savers, who supply capital, and investors, who demand capital to invest in various projects. Taxation of the return to capital introduces a general distortion to these markets, but differences in levels of taxation between countries can distort the allocation of both savings and investment between countries. Strictly speaking, full harmonisation of world rates of tax on capital income would be needed to eliminate these misallocations between countries. Since this is seen as unrealistic, the traditional approach is to distinguish between capital export neutrality (CEN)

[2] *See eg* L. Chennells and R. Griffith, *Taxing Profits in a Changing World* (London: Institute for Fiscal Studies, 1997).
[3] *See eg* M.J. Graetz, 'Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies' (2001) 54 *Tax Law Review* 261, 270-273.
[4] *See eg* J.E. Stiglitz, *Economics of the Public Sector* (New York, London: W.W. Norton, 3rd ed, 2000).

and capital import neutrality (CIN). These forms of neutrality eliminate distortion in the allocation of investments and savings respectively.[5]

CEN implies using foreign tax credits in order to provide relief from double taxation.[6] This seems to imply support for residence-based taxation. In contrast CIN implies using exemptions from domestic (residence-based) tax to relieve double taxation. This implies support for source-based taxation. The result is that the use of the CEN / CIN distinction has typically come down to an argument about the relative merits, both theoretical and practical, of source and residence taxation.[7]

Economic research generally suggests that it is more important to achieve CEN than to achieve CIN, on the ground that investment is said to be more responsive to relative changes in tax rates than savings.[8] However, Horst argued that if neither investment nor savings is wholly inelastic, best policy lies somewhere between CEN and CIN.[9] Optimal tax theory has pointed to one clear criterion for efficient taxation: production efficiency. This requires that producers face undistorted input and output prices. It can be obtained with pure residence taxation, even if rates differ between countries, but with source taxation, it is only possible with equal rates.[10] Despite these arguments, developing countries tend to favour source taxation. They see themselves as capital importers with a relatively stronger base for source taxation.[11] Economics thus appears to work against their interests in this debate.

There are really two problems here. The first is that the conclusion of economics is not a strong one and has certainly not proved to be decisive in developing policy. In part this problem is practical. Few countries are willing to adopt either pure residence taxation or pure source taxation. Instead, these bases are approximated through the operation of the double taxation relief methods. But the ordinary credit method does not reflect pure CEN, and the exemption method has to be implemented by the country of the taxpayer's residence, so it is not in

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[5] Graetz, n 3 above, 271. For a more technical formulation see T. Horst, 'A Note on the Optimal Taxation of International Investment Income' (1980) 94 *Quarterly Journal of Economics* 793, especially 796; M.P. Devereux and M. Pearson, 'European Tax Harmonisation and Production Efficiency' (1995) 39 *European Economic Review* 1657, 1659.

[6] Of course, one of the problems is that CEN really implies the use of full foreign tax credits that would give a credit for foreign taxes even if the foreign tax were more than the relevant domestic tax. Instead, actual foreign tax credit systems give an 'ordinary' credit, capped at the amount of domestic tax. Since the effect of a capped credit is equivalent to that of an exemption from domestic tax, the ordinary credit seems to mix the goals of CEN and CIN.

[7] A. Schindel and A. Atchabahian, 'General Report' in International Fiscal Association (ed), *Source and Residence: New Configuration of their Principles*, vol 90a, Cahiers de droit fiscal international (The Netherlands: Sdu Fiscale & Financiële Uitgevers, 2005), 35.

[8] *See eg* Avi-Yonah, n 1 above, 1607.

[9] n 5 above.

[10] *See* J. Slemrod, 'Free Trade Taxation and Protectionist Taxation' (1995) 2 *International Tax and Public Finance* 471.

[11] *See eg* A.H. Figueroa, 'Argentina' in International Fiscal Association (ed), *Source and Residence: New Configuration of their Principles*, vol 90a, Cahiers de droit fiscal international (The Netherlands: Sdu Fiscale & Financiële Uitgevers, 2005).

the control of the source countries, the capital importers, which are the countries with the greatest self-interest in CIN.

The second problem is that the choice between source and residence taxation has been made less simple by globalisation. In different ways tax competition undermines both residence and source taxation. It undermines residence taxation because it makes it possible to earn capital income in other jurisdictions in ways that make it possible to escape taxation at home either by avoidance or by actual evasion (concealment). It undermines source taxation directly by allowing taxpayers the mobility to choose to locate in jurisdictions offering lower tax rates. Indeed, this can be seen as the basic form of tax competition, if governments are in turn encouraged to compete with each other by reducing rates of source taxation in order to attract taxpayers, and tax revenues.[12] As I will discuss below, the existence of this second stage to the effect on source taxation is less obvious.

ALTERNATIVES TO CEN / CIN

The national interest

The problems with the CEN / CIN distinction seem to have made it a rather sterile one for tax policy. This is a conclusion that others have also reached. For example, Michael Graetz argues that the problem with CEN and CIN is that they are framed in terms of achieving global efficiency.[13] Their use fails to recognise that countries are concerned with their own national interest, not necessarily with a global ideal. Global efficiency may not be in a particular country's national interest.

He rejects the criterion proposed by Peggy Musgrave as the one reflecting the national interest.[14] That criterion, national neutrality (NN), assumes that a country has no interest in the taxes imposed by other countries. A country adopting this criterion would regard foreign taxes as merely a cost of doing business in other countries that was faced by its own taxpayers. NN would only support giving a deduction for foreign taxes. Graetz understandably rejects this on the grounds that, since it would give much less relief for double taxation than is normally given today, it would significantly contract world trade. Unfortunately, he does not propose any well-defined alternative.

The problem with national neutrality, as Graetz notes, is that it ignores the reactions of other countries. But this shows the weakness in Graetz' argument. It

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[12] This type of tax competition could also exist in respect of residence-based taxes, but it is generally accepted that individuals (either as providers of labour or as owners of capital) are significantly less mobile than capital. The migration of individuals is still important for taxation, even if it does not result in phenomena that could be classified as overt tax competition. The tax competition problem has been more relevant in the case of residence-based taxes on corporations, given the nature of the residence of a corporation. The concern in the United States with the so-called corporate inversions may be seen as an example. *See eg* H. Hicks, 'Overview of Inversion Transactions: Selected Historical, Contemporary, and Transactional Perspectives' (2003) 30 *Tax Notes International* 899.

[13] n 3 above.

[14] *See* P.B. Musgrave, *United States Taxation of Foreign Income: Issues and Arguments* (Cambridge, Mass.: Law School of Harvard University, 1969).

is all very well to suggest that countries are interested in the national self-interest in taxation, rather than the global interest, but the national self-interest is dependent generally on what other countries do: how they react.[15] This is all the more true in the face of globalisation.

I suggest that the problem with Graetz' argument comes from not fully considering the role of efficiency. An efficient allocation of resources maximises the value of world production, so it maximises the amount of income available for division among nations. In addition, the principle of competitive markets says that a competitive equilibrium can be reached by each of many actors seeking their own self-interest, while the so-called first fundamental theorem of welfare economics says that a competitive equilibrium will be efficient. In other words, in principle the goal of maximising global efficiency is consistent with each country seeking its own interest under competitive conditions. What is necessary, however, is that countries do this in an institutional context that operates like a competitive market.[16] Otherwise, an individual country can only get a larger piece of the pie at the cost of making the pie smaller.

This leaves us with the interesting question of whether we can say that such an institutional context exists, or could be constructed. It is also related to the question of tax competition, to which I shall return. To find such a context it would be necessary to identify what we can understand by the 'market in taxation'. Taxpayers pay in that market, but what are they paying for? What is the product?

The answers to these questions are not trivially obvious. So it is more helpful first to consider more generally how to break away from the CEN / CIN dichotomy.

Redefining the dichotomy

A number of authors have tried to redefine the dichotomy. One of the most interesting is that found in Desai and Hines' concepts of capital ownership neutrality and national ownership neutrality.[17] They argue that to a large degree foreign direct investment (FDI) is now about changes in the ownership of assets

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[15] This does not require that a country have a sophisticated understanding of how other countries react. The simplest assumption, that the country assumes that other countries will not change their tax system (unless and until they are observed to do so), is the basis of one of the best studied bases for interaction: the Nash equilibrium. Its interesting feature is that, under certain conditions, the tax systems of countries behaving on this assumption would reach a stable equilibrium.

[16] The so-called first fundamental theorem of welfare economics states that a competitive equilibrium will be efficient. The second theorem states that an efficient allocation of resources can be achieved by a competitive equilibrium with an appropriate (lump-sum) redistribution of resource endowments. While these need to be qualified in the second-best context of economies with taxation, the essence of the argument is that a competitive structure is sufficient for an efficient outcome, and in addition any efficient outcome could be attained by a competitive structure with appropriate redistribution. Of course, one problem with these theorems is that they do not themselves provide any guidance as to the relative desirability of alternative efficient outcomes.

[17] M.A. Desai and J.R. Hines, Jr., 'Evaluating International Tax Reform' (Harvard NOM Working Paper no. 03-48, 2003), at <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=425943> (last visited 15 April 2011).

rather than about investment in new assets. As they discuss, there are reasons to believe that, especially as behaviour harmonises in the globalised world of today, the productivity of capital assets is affected by who owns them. In particular, a multinational may be able to use assets more productively than a domestic firm: for example, it may be able to use international brands or to internationalise brands effectively, and it may have its own intellectual property that it can use to enhance the productivity of the local assets.

As a result they consider the conditions under which tax systems will be neutral internationally between ownership by investors in different countries, which they call capital ownership neutrality (CON). They conclude that it will be satisfied if all countries adopt an exemption system or all countries adopt a credit system. Under a universal exemption system an investment in a country will only be subject to source taxation, so it will be subject to the same tax regardless of the country of its ownership. Investments in particular countries may be favoured by low tax rates, but all potential owners will benefit from those rates, so ownership will not be distorted. Under a universal credit system each investor faces the same rate of tax wherever it invests. Investors from different countries may face different tax rates, but their relative tax rates will always be the same for any investment.

Their second concept, national ownership neutrality (NON), corresponds to national neutrality (NN), but reflects that idea that, if FDI is principally about the ownership of an existing stock of investment, then investment abroad by domestic investors will not reduce the home capital stock. Instead the domestic investment will be replaced by foreign investment from abroad. As a result, it is desirable to exempt the foreign income of domestic firms. Such foreign earnings contribute to the profitability of domestic firms without reducing the level of domestic capital.

These results are, as they acknowledge, dependent on the extent to which FDI is in fact concerned with changing the ownership of assets. For example, they suggest that if only a proportion of investment abroad by domestic firms is replaced by foreign investment, then a proportion of foreign earnings of domestic firms should be taxed, based on the investment replacement proportion, and also on the relative domestic and foreign tax rates.

The weakness of these concepts is that they only describe the welfare effects of taxation in response to a specific characteristic of FDI. Indeed, while they argue that the importance of ownership as a reason for FDI should not be underestimated, they also recognise that it is not the only factor. As a result, they do not propose CON and NON as the only criteria on which to assess international taxation. Thus their proposal does not so much escape the CEN / CIN dichotomy as add to the choices. Moreover, their concepts have two other related weaknesses. The concern with ownership is, by their own description, a greater concern with respect to FDI between industrialised countries. The premise of their argument is that FDI to determine the location of investment does not seem to explain well the high levels of FDI between industrialised countries. The second problem is that is the concepts have a very static feel. It seems implicit that, whether the issue is the ownership of capital or the location of capital, the total capital stock is fixed. So if the reason for FDI is location, investment abroad by domestic firms reduces the domestically located capital stock. This is not a model that considers the role of FDI and taxation in growth.

A different approach has been presented by Eric Kemmeren.[18] He argues for source-based taxation based on a principle of origin. This defines the source of income in terms of the place where the activity that has generated it has occurred. This redefinition of 'source' as 'origin' or 'economic location' implies, in his analysis, a substantial shift of tax jurisdiction to source (origin) countries. This is linked to his strong 'benefit principle' view of taxation.[19] The State that has provided infrastructure (physical and otherwise) for economic activity has the right to tax it. He would thus replace CEN and CIN by the concepts of capital and labour export efficiency and capital and labour import efficiency (CLEN and CLIN). He argues 'that only individuals can create income, and that things in themselves cannot'.[20]

The difference between CLEN and CLIN in comparison with CEN and CIN is that the former apply to the migration of labour as well as capital, but they also support his concept of source. A direct consequence is that he regards efficiency in terms of efficiency in the allocation of productive factors. Investments should be made in the location that will minimise the costs of production. He favours CLIN because, he argues, under CLEN investors resident in high tax countries are at a competitive disadvantage relative to those resident in low tax countries. This means, he says, that CLEN does not achieve production efficiency. The problem with this argument is that it really amounts to saying that the weakness of CLEN is that it is not CLIN.

Under CLEN (and CEN) investors resident in a country are neutral between investing at home and investing abroad. However, with regard to a particular investment, it is true that investors from higher-tax countries will see the investment as less attractive than those from lower-tax countries. But this does not result in a misallocation of production.[21] It merely changes who invests in that production, ie it tends to change the location of savings because saving becomes relatively more attractive (all other things being equal) in lower-tax countries. That is, however, precisely the difference between CEN and CIN: CEN achieves neutrality as to the place of investment; CIN achieves neutrality as to the place of

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[18] E.C.C.M. Kemmeren, *Principle of Origin in Tax Conventions: A Rethinking of Models* (Tilburg: Katholieke Universiteit Brabant, 2001); E.C.C.M. Kemmeren, 'Source of Income in Globalizing Economies: Overview of the Issues and a Plea for an Origin-Based Approach' (2006) 60 *Bulletin for International Taxation* 430 (hereinafter Kemmeren, *Source of Income*).
[19] The benefit principle is discussed further below in the section Fairness in Taxation: The Participation Principle, beginning with text to n 37.
[20] Kemmeren, *Source of Income*, n 18 above, 434.
[21] Except to the extent that, as Desai and Hines, n 17 above, argue, who the owners are affects the productivity of the investment, but then the conditions for neutrality are different.

savings. This view that CEN creates a competitive disadvantage is not one limited to Kemmeren, so it will be necessary to return to it later.

TAX DISCOURSES

The different discourses of tax

The CEN / CIN dichotomy arises from an attempt to provide a solution to the problem of international tax policy purely in terms of economic theory. This is appropriate to the consideration of the economics of taxation, but it is important to recognise that this is not the only context within which we can speak of taxation. Taxation is an element of society, a vehicle for the construction of relations between members of society, one of the mechanisms by which value is transferred between individuals within society, an expression of secondary relationships of power between different social categories and classes, and a legal construct that can be characterised not merely by its financial significance but as much by its importance in regulating the allocation of power within constitutional structures. In other words taxation is considered and understood through a variety of discourses.

We are used to the legal discourse, in which we understand tax as implicating the creation of a set of contingent obligations, principally the obligation of payment, to be fulfilled in accordance with rules and balanced by certain corresponding rights, such as the right of equal treatment under the terms of any tax legislation. Within this one can identify an administrative discourse that explains how tax is imposed – how the system operates in practice.[22] This in turn leads back into the ever-vital aspects of legal discourse concerning the issue of controlling tax avoidance.

The social discourse concerns the impact of taxation on particular groups within society, or upon the structure of society. The relationship of the tax system to issues such as gender and marriage is relevant here. We can also distinguish a moral discourse on taxation in which the moral and ethical implications of taxation are considered as moral and ethical questions rather than as social questions. In addition, there is the political discourse in which the power relations underlying taxation form the basis from which the structure and operation of the tax system are understood.

Next, there is the economic discourse on tax. This discourse explains the economic effects of tax: for instance, the extent of distortions created by the tax

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[22] A legal theorist might find this a surprising distinction: what I have termed 'administration' is in other fields intrinsic to the legal discourse. The tendency of academic tax law, at least in the Anglo-Saxon tradition, to treat 'administrative' questions in a relatively cursory manner can be ascribed to two causes. First, these questions have often been effectively adopted by accountancy (and by accountants in practice). Second, the Anglo-Saxon tradition has situated tax law within the general field of commercial law (law about money), rather than public law (law about administration), so that the 'administrative' questions are of less interest to tax law in this tradition. A more practical justification for the distinction is that many of the 'administrative' questions are determined by officials within the tax administrations, who look to their official internal guidance, which may be at variance with tax 'law', a distinction whose value, I hardly need add, will be self-evident to any lawyer.

system, and the economic incidence of taxes. Traditional neo-classical economics focuses on the position and behaviour of individuals using the concept of utility maximisation. Since utility only provides for the ranking of individual preferences, it is a concept that is not commensurable between individuals. Basic economic analysis, including the analysis of efficiency, thus has little content that reflects social values.[23]

Welfare economics has developed the concept of the social welfare function in order to incorporate social values into its analysis. The social welfare function does this, however, in a stylised way. It has been developed sufficiently well to provide a useful context for economic analysis, but it does not provide a very rich presentation of the included values, nor does it provide criteria for selecting any particular value system.[24] In the economic analysis of taxation, the use of a social welfare function permits the economic discourse to consider whether the requirements of economic efficiency are consistent with the requirements of what economics calls 'equity', and, if not, to consider the implications of the interaction of efficiency and equity. But it does not offer an analysis of the specific terms of equity, so equity tends to be seen as the secondary objective. Since equity is ill defined in the economic discourse, it is hard to state a case in this discourse for the importance of equity that can match the immediate apparent importance of efficiency.

This does not exhaust the list of discourses on tax that we may wish to identify, but I want to focus on one further discourse. There is also a policy discourse on taxation that is distinct from the others I have referred to, and in particular from the economic discourse. To understand how distinguishing a policy discourse can be useful, it is helpful to look further at the nature of discourses. The idea of treating discussions of tax as occurring within a variety of discourses can be seen as merely a heuristic device to provide a way of classifying or compartmentalising debates about tax.

The role of discourses in taxation

I suggest that it is more significant than that. The distinction is related to the concept of social discourses, in particular law, as autopoietic systems, elaborated

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[23] The two fundamental theorems of welfare economics explain the relationship between an economic system in competitive equilibrium and one at an efficient position in the sense of being Pareto-efficient. This is done without going beyond (or needing to go beyond) the concept of individual utility. A position is Pareto-efficient if no one can be made better off without anyone being made worse off; so it is a weak value concept. In particular, the theorems leave open the possibility that an economic system may have many possible Pareto-efficient equilibrium positions, each with a different distribution of resources. But, they provide no means to identify any one of them as preferable.

[24] The one partial exception is that there are circumstances where a particular value system, such as utilitarianism, is easily represented in a (measurable) social welfare function, and thus yields interesting results relatively easily. This is not an approach that can be especially appealing to anyone who is interested in the content of value systems.

by Luhmann, Teubner, and others.[25] This is a model in which separate social systems, such as law, operate in distinct linguistic frameworks. The result is that they operate as closed systems and develop self-reflexively through processes that are circular rather than hierarchical. Particular ideas (or rules or decisions, etc) develop from past ideas and with a view to the future development of future ideas, without any of them necessarily being 'higher' or the source of others; constitutional principles develop from particular legal decisions just as much as the reverse. The systems do interact within society, but each can only deal with the 'realities' presented by other parts of society by converting them into its own terms. Law can only deal with an event or concept or value set presented by economics or politics by understanding it in legal terms, and within its own operations the law is autonomous.[26]

Teubner argues the law faces challenges from economic, political, scientific, and moral theories that seek to impose their analytical systems as universal (as in the case of the economic analysis of law).[27] He presents an approach by which the legal discourse can be preserved as a system distinct from these external theories of law. His answer, drawn from an autopoietic perspective, is for law not to try to resolve the conflicts between the demands of these competing external theories, but to maintain them in conflict, referring to each of them in turn and recursively, but internalising the contributions in the terms of legal discourse and argumentation. The identification of discourses of taxation is sympathetic to Teubner's approach. The sort of maintenance of conflict or tension between competing analytical systems represents an acknowledgement of their importance, combined with recognition that they have distinct roles and objectives.

The policy discourse

For taxation the policy discourse is the context in which discussion of how the tax system should be structured or reformed takes place among legislators, administrators, and taxpayers. This appears to place it at the interface of the legal, economic, moral, and political discourses, but, at least in the context of taxation, it is helpful to consider it as a separate discourse with its own language. The policy discourse is where those with competing interests in the operation of the tax system, governments, taxpayers, and also legislators, tax advisers, and tax economists, set forth arguments in support of their interests and seek to control or influence the resulting structure of the tax system, as embodied in tax law.

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[25] *See eg* N. Luhmann, 'Law as a Social System' (1989) 83 *Northwestern University Law Review* 136, G. Teubner, *Law as an Autopoietic System* (Oxford: Blackwell, 1993).

[26] The cases where a particular value system, such as utilitarianism, is easily represented by economists in a (measurable) social welfare function can be seen as examples of autopoiesis at work: the economic discourse is only able to represent value systems by converting them into economic language and using them to make, not elements of value systems, but elements of economics. The process of conversion leaves a concept that may be scarcely recognisable by the social (or legal) philosopher.

[27] G. Teubner, '*Altera pars audiatur*: Law in the Collision of Discourses' in R. Rawlings (ed), *Law, Society and Economy* (Oxford: Oxford University Press, 1997).

In a sense this can be seen as a defective discourse: the participants are actors in a number of discourses. They present arguments derived from the language of their own discourses, but they may also adopt the language of another discourse. Thus a taxpayer may lobby using arguments couched in the language of economics, or law, or accounting. One of the difficulties of coherent policy-making for policymakers is to understand these external arguments within the policy discourse. In other words, these various external arguments have to be converted into a common linguistic context in order to construct a coherent policy out of them. This context is the policy discourse. The policies generated within this discourse will only be coherent in the sense that they will be expressed comprehensibly in terms of policy-making, from which they will in turn be translated into legislative action. This is a weak sense of coherence. It does not imply that the result will yield legal rules that will, for instance, show what Dworkin terms 'integrity'.[28] Nor need they look coherent as economic policy.

It may be objected that this looks more like an interaction between discourses than a discourse itself. In part this arises from the fact that the legislative process is first of all one where competing interests are resolved into adopted policy, and secondly where the policy is converted into legislation. The first part expresses the element of interaction that is indeed present, but the second part points out a different ambiguity. The conversion of policy into legislation sounds like an operation of the legal discourse,[29] but the resolution of interests into policy sounds like an operation of the political discourse. This ambiguity is, I suggest, the true reason why it is not necessary to be concerned about the presence of interactions. It is natural for a discourse to relate to other social activity by relations with a variety of other discourses.[30] In order to do so it must internalise what it abstracts from those discourses. This process requires not only that the abstractions be converted into its own linguistic terms, but also that their interactions must be resolved. The autopoietic approach argues that the resolution will be made using the limited set of concepts available within that discourse – the necessary result of the conversion process.

The role of the policy discourse in taxation

My concern is with the criteria available within the policy discourse. The policy discourse is obviously concerned with the issues of tax equity with which we are familiar: horizontal equity, vertical equity, and their extensions. But efficiency also enters the policy discourse. One has only to look at the policy debates in the US

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[28] R. Dworkin, *Law's Empire* (London: Fontana Press, 1986).

[29] Dworkin, ibid, 167, describes his principle of integrity as comprising a legislative and an adjudicative principle. Luhmann, n 25 above, includes the creation of legislation as part of the legal discourse. For present purposes it is more helpful to describe a separate policy discourse.

[30] Indeed, the strength of the argument of Teubner, n 27 above, is that the normal relation of a discourse to the rest of the social order involves interaction with a variety of other discourses, so that maintaining a tension between them would be a natural way for a discourse to internalise its relations with other discourses.

on international taxation, in which the interests of different parties are expressed in terms of CEN and competitiveness, to see the importance of efficiency in the policy discourse. In the policy discourse, however, we must understand efficiency as something different from the economic concept. The economic concept is essentially descriptive. It describes the result of the operation of a tax and the economic consequences of that result. This is important information, but we need to distinguish it from efficiency in the policy discourse.

The value of making this distinction can be seen from two examples given by Graetz.[31] He explains that, when business representatives argue in favour of a particular policy direction on the basis that they need it to maintain 'competitive advantage', they may be asserting various alternative economic arguments, but central to their argument is a claim about fairness. Similarly when Bill Clinton campaigned in 1992 for a policy to deal with the supposedly low level of taxes paid by foreign companies in the United States, according to Graetz the arguments for this policy were based in terms of fairness, rather than economics. If we understand these arguments as being made in the policy discourse, the matter becomes clearer. In the policy discourse the arguments are framed in a language of interests and fairness as between interests. Claims in such arguments framed in terms of economic concepts are not secondary, or concealing a parallel fairness argument. Instead the economic arguments should not be understood as being the same as economic arguments raised in the economic discourse. In the policy discourse economic concepts are foreign concepts that can only be understood in the language of policy, where the central concept is fairness.[32]

It follows that efficiency takes on a very different role in the policy discourse. It now explains when taxation gains legitimacy by minimising the distortion cost, ie when the tax system provides what might be called simply value for money. In this sense, from a policy perspective (as opposed to the perspective of the economist), the importance of efficiency (or its expression as a criterion for the structure of a tax system, neutrality) is as a fairness criterion. It follows that in the policy discourse the way to reconcile conflicting claims of efficiency and traditional tax equity (particularly redistributive equity) is in a context of fairness. The importance of efficiency here is that it explains effects of taxation (the costs of the distortions created by a tax, where the true burdens of the tax fall) that affect the fairness of taxation.

Here we have a reversal of the implicit hierarchy of criteria in the economic analysis of taxation: economics can acknowledge a role for equity, but, because economics cannot ascribe detailed content to equity, it has difficulty in identifying cases where equity considerations could appropriately dominate considerations of efficiency. In contrast, since the policy discourse concerns the process of balancing the claims of competing actors who are participating directly in the discourse, it is natural for the policy discourse to turn centrally on issues expressed

[31] n 3 above, 305-306.
[32] I am using fairness here in a substantive, rather than procedural, sense. 'Justice' would be a suitable alternative in legal discourse.

in terms of fairness, whether this is done explicitly or by using texts coded in the language of other discourses. Equity is easily understood as a fairness criterion. While efficiency can play a role as a fairness argument in the policy discourse, it does so, not by explaining what is fair, but by describing the extent to which a tax meets standards of fairness. In this structure efficiency may easily end up playing only a supporting role.

This description of the operation of the policy discourse in taxation is not meant to be an argument that we should from now on treat equity as dominating efficiency in matters of taxation. My argument is not that the real debate about taxation occurs in the policy discourse. It is rather that there are a number of discourses of taxation, and we can only understand the arguments about taxation by recognising that they are not all made in the same discourse. It is not that any one discourse is more valid than any other, but that the discourses are different. The discourses involve different activities. The distinction between them, and the limitations of the differentiated semantic sets of each of them are what make them effective in the conduct of these activities. However, these activities are not performed in isolation.

In taxation the legal, economic, and moral discourses are ways of describing the tax system just as much as the policy discourse is. The different operations that can be performed in respect of the tax system are performed within the appropriate discourse. In the argument of autopoiesis, each discourse develops by creating itself out of its own past (and future) statements and actions. However, the operation of policy-making takes place within (and defines) the policy discourse. It is in this sense that the policy discourse has particular relevance. Once again this does not make the priorities of the policy discourse 'superior', even for policy-making. But it does mean that they are the linguistic context in which policy is made.

THE SOURCE-RESIDENCE ISSUE

Three dimensions

Let us look at how distinguishing the policy discourse affects the question of the choice between the alternatives of source and residence taxation. The alternatives create choices along three different dimensions: fairness (between the taxpayer and the governments involved), administrative (in terms of the feasibility of (procedurally fair) collection), and allocative (between the governments themselves). All three are relevant to the formation of policy on the question. I will leave the administrative dimension to one side for now. It is now customary to start by proposing a form for the tax system before making statements about the feasibility of collection. It is only then that a recursive dialogue between the administrative and the other dimensions becomes necessary.[33]

The allocative dimension is the one reflected in the terms of double tax treaties. It involves a tension between allocating an 'appropriate' share of the total available revenues between countries and selecting a basis for the sharing that will be accepted as legitimate. Unless there is actual sharing of revenues between governments (whether directly or through an inter-governmental, supra-national, or federal body), this requires the adoption of bases of taxation that will both be fair to taxpayers and result in the agreed allocation of revenues.[34]

The first problem lies in defining a basis for the agreed allocation of revenue. Graetz and Avi-Yonah both make this explicit from different perspectives under the rubric of 'inter-nation equity', a term first proposed by Peggy Musgrave.[35] The difficulty is that this is where the national self-interest of governments makes itself felt. In situations where an actual sharing of revenue is not politically feasible (including nearly all international settings, and even to a large extent within the European Union), this self-interest will prevent there being any explicit agreement, and any implicit agreement will be hard for an external observer to identify. Indeed it will only be found in the expectations that the governments have as to the consequences of the agreed treatment of taxpayers. The changes resulting from globalisation represent a challenge because they threaten to undermine these expectations.

For the agreed treatment of taxpayers to be acceptable, it must be perceived as fair. Fairness will not merely depend on preventing double taxation (the single tax principle of Avi-Yonah)[36] because effective tax rates differ. The allocation of taxing authority between the governments must be perceived as being based on (and actually reflecting) an acceptable principle. Efficiency may be relevant in determining this, but, since the issue is framed in terms of fairness (being within the policy discourse), we must start by looking more generally at how the allocation can be fair to taxpayers.

Fairness in taxation: The participation principle

It is best to begin from the general principles of fairness in taxation, outside of the special context of international transactions. At the broadest level of classification two general principles of fairness in taxation are presented: the benefit principle and the ability-to-pay principle. Under the benefit principle the amount paid by a taxpayer to the state should reflect the amount of benefit the taxpayer obtains

[33] It may be argued that there was a time when this was not the case (and that it is not always the case today). A government (rule) with few choices may start by looking for a feasible revenue source before considering what arguments might give the choice legitimacy.

[34] As a result the agreed allocation will usually be (implicitly) a functional allocation, not an allocation of a specific percentage.

[35] Graetz, n 3 above, and Avi-Yonah, n 1 above. *See* P.B. Musgrave, 'International Tax Base Division and the Multinational Corporation' (1972) 27 *Public Finance* 394.

[36] R.S. Avi-Yonah, 'Tax Competition, Tax Arbitrage, and the International Tax Regime' (2007) 61 *Bulletin for International Taxation* 130.

from the state. Under the ability-to-pay principle, the amount paid by a taxpayer should reflect the amount of the taxpayer's resources, measured by income, wealth, consumption, or whatever metric is considered appropriate. In discussions of taxation in the domestic sphere the benefit principle is usually considered to be inappropriate as a foundation for general taxation. This is both because it is often, as in the case of many public goods, very difficult to determine separately the amount of the benefit that each person receives from the state, or because of the distributive effects of benefit taxation. Some version of the ability-to-pay principle is thus typically used for general taxation.[37]

The problem with the ability-to-pay principle, however, is that it decouples a person's obligation to pay tax from the level of benefit received from government spending. Of course, this is in fact the objective of the ability-to-pay principle: it says that benefits from the state provided out of general taxation should be available to all, instead of being priced to each citizen. This may be because of the public goods problem, or it may be because the benefits are explicitly intended to redistribute resources between citizens, as in the case of welfare payments and other subsidies. This is an important point because the problems that the mobility of capital and tax competition can create are closely related to this problem with the ability-to-pay principle.

When we come to the international setting we find that, curiously enough, the benefit principle seems to take on new life. Thus Avi-Yonah first suggested that source taxation (of corporations) is founded on the benefit principle,[38] and he has since gone on to describe the 'benefits principle' as one of the two norms, along with the single tax principle, underlying the international tax regime.[39] In order to understand the extent to which the benefit principle can have an international role, it is necessary to reassess the relationship between benefit and ability-to-pay.

I suggest that the answer is that ability-to-pay is itself really a form of benefit principle, but it is one where the relationship between the amount of the tax paid and the amount of the benefit received is subtler than in the case of the traditional benefit principle. Instead, there is effectively a social agreement that the appropriate price for a person to pay for the whole of general government services, including redistribution, is the amount determined by measuring ability to pay. Or to put it another way, the appropriate measure of the total benefit received from general government services is taken to be the amount of the tax due on the basis of ability to pay.

This argument consists of more than just a rearrangement of terms. Take the most problematic element of general government services: redistribution. If there is a social consensus that redistribution is legitimate, that must include a general

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[37] Libertarians, or neo-libertarians such as Nozick, may favour benefit taxation, but only because their limited view of the legitimate role of the state means that there is little role for general taxation, so the problems of benefit taxation are largely avoided.
[38] n 1 above.
[39] n 36 above.

acceptance that redistribution has a social value beyond merely the value to those directly receiving the benefits of redistribution.[40]

When we turn to consider the international situation, we have to ask who are those who are receiving the accepted benefits of general government services (and who may be assumed to accept at least the legitimacy of this measure of benefit). The answer must be, those who are participating in the life of the country operating under this government, that is the residents, citizens, or others with a similarly close and active connection to the country. This in turn suggests that the ability-to-pay principle requires residence-based taxation.

To recapitulate: my argument is that the ability-to-pay principle is really an extended benefit principle in which benefit is given an extended meaning so that it can apply to the benefits derived from such government services as public goods and redistribution. Ability to pay is the measure of this extended benefit as accepted by social agreement. For convenience I shall call this extended benefit principle the 'participation principle'. It follows from this conclusion that general taxation, such as income taxes, is justified by this participation principle. Ability-to-pay provides the basis for determining the amount of a taxpayer's liability, but this is an application of the participation principle. The participation principle also tells us whose ability to pay is relevant: we need merely determine who has sufficient participation in the country.

Under the standard allocation of taxing jurisdiction between countries, as embodied in the OECD model double tax treaty,[41] the right to tax business profits earned through a permanent establishment, wages and salaries earned by an employee who works in a country for more than six months,[42] and income and gains from land located in the country is allocated to the country of the source of these items of income.[43] There are also limited rights to tax investment income, effectively by means of withholding taxes. Apart from the withholding taxes, the allocation criteria are essentially criteria measuring degrees of presence or participation within the country, so they can be seen as applications of the participation principle. Under this interpretation, they are criteria for determining the degree of connection that the taxpayer has to the host country, so as to determine whether that taxpayer is to be taken to receive enough benefit from

[40] I suggest that it is sufficient if there a consensus that redistribution has legitimacy and reasonably widespread agreement that redistribution has social value. In other words, those who may not agree that redistribution has social value nonetheless accept that there is wide enough agreement to the value of redistribution to give it legitimacy, and they will accept that they are expected to abide by the implications of the social value of redistribution – such as redistributive taxation. We can then say that there is a consensus that redistribution is accepted to have social value. I leave aside the question of the extent to which, under these conditions, redistribution may also be considered to be just.

[41] Organisation for Economic Cooperation and Development, *Model Tax Convention on Income and on Capital* (Paris: OECD, 2003) (hereinafter OECD Model).

[42] These allocations are based on the location of the permanent establishment and the location of the place where the employment is exercised. *See* OECD Model, n 41 above, arts 5, 7, and 15 for the precise conditions.

[43] I ignore the more specialised sources of income, such as aircraft and shipping income.

general government services so as to be obliged to pay the share of the cost of those services, measured by the taxpayer's ability to pay.

In other words, these allocations of taxing authority are really allocations on an extended residence basis, even though they are normally thought of as prime examples of source taxation.[44] The only difference is that, since they are cases where the taxpayer has only limited participation in the country, the taxpayer bears only a limited burden. Equally, such taxpayers would normally have only a limited right to help determine social consensus on which the level of general government services and the measure of ability to pay are based.

The participation principle is superficially similar to Avi-Yonah's benefits principle;[45] however, his principle is an attempt to encapsulate the allocation of jurisdiction between source and residence jurisdictions under typical double tax conventions, and in particular the OECD Model. He offers four normative justifications of the principle, but only one of them reflects the traditional benefit principle (that the amount of tax due should reflect the amount of benefit the taxpayer gets from the State). The others offer further attractive explanations of why this allocation makes sense, but cannot be said to appeal to theoretical foundations.[46] On the benefit side, he argues that source taxation of business activities is appropriate, since businesses benefit from a significant portion of government infrastructure and other spending in a jurisdiction; thus they should bear some of the cost through taxation. Note that this is not a traditional benefit tax argument, since the benefit to the business is not quantified, nor indeed quantifiable. Thus the nominal connection between Avi-Yonah's benefits principle and the traditional benefit principle of taxation is limited, and the former might be better called the 'active / passive allocation principle'.

In contrast, the objective of the conclusions I have reached above is to help us understand the basis of international taxation in terms of fairness at the level of taxpayers. Thus, I argue that we really have only two fairness grounds for taxation: the traditional benefit principle and the participation principle, which manifests itself domestically as ability-to-pay. The participation principle can justify much of what is traditionally termed source taxation, if we understand it as really being an extension of residence taxation.[47] In contrast the fairness basis for taxing

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[44] As a result of this conclusion, I will use the term 'host country' to describe the country where such incomes are earned.

[45] n 36 above.

[46] The other justifications are: that the division between active and passive income aligns roughly with the division between corporate and individual income tax, and it is easier to tax multinational corporations on a source basis while taxing individuals on a residence basis; that the division is pragmatic, since countries will inevitably seek to tax their domestic sources, but in practice cannot tax passive income at source; and that the division fits with the single tax principle because individual income tax rates vary greatly between countries, which is acceptable for a residence-based tax, while corporate tax rates are much better aligned and below the top individual rates.

[47] The conclusion that these taxes are a type of extended residence-based taxes rather than source taxes applies within this policy discourse. They can still be described as source taxes in, for example, the

investment income at source becomes less clear. The sort of intangible investments that give rise to such income involve little presence or participation in the host country. It is hard to argue that a bondholder receives much of even an indirect benefit from the general government services provided in the country where the debt happens to be legally located. To see this it is only necessary to consider how easily the bondholder could earn virtually the same return under virtually the same conditions in the form of an investment in another country.[48]

The implications of this are particularly serious for what is seen as the typical developing country preference for the international allocation of taxing jurisdiction. This extends the definitions of the typical source categories, sometimes in ways that go beyond what can be explained by the participation principle.[49] On the other hand, the participation principle does offer a way of opening up the policy discourse on international taxation in directions that avoid the unsatisfying CIN / CEN trade-off. It suggests that we want to ask what is the nature of the participation by FDI in developing countries in the digital age – what level of participation is required to justify taxation by a host country? Before turning to that question, however, it will be helpful to examine the more general question of how this analysis relates to our understanding of the effects of globalisation on taxation in terms of tax competition.

GLOBALISATION AND TAXATION

THE NATURE OF THE CONCERN

I began by characterising the standard description of the effect of globalisation on taxation as 'pessimistic'. This is on the grounds that it appears to be imposing increasing constraints on the ability of governments to impose the taxation that they consider appropriate. Where these governments are democratic, this appears to be a constraint on the democratic consensus. Of course, this is not a bad thing

economic discourse, where the concerns are with identifying economic flows between countries, rather than on understanding the fairness basis that legitimises particular taxes.

[48] The participation principle can be used to support worldwide residence taxation. That would include residence taxation of investment income. It might be argued that international withholding taxes levied at source as an enforcement measure would be appropriate to preserve the fairness of the ability-to-pay measure employed by the taxpayer's country of residence, but the withholding taxes that normally arise in international taxation are allocated to the source country. However, the exception of division of the withholding taxes levied under the EU Savings Directive (Council Directive 2003/48/EC of 3 June 2003 on Taxation of Savings Income in the Form of Interest Payments, [2003] OJ L 157/38, at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2003:157:0038:0048:en:PDF> (last visited 9 August 2009)) between the source and residence countries shows that there can be realistic alternatives.

[49] One example is the use of the 'force of attraction' principle instead of 'effective connection' to extend the range of income taxable in the host country as a result of the presence of a permanent establishment. Force of attraction can bring into tax all income arising in the host country, even if there is no connection between the permanent establishment and the income. This seems a poor measure of the proportion of ability-to-pay that ought to be attributed to the limited use of general government services by the taxpayer.

from the libertarian or the neo-libertarian perspective, which does not see sufficient value in what I have termed general government services to justify the imposition of significant taxes on the participation principle. It may also not be a bad thing from the perspective of the public choice school, which sees even democratic governments as Leviathans, having the goal of maximising their own size, and being able to grow to a size greater than that which is socially optimal and would be chosen by a truly independent democratic consensus.[50] The libertarian perspective sees virtually any reduction in taxation and government spending as desirable, because of its view about the appropriate, minimal size of government. The public choice perspective may often be espoused by people who are ideologically sympathetic to the libertarian or neo-libertarian perspective, but it is essentially a procedural or process-based view. It maintains that governments are able to grow to a size larger than the optimal, but without itself specifying what the optimal size is. Strictly speaking public choice theory should only require that governments be constrained to their optimal size, but this often begs the question of how that optimum can be determined.

The argument about the effect of globalisation on international taxation depends crucially on two elements. One is that there is a force of tax competition in operation that will inevitably drive down effective tax rates in the face of mobile capital. The other is that capital is, indeed, as mobile as is suggested. Effective tax rates on income from capital will only inevitably be driven down to zero by tax competition if capital is fully mobile, or virtually so. If capital is not fully mobile, merely highly mobile, then even if there is tax competition, tax rates may go down, but not to zero.

THE MOBILITY OF CAPITAL

Mobility as lack of cost

Let me consider the second point briefly. I would like to explain it in slightly different terms from those usually used. The key to this is to ask what is mobility. What do we mean when we say that capital is mobile? As I have argued previously, to say that capital is mobile means that it can move between jurisdictions without cost.[51] So capital becomes more mobile if it can move at a lower cost than before. We may want to think of a tax as a cost, at least in certain circumstances.[52] Globalisation means that other costs of moving capital have fallen. This makes any tax cost more important in determining where capital will be invested, since the tax cost will more often be what determines where the best return on an investment can be obtained. If capital is fully mobile, then the tax cost will be the only cost. In this case a country that imposes a higher tax cost will lose investment

[50] The classic statement of the Leviathan model is G. Brennan and J.M. Buchanan, *The Power to Tax: Analytical Foundations of a Fiscal Constitution* (Cambridge: Cambridge University Press, 1980).
[51] I. Roxan, 'Assuring Real Freedom of Movement in Direct Taxation' (2000) 63 *MLR* 831.
[52] Following Roxan, ibid, 843-846, in many cases it will make more sense to think of a tax as an incentive.

to other countries, putting pressure on it to reduce the tax. This is tax competition. However, when tax is only one source of the variation between the returns on different investment, it is unclear that tax will be a sufficiently important source of variation for there to be any strong tax competitive pressure. So the degree of mobility matters.

Costs determine the degree of mobility. This includes taxes that operate as costs. But increased mobility increases the responsiveness of actors to incentives – including taxes that operate as incentives. This yields a paradox: reducing tax costs increases the competitive influence of tax incentives. Does it also follow that reducing tax subsidies reduces the effect of tax incentives? That depends on the effect of subsidies. If costs are an obstacle to migration, are subsidies an obstacle to remaining? Is this different from distorted incentives because of the asymmetry that those who arrive are present on more favourable terms than natives – ie the ring-fencing problem?

Variations in the mobility of capital

Without going into the evidence that there is, which is not always particularly conclusive,[53] I suggest that it is clear that, at the very least not all capital is equally mobile. Some types of financial capital – the instruments traded on international securities exchanges – are highly mobile. At the other extreme, major investments in real productive facilities will be much less mobile, at least in the short run. Moreover, nearly all investments are risky. While some elements of risk are common to related investments (for instance investments in one industry, country, or type of instrument), another part will be particular to the individual investment. This means that, even if the markets for the most mobile financial investments determine a basic world interest rate, the market rates of return on individual investments will still show substantial variation. In addition, understanding the risk of a particular investment can be costly. As a result, it is not hard to see that there are, in practice, some real limits to how much mobility globalisation generates.

TAX COMPETITION

The concept

At the centre of the question of whether the standard description should be seen as pessimistic lies the question of whether tax competition is desirable. Or is it desirable in some circumstances but harmful in others, as the OECD and EU initiatives have maintained?[54] Part of the problem comes from the name, tax

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[53] A. Haufler, *Taxation in a Global Economy* (Cambridge: Cambridge University Press, 2001) discusses a number of econometric studies. *See also* J.D. Wilson and D.E. Wildasin, 'Capital Tax Competition: Bane or Boon' (2004) 88 *Journal of Public Economics* 1065.

[54] Organisation for Economic Co-operation and Development, *Harmful Tax Competition: An Emerging Global Issue* (Paris: OECD, 1998); Council of the European Union, 'Conclusions of the ECOFIN Council Meeting on 1 December 1997 Concerning Taxation Policy – Resolution of the Council and the Representatives of the Governments of the Member States, Meeting within the Council of 1 December 1997 on a Code of Conduct for Business Taxation – Taxation of Saving', [1998] OJ C 2/1. Two recent

competition. Competitive markets are supposed to be efficient, so surely tax competition must be a good thing. The name, however, belies the question of the nature of the competition that is taking place here, and whether there is a true competitive market. To attempt to shed some new light on this question, it will be helpful again to distinguish between the economic and policy discourses.

Conceptually the problem with the idea of tax competition is that the phrase implies that it reflects the operation of a competitive market in taxation. If that is so, what is being sold, who is selling, and who is buying? Taxpayers pay something. Is this the price of some product? The participation principle implies that that is exactly the case: taxpayers are paying for the opportunity to benefit from general government services, or to put it rather more precisely and correctly, for the opportunity to benefit from the social consensus as to the provision of general government services. The difficulty is that this story falls apart when we look at the element of taxation most vulnerable to the supposed effects of tax competition: taxes on highly mobile financial capital. The mechanism of tax competition is the ability of the taxpayer to shift income to another taxing jurisdiction with lower effective rates. However, income from financial capital, in part because of its very mobility, does not appear to involve the sort of degree of participation in the country where it is invested that would justify its taxation there under the participation principle. Indeed the justification for at least the core of general government service provision is that these are services (public goods or redistribution) that cannot be provided through a competitive market mechanism. In other words, while the participation principle provides a good explanation of the legitimacy and fairness of general taxation to pay for socially desired general government services, by its very nature it does not imply the existence of a competitive market.

This argument can also be put in more traditional terms. A standard justification that is offered for the proposition that tax competition is economically efficient is the Tiebout hypothesis.[55] The hypothesis says that, if there are a large number of communities offering different mixes of public expenditure, and individuals can move freely, then they will move to communities offering mixes that suit their preferences in a way that will be efficient.[56] With certain assumptions the hypothesis can easily be extended to taxation, but the assumptions required are precisely the problem.[57] In particular the hypothesis does not apply here because of the disjunction between tax paid and benefit received

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theoretical approaches that confirm this can be found in A. Haufler, A. Klemm, and G. Schjelderup, 'Redistributive Taxation, Multinational Enterprises, and Economic Integration' (2008) 24 *European Journal of Political Economy* 249; and E. Janeba and G. Schjelderup, 'The Welfare Effects of Tax Competition Reconsidered: Politicians and Political Institutions' (2009) 119 *Econ. J.* 1143.

[55] First expounded in C. Tiebout, 'A Pure Theory of Local Expenditure' (1956) 64 *Journal of Political Economy* 416.

[56] Moreover, this applies even if voting for elected representatives gives too little information about specific voters' preferences for public expenditure on particular items.

[57] Stiglitz, n 4 above, 736.

when only income moves. This is most notably a problem where the government engages in redistribution.

Another approach is to consider the nature of the obligation to pay tax. This obligation can be seen as a condition on the right to earn the income subject to tax. This brings us close to Nozick's neo-libertarian view of taxation as forced labour.[58] Since Nozick denies that the benefit that the individual taxpayer receives from general government services can be sufficient to justify the forced taking by taxation, this does not seem to be a very helpful approach outside of the neo-libertarian perspective.

Given the difficulty of identifying a market in taxation, how can any sort of tax competition be seen as efficient in the economic discourse? The answer lies in the economic distinction between competition and efficiency. For an economist tax competition involves governments competing for tax revenues in the general sense of setting tax rates so as to obtain tax revenues that might otherwise go to other governments setting more favourable rates. Where it is seen as having economic virtue, that virtue is efficiency, not operation on a competitive basis. For an economist efficiency is Pareto-efficiency. An outcome is Pareto-efficient, if there is no other feasible outcome under which everyone would be at least as well off as under the first outcome, and at least one person would be better off.[59] This is a concept that is strong in that it is largely independent of any value system,[60] but weak in that, concomitantly, it can easily result in outcomes that are not very attractive under any value system,[61] and in that it sets a standard that is difficult to attain.

Thus the policy intuition that tax competition is good because it subjects governments to the forces of competition, in the sense of a competitive market, represents a misapprehension as to the nature of tax competition. On the other hand, for the economist there is an element of interest in tax competition that is related to the idea underlying the competitive market: decentralisation.

The importance of markets, and the price mechanism by which they operate, comes from the insight that can be traced back to Adam Smith. Through what Smith called the 'invisible hand', competitive markets yield an efficient outcome without needing any co-ordination from government or elsewhere to ensure that appropriate prices are chosen. This can also be described as the decentralisation of decision-making to the individual actors in the market. The interest in tax competition as a potentially positive force lies in the extent to which decentralised behaviour on the part of governments can yield an efficient outcome. In a competitive market individual buyers and sellers treat prices as given. In the case of tax competition, governments actively set tax rates, so this does not look like

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[58] R. Nozick, *Anarchy, State and Utopia* (Oxford: Blackwell, 1974).

[59] H.R. Varian, *Microeconomic Analysis* (New York, London: W.W. Norton, 1978).

[60] It has an individualistic basis, but, since it can also be applied to the behaviour of individual governments, that is less of a limitation than it appears.

[61] Varian, n 59 above, 145 gives the example of an allocation where one person gets everything, and everyone else gets nothing. This is Pareto-efficient because the person with everything will get less under any other allocation.

the result of perfect competition. If there is no collusion or co-operation between governments, there can still be an equilibrium position. If countries are small, and capital is perfectly mobile, savers and investors all face a world net rate of return on capital. Taxes on capital only affect the gross rate of return. This means that owners of capital do not bear the burden of a tax on capital (even domestic owners of capital). Instead the tax is shifted onto immobile factors (labour or land). This is similar to a competitive equilibrium in the sense that it is decentralised: the taxation decisions of one government are taken independently of any other government; but it is not optimal. If the countries are relatively large, any equilibrium will typically be a Nash equilibrium,[62] or the result of some other n-player game. Its efficiency is not, therefore, a foregone conclusion.

The problem with the non-cooperative equilibrium derives from the fact that each government sets its tax rates in order to maximise the benefit for its own country. Higher tax rates on capital income in one country (country *A*) induce some (mobile) capital to migrate to other countries. However, this increases the tax revenues and income for a receiving country (for example, country *B*). This benefit to *B* is described as a positive externality benefiting *B*. Because the government of *A* does not take the benefit of this externality into account in setting its policy, it overstates the net cost of the higher tax rate in global terms. As a result it tends to set a tax rate that is below the global optimum level, and tax rates generally tend to fall below their globally optimal levels.[63] The important corollary of that is that it may be possible for governments to eliminate this distortion through co-operation or co-ordination, possibly through actions by a higher level of government.[64]

From a policy perspective it is useful to look further at the nature of the benefit to country *B*. If country *A* were in a position to take into account the additional revenue that that country *B*'s government now earns (because its tax base has increased), it would maintain the level of its general government services. Since it is not, it will provide less than the optimal amount of such services.[65] Now consider the implications from the perspective of the taxpayer. The relative shortfall in the level of general government services is spread among all citizens, but the loss of tax base benefits only those taxpayers who have moved capital abroad. If the benefit arises as the result of the movement of (financial) capital, we can assume that such a taxpayer is making the same level of use of general government services in country *A* as before, so the taxpayer is paying less than the

[62] *See* n 15 above.
[63] This result is due classically to G. Zodrow and P. Mieszkowski, 'Pigou, Tiebout, Property Taxation and the Underprovision of Local Public Goods' (1986) 19 *Journal of Urban Economics* 356. *See* J.D. Wilson, 'Theories of Tax Competition' (1999) 52 *National Tax Journal* 269.
[64] These effects were first discussed in the context of a federal state, such as the US, but they also apply internationally or to regional groupings of countries such as the EU.
[65] Assuming that the government is not a self-serving Leviathan, this is also the socially desired amount.

accepted ability-to-pay measure of tax in respect of her total income.[66] Thus another way of describing the problem is that under tax competition owners of mobile capital are able to benefit from the social arrangements in their country supported by general government services without paying the socially agreed cost. This separation of taxation and the provision of general government services is central to the problem of inefficient tax competition.[67]

The problems are exacerbated where the government services include redistribution. Where perfect mobility of capital shifts the burden of capital taxes on labour, there is a further problem when those earning largely labour income are generally less well off than those earning largely income from capital. In this case the government policy is undermined both by the loss of tax base and by the shifting onto the immobile factor.

Good and harmful tax competition

The basic model of tax competition is that it creates distortions, ie inefficiency, making it economically bad. Further economic research has made this picture much less clear. First of all factor mobility may give rise not only to tax competition but also to tax export. If some land or other natural resources (immobile factors) in a country are owned by persons in another country, some of the burden of any tax increase will be passed on to these non-residents, this time creating a negative externality in the other country. This time the government, again ignoring the externality, underestimates the impact of the tax. Taxes and general government services end up at a higher level than is efficient. The tax export effect can offset the effect of tax competition.[68]

Apart from this, recent research has examined a number of ways in which tax competition itself can either contribute to social welfare (in the economic sense) or detract from it.[69] A key issue is the motivation of governments. In the traditional Pigovian economic model the government is assumed to be selflessly interested solely in improving social welfare. In contrast, a 'Leviathan' motivation results in wasteful or excessively large government that is itself a distortion. Tax competition may tend to correct this, even if it does not do so in a very exact way.

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[66] This assumes that the taxpayer is no longer paying (the full rate of) country *A* tax on the income. This may be because *A* uses the exemption method of double tax relief, or because the taxpayer's investment has been structured to avoid country *A* tax, for instance through a foreign corporation that enables the taxpayer to benefit from deferral of country *A* tax. S. Bucovetsky and A. Haufler, 'Tax Competition When Firms Choose Their Organizational Form: Should Tax Loopholes for Multinationals be Closed?' (2008) 74 *Journal of International Economics* 188 note that this is why the literature tends to assume that corporate income is in effect only taxed at source.

[67] This is a feature that distinguishes capital tax competition. The Tiebout hypothesis is based on actual migration of citizens, so it does not involve any disjunction between costs and benefits.

[68] For a survey that identifies these two effects as central to the tax competition debate see C. Fuest, B. Huber, and J. Mintz, 'Capital Mobility and Tax Competition: A Survey' (2005) 1 *Foundations and Trends in Microeconomics* 1, at <http://ssrn.com/abstract=415042> (last visited 11 August 2009). It is also possible to identify a terms-of-trade externality that arises when tax changes in a large country can have an effect on the world interest rate. This externality will encourage a capital importing country to adopt higher taxes on capital, but will encourage a capital exporting country to adopt lower taxes, so it may either offset or complement the effect of tax competition. *See* Haufler, n 53 above, 33.

[69] This discussion largely follows issues highlighted by Wilson and Wildasin, n 53 above.

It may, however, also increase the size of government because of a positive effect on demand for public goods. Tax competition can also correct other more wasteful distortions, for instance by replacing export subsidies. Tax competition may also interact with risk. Increased mobility of capital can reduce the risk associated with income from capital. This can reduce the need for social insurance. On the other hand, increased mobility of capital may also increase the risk associated with labour income or earnings from trade, leading to demand for increased social insurance. Tax competition would then be harmful because it would limit the ability of government to respond to those demands.

Another issue concerns the relative effects of tax competition on financial capital as opposed to 'real' or 'physical' capital. Government initiatives, such as the OECD's 1998 *Harmful Tax Competition* report,[70] have tended to distinguish between tax competition in respect of the two. Tax competition in respect of financial capital is typically seen as being the more serious of the two because financial capital need have very little 'real' connection with the jurisdiction where it is legally located (and which is treated as the 'source' of income from that capital for tax purposes). 'Tax havens' can thus attract such capital with offers of virtually zero tax rates at little cost to themselves, since the 'presence' of such capital imposes little marginal demand on the general government services provided by the haven.[71] Physical capital, such as manufacturing production, or even active financial services, such as advisory investment banking, involve a physical presence with demands upon general government services. On the one hand this seems to be less mobile (there are costs to moving a physical operation), while on the other hand the demand for general government services implies a limit on the extent to which governments can engage in highly aggressive tax competition.[72] In contrast Michael P. Devereux argues that tax competition in respect of physical capital should be seen as more serious precisely because of its physical presence. The physical presence implies that distorting its location through tax competition will have more serious distortionary effects on the economy than distorting the location of low-impact financial capital.[73]

Economics has traditionally defined capital to mean goods and services used in production. In this sense financial capital is not capital at all, but funds to pay for investment in economic capital. Nevertheless, those providing the funds require that the economic capital produce a sufficient return to remunerate them adequately for providing the funds. Into this picture comes the concept of the firm, an economic concept informed by the modern corporation. The firm is the

[70] n 54 above.

[71] There must, of course, be some presence, or there would be no advantage in attracting the capital. The presence may be felt in terms of (limited) employment opportunities and, typically, in the form of corporation registration fees, which are in effect extremely low taxes.

[72] A related test is that of no 'ring-fencing', which insists on a rule of non-discrimination in the taxation of incoming income from capital.

[73] *See eg* M.P. Devereux, R. Griffith, and A. Klemm, 'Corporate Income Tax Reforms and International Tax Competition' (2002) 17 *Economic Policy* 449.

actor that engages in production. It is therefore firms that use economic capital. The funds to purchase the capital (to invest) are seen as coming from the savings of the personal (household) sector. It is thus easy to see the firm as a type of generalised corporation. Devereux uses this to model the distinction as being between finance (portfolio investment) provided by individuals and investment in physical capital (direct investment) conducted by firms.[74] The distinction between personal and corporate income taxes is relevant to this distinction between types of capital.

At heart the linguistic problem appears to arise from the fact taxes on the return on funds for investment are described as taxes on income from capital, and the legal classification has transferred to the economic discussion. Other authors, including Janeba and Haufler,[75] have distinguished the mobility of (financial) capital from the mobility of firms. This is essentially equivalent to Devereux's distinction, given the nature of the economic firm. A distinction can then be made between taxes on (income from) capital and taxes on profits. In these models firms have firm- (or location-) specific costs and have the possibility of earning economic rents.[76] In contrast to the standard tax competition model, the government may well be able to tax the rents successfully, even when (financial) capital is fully mobile. The rents may be due to a favourable mix of public goods and services provided by the country's government. In this case the profits tax becomes a general benefits tax where the measure of the benefit is rather more direct than being a measure of social benefit in the form of ability to pay. Indeed, the tax becomes a true benefit tax in fairness terms, even though it is probably not possible to measure the benefit directly. Moreover, in this sense it is really not different from a zero rate tax, if we look at it in terms of the amount of tax net of the public infrastructure benefit to the firm. Janeba concludes that the addition of firm mobility with imperfect competition makes it possible to reach a second-best equilibrium in taxation, because the need to engage in wasteful subsidy competition is eliminated.[77] The condition is that the taxes be non-discriminatory. Wooders and Zissimos go further and look explicitly at the impact of governments offering different sets of amenities. They conclude that, not only is the result inefficient in the absence of co-operation between government, but also it is likely to be unstable.[78]

These considerations suggest that tax competition in respect of physical capital is distinctly different from that for financial capital. There appear to be

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[74] M.P. Devereux, 'Issues in the Taxation of Income from Foreign Portfolio and Direct Investment' in S. Cnossen (ed), *Taxing Capital Income in the European Union: Issues and Options for Reform* (Oxford, Oxford University Press, 2000). *See also* M.P. Devereux and R. Griffith, 'The Impact of Corporate Taxation on the Location of Capital: A Review' (2003) 33 *Economic Analysis & Policy* 275.

[75] E. Janeba, *International Tax Competition* (Tübingen: Mohr Siebeck, 1997); Haufler, n 53 above.

[76] Economic rents are profits beyond the market rate of return that are explained by factors uniquely available to that firm / location.

[77] E. Janeba, 'Tax Competition in Imperfectly Competitive Markets' (1998) 44 *Journal of International Economics* 135.

[78] M. Wooders and B. Zissimos, 'Hotelling Tax Competition' (CESifo Working Paper no. 932, 2003), at <http://www.cesifo-group.de/DocCIDL/cesifo_wp932.pdf> (last visited 15 April 2011).

arguments for concluding that physical capital is less mobile than financial capital and has more location-specific features. In addition, since those location-specific features include relevant provision of public goods and services, the disjunction between taxation and benefit that characterises financial capital tax competition is at least reduced in the case of physical capital. Janeba's conclusion on non-discrimination also appears to support the concern with ring-fencing.[79]

THE INEVITABILITY OF TAX COMPETITION

We have the impression that there is tax competition because statutory tax rates have fallen over the last few decades. Governments discuss the pressure they feel under.[80] Business representatives seek to influence government policy by describing how tax changes will affect their location decisions.[81] The impression that these stories leave is not, however, necessarily evidence of true tax competition. In true tax competition, governments adjust tax rates (and other elements of the tax system) in response to the migration of mobile factors of production. It is a behavioural response to economic circumstances. The suboptimal tax rates and underprovision of general government services in the Zodrow-Mieskowski model follow from the assumption that governments (inevitably) behave in this way. But this is an assumption. Other explanations are possible.

Types of tax competition

Besley and Case apply Shleifer's concept of 'yardstick competition' to taxation between jurisdictions.[82] This is an approach that takes a middle line between the Pigovian view of benevolent government and the public choice view of government as Leviathan composed of self-serving politicians. Here the assumption is that there are both selfless and self-serving politicians ('good' and 'bad'), but voters cannot easily distinguish them. Instead voters evaluate the behaviour of the government by comparing its performance to that of governments in other countries. If the voters see that the local tax rates are out of line, they may interpret that as an indication that their government is following

[79] n 77 above. E. Janeba and M. Smart, 'Is Targeted Tax Competition Less Harmful Than Its Remedies?' (2003) 10 *International Tax and Public Finance* 259 examine when restricting tax preferences is welfare enhancing. Their results are interesting and appear consistent with the discussion here, but they do not provide conclusive policy advice.

[80] *See eg* Inland Revenue, 'UK Welcomes OECD Report on Progress in Identifying and Eliminating Harmful Tax Practices' (Inland Revenue News Release no. 110/00, 26 June 2000).

[81] *See eg* N. FitzGerald, 'UK Must Leave Out a Welcome Mat for Investors' (9 September 2003) *Financial Times*, 19; B. Sherwood and V. Houlder, 'WPP Chief Warns on Tax Plans' (6 October 2008) *Financial Times*, at <http://www.ft.com/cms/s/0/fe4dc7ba-932d-11dd-98b5-0000779fd18c.html?nclick_check=1> (last visited 10 August 2009).

[82] T. Besley and A. Case, 'Incumbent Behavior: Vote Seeking, Tax Setting and Yardstick Competition' (1995) 85 *American Economic Review* 25. *See* A. Shleifer, 'A Theory of Yardstick Competition' (1985) 16 *Rand Journal of Economics* 319.

inappropriate policies, and vote accordingly. This resulting pressure is a political pressure. The governments may be unaware of any direct economic pressure, which would be felt through changes in tax revenues.

Besley and Smart look at the effects of both true tax competition and yardstick competition.[83] When there are both good and bad politicians, elections create two types of beneficial effect: selection gives voters the chance of replacing bad politicians with good ones, provided that they have sufficient information to distinguish them; elections also provide discipline since in certain circumstances bad politicians facing election will behave as a good politician might, limiting the amount of 'wasteful' (diverted) government spending. Besley and Smart surprisingly conclude that, under both types of competition, voter welfare is more likely to be improved by competition between jurisdictions if most politicians are of the good type. Briefly, this is because the greater information that competition gives voters (improved selection) is at the cost of a reduction in the discipline imposed on bad politicians. When most politicians are bad, information is of little value in selection because the chances of being able to bring more good politicians into government are low. Depending on the relative weights of these effects, competition of either type can either increase or reduce voter welfare. It seems from their discussion that there are more circumstances where true tax competition is likely to be welfare-reducing; however, it does not necessarily follow that those cases are more important. In the cases where competition of either type increases voter welfare, it does so at the cost of increased wasteful spending, which is again contrary to the usual intuition of the pure Leviathan model.

This model further shows how difficult it can be to derive unambiguous results about the net effects of tax competition, but it also shows that yardstick competition is a credible explanation of how governments may actually be behaving,[84] and suggests how difficult it can be to distinguish the two forms of competition. The matter is further complicated by the fact that, as Professor Besley has pointed out, in some cases what looks like tax competition can simply be a reflection of common intellectual trends. An example is the move to reduce statutory rates and broaden tax bases that was begun by Reagan in the United States and Thatcher in Britain. Countries adopted that approach first of all because it appeared to make economic sense, as a way of reducing the distortion caused by income taxation without reducing revenues, and even in the hope of increasing them. The spread was the result of the force of the intellectual argument.

The true (usual) sense of tax competition is the case where governments change tax rates in reaction to changes in the tax base resulting from the behaviour of (some) taxpayers (rather than governments or voters). This is the

[83] T. Besley and M. Smart, 'Does Tax Competition Raise Voter Welfare?' (CEPR Discussion Paper no. 3131, 2002), at <www.cepr.org/pubs/dps/DP3131.asp> (last visited 15 April 2011).

[84] Besley and Smart, ibid, refer to a number of studies in both the United States and Europe that have found evidence of yardstick competition.

same type of behaviour as seen operating in private sector markets. That is to say, it involves the operation of price mechanisms on tax systems.[85]

Is there evidence of tax competition?

The problem remains that, if we try to measure tax competition, it is very difficult to know whether we are measuring true tax competition of this type, or rather a form of yardstick competition, or even intellectual trends. As Wilson and Wildasin discuss, few of the studies that have attempted to measure whether there are significant effects from tax competition have tried to distinguish true tax competition from yardstick competition, in particular. They report on several recent studies.[86] Some studies have looked at the effect of capital mobility on tax levels over time. The results are ambiguous. Although effective corporate tax rates appear to have fallen, the revenues from corporation taxes have risen. It is far from clear what this indicates. Tax competition may simply have shifted the burden of corporation taxes from capital (the shareholders) onto labour. This is less efficient than directly replacing corporate taxation with increased taxes on labour.

Another study found indications that the corporate tax rates of countries respond to changes in the tax rates of other countries. That is an approach that considers the behaviour of governments. It does not give present evidence of the reasons for these reactions, although it argues that the reactions reflect decision-making by firms. As a result it is not clear whether the study identifies the existence of true tax competition.

A further study reported by Wilson and Wildasin includes some preliminary work to estimate the reactions of OECD governments to a range of taxes. The results are also consistent with the existence of some sort of reactive tax competition. It finds greater responsiveness for taxes on items that are expected to be more mobile, such as corporate income tax and VAT. Wilson and Wildasin suggest that this implies that true tax competition is operating, arguing that there is no reason to suppose that yardstick competition would apply more to taxes with mobile bases. However, as Besley and Smart point out, where increased mobility results in a higher level of true tax competition, stronger yardstick competition results when voters believe that the circumstances in the other jurisdiction are a better indicator of domestic circumstances, and this may be the result of economic

[85] Even here we can distinguish between political pressure and economic pressure. True market-based tax competition occurs when governments look at the behaviour of tax revenues or of tax bases and change tax policies as a result. Governments may also react to lobbying from taxpayers threatening that they will move their operations out of the country (or not move them to the country) unless tax policies are changed. We cannot necessarily assume that such statements are accurate predictions of future behaviour. Taxpayers' self-interest lies in reducing their own tax burden. If lobbying based on an intellectual trend can achieve this, it represents a good strategy. It does not necessarily follow that if the strategy fails, the corporation will decide it is desirable to follow up on the threat. Analytically it is probably most useful to treat this as a more complex variant of yardstick competition.

[86] n 53 above.

integration, ie globalisation. Since globalisation also drives increased factor mobility, it is not unreasonable to consider that governments and voters may think that the experiences of other jurisdictions are more relevant in the case of mobile taxes. This is more likely to be the case where lobbyists and commentators assert that there is true tax competition.[87]

Finally, Devereux, Lockwood and Redoano claim to have identified competition across both effective marginal corporate tax rates and statutory corporate tax rates.[88] They argue that this two-dimensional competition can explain why corporate tax revenues have not fallen. In addition, because their results indicate a greater response where the level of capital controls imposed by a country is lower, they argue that their results reflect the presence of true tax competition. The first question is whether their measure of capital controls is adequate.[89] They say that they have no reason to suppose that their variable is correlated with the tax data, but if the results were due to yardstick competition or intellectual trends, this might not be so obvious. For example, the level of capital controls might itself be the result of a similar yardstick competition or intellectual trend. Moreover, their data is restricted to 21 OECD countries, the original 20, excluding Iceland, Luxembourg, and Turkey, plus the next four admitted: Japan, Finland, Australia, and New Zealand. In other words, these are all well-established developed countries. It is not clear how well their results might extend to a broader mix of countries. Nevertheless, they have made an important contribution to understanding whether there is tax competition.

The ambiguity that remains in these results confirms that it is still not clear that true tax competition is having major effects. It also appears that there are limits to the extent of globalisation, as I have discussed. Of course it is true that globalisation has had some effect on the rates of and revenue from taxes on income from capital. Indeed Avi-Yonah has shown how in many cases taxpayers have opportunities to avoid or evade both source and residence taxes by changing where their capital is invested.[90] On the other hand, Haufler, et al argue that tax rates may have held up because globalisation does more for the profitability and productivity of companies than the literature has generally acknowledged, and that this offers, to a greater or lesser degree, a counterweight to the greater ability of multinationals to shift profits in a globalised world.[91] In any case, it does not appear that we have reached the stage of the inevitable decline of effective rates of tax on income from capital all the way to zero. The situation is far from being as hopeless as the standard description that I started with suggests.

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[87] Besley and Smart, n 83 above.

[88] M.P. Devereux, B. Lockwood, and M. Redoano, 'Do Countries Compete Over Corporate Tax Rates?' (2008) 92 *Journal of Public Economics* 1210.

[89] They have tried some other measures, but it is not clear how far these alternatives answer any doubts.

[90] n 1 above; R.S. Avi-Yonah, 'Bridging the North/South Divide: International Redistribution and Tax Competition' (2004) 26 *Michigan Journal of International Law* 1.

[91] n 54 above.

GLOBALISATION AND POLICY

Bridging the discourses

This discussion has so far been essentially in the economic discourse. This includes the discussion of the models of political behaviour, which are in the nature of economic analysis of politics. This is not in any way to undermine the value and interest of those results, but it is important to understand the language in which they are expressed.

A number of political scientists have done econometric analyses of the effect of globalisation on taxation. Rodrik found evidence of a shift from taxation of capital incomes to labour incomes as a result of increased openness in trading in an economy.[92] Garrett and Quinn found evidence that liberalisation of capital markets resulted in increased taxation of capital incomes.[93] They suggest that governments do not seek to minimise the distortionary effects of taxation, but rather to compensate those who are disadvantaged by economic integration. Following Bretschger and Hettich, Haufler concludes that the difference between these studies is due to the inappropriate methodology used by Garrett and Quinn.[94] This is a tidy economic response, but ventures into the economic discourse.

From the perspective of what I have called policy, what is interesting is that the economic results are surprisingly inconclusive. The economic story has two obvious elements. First, that perfect capital mobility, which is generally taken to be an appropriate assumption for modelling purposes, will drive taxes on income from capital to zero, because the after-tax rate of return on capital is fixed in world markets. Second, that this will result in the underprovision of general government services, because governments supply a less than optimal level of public goods and services, and in addition taxes are shifted (directly or indirectly) from capital to labour, with negative distributional effects that tax competition leaves the government unable to rectify. The corollary is that there is a remedy in some form of tax co-ordination, either between jurisdictions or at a higher level, such as a federal government.

The second point is most notably undermined by the Leviathan view of government. Intuitively, however, it far from obvious that tax competition would merely eliminate Leviathan waste without still resulting in underprovision of general government services, unless tax competition is relatively weak, or one takes the view that the optimal level of general government services is low. Besley

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[92] D. Rodrik, *Has Globalization Gone too Far?* (Washington, DC: Institute for International Economics, 1997).

[93] G. Garrett, 'Capital Mobility, Trade, and the Domestic Politics of Economic Policy' (1995) 49 *International Organization* 657; D. Quinn, 'The Correlates of Change in International Financial Regulation' (1997) 91 *American Political Science Review* 531.

[94] n 53 above. *See* L. Bretschger and F. Hettich, 'Globalisation, Capital Mobility and Tax Competition: Theory and Evidence for OECD Countries' (2002) 18 *European Journal of Political Economy* 695.

and Smart show some of the difficulties with the Leviathan view in a more realistic setting, and seem to confirm the concerns with the ability of competition to improve welfare in the presence of government waste.[95]

The first point is vulnerable on the question of whether it is appropriate to treat capital, particularly physical capital, as perfectly mobile, and therefore on the question of the globalisation of capital markets that we have seen as driving down effective rates of tax borne by income from capital. This relates both to the question of how mobile physical and financial capital are, and to the question of whether this mobility is directly affecting governments, as opposed to some other phenomenon, such as yardstick competition. The two questions are hard to disentangle.

Moreover, one prescription for capital tax competition is clear: taxation in the country of residence. If tax competition does seriously affect taxation of income from capital, it is taxation at source that is directly affected. It follows from the discussion about the nature of the economic firm above, that this really refers to residence taxation of individuals. The question is whether residence taxation, even of individuals, is feasible.

Haufler argues that residence taxation is sufficiently unfeasible for him to ignore.[96] He sees residence taxation of foreign-source capital income as being eliminated by evasion, by deferral of corporate distributions, or by double taxation relief, even when tax credits are used. He reaches this last conclusion by considering the case where there is only one capital exporting country using tax credits and the source country knows the (single?) effective tax rate it imposes. While these are legitimate concerns, it is overstating them simply to ignore residence taxation. Avi-Yonah argues that residence taxation of capital income has been severely constrained: residence taxation of interest can be avoided by investing through a corporation located in a tax haven with bank secrecy laws, while active business income earned abroad is generally not taxed on a current basis.[97] This is a more specific version of Haufler's argument. Nevertheless, the debates that continue around policy proposals on the taxation of foreign income in both the US and the UK suggest that residence taxation is not as insignificant as these authors seem to imply.[98]

The problem of evasion is to a significant degree one of information. Eggert and Kolmar suggest that voluntary information exchange can result without central co-ordination (although no exchange is also a feasible outcome), except in

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[95] n 83 above.
[96] n 53 above, 51-54.
[97] n 90 above, 6-7.
[98] *See eg* C. Swann and E. Alden, 'Panel Calls for End to Foreign Profits Tax' (19 October 2005) *Financial Times*, at <http://www.ft.com/cms/s/0/c69a2c0a-4010-11da-8394-00000e2511c8.html> (last visited 16 August 2009); V. Houlder, 'US Multinationals Fear Gains for Foreign Rivals from Tax Reforms' (6 May 2009) *Financial Times* (Asia Edition), 3; J. Eaglesham, 'Darling in U-Turn on Foreign Profits Tax' (21 July 2008) *Financial Times*, 1.

the case of an economy with a relatively large financial sector.[99] This suggests that prospects for effective information exchange with co-ordination could be better than past experience might otherwise suggest.

Fairness and globalisation

Thus we are brought back to a situation where residence-based taxation again has advantages over source-based taxation in principle, even though the story about feasibility is much more complicated. This is a result that can be transferred back into the fairness context of the policy discourse. Interestingly there is a consistency between my conclusions about the forms of international taxation that are supported on fairness grounds and the general implications that seem to come out of the tax competition material. So residence-based taxation is again favoured.

Moreover, the idea that financial capital is more mobile than physical capital (especially when interpreted as decisions about the location of firms), so that the latter can more easily be subject to source taxation, is consistent with the idea that what are usually termed source taxes can only be justified on a fairness basis under the participation principle. To come within that principle the activity needs a sufficient degree of participation in the economy to be benefiting (directly or indirectly) to a sufficient degree from general government services. This recalls the use in some of the studies of firm mobility of public inputs as a source of firm-specific rents, providing a limitation on mobility. As I noted above, this classification is also similar in its general form to the allocation of taxing competence in the OECD Model.[100]

Even though there is this consensus on the nature of the classification, the question of where the lines should be drawn is less well defined, and is one on which there is less agreement. The debates about drawing the lines for the purposes of double tax treaties are well known, and have been led by the OECD. See the OECD Reports on the definition of permanent establishments and on the classification of income. In economics the key concept here is that of the firm. It is a simple and powerful idea. In the legal context we are used to thinking of it as unproblematic because it embodies the underlying economic reality that we would like to be able to incorporate into legal distinctions. Looked at more closely, as in the area of tax competition, it turns out to be a surprisingly inchoate idea, at least viewed from the policy perspective. Indeed part of its success seems to depend on the broad range of occasions when economists take its nature for granted. In most applications economists do not ask whether a firm is incorporated. They do not ask whether a firm can have subsidiaries. Alternatively, should the entire corporate group be treated as one firm? Or if the concern is with productive activities, perhaps the firm is the (local) productive unit? In that case holding companies

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[99] W. Eggert and M. Kolmar, 'Residence-Based Capital Taxation in a Small Open Economy: Why Information is Voluntarily Exchanged and Why it is Not' (2002) 9 *International Tax and Public Finance* 465.
[100] See text to n 41 above.

could be ignored as being emanations of the investing individuals. Of course, questions about the operation and structure of business entities can be and have been considered economically.

So what are the implications for the fairness-based view of taxation I have outlined? Once again efficiency becomes a measure of the cost of achieving particular outcomes. The economic results express qualifications on our ability to implement ordinary residence-based taxation, but those qualifications are as much about what other elements are needed in the tax system to support residence-based taxation. In fact, that necessarily includes the question of the scope of the extended residence basis, ie those taxes traditionally termed source taxes that can be justified on fairness grounds.

An important implication is that, not only is a sufficient level of participation needed to justify taxation by the host country, but also the host country may well not be able to impose a tax that will economically burden such incomes unless there is such a level of participation (because otherwise the tax may simply burden local immobile factors). Participation implies that the local environment, including general government services, offer, in economic terms, firm / location-specific rents that can support local taxation. So efficiency is relevant to defining what is sufficient participation, because the cost of extending the borderline eventually becomes excessive. Eventually the tax is borne too much by local factors to justify the additional extension of what is sufficient participation. We do not need to think of this as a quantitative problem. (The quantitative problem probably could not be solved in any event.) The point is that arguments, for instance, that a certain extension of taxation will discourage new foreign investment or will encourage existing firms to leave can be understood as legitimate, in terms of fairness, to the extent that they are grounded in the types of considerations that I have outlined.

TAX JURISDICTION AND DEVELOPING COUNTRIES

THE DEVELOPMENT OF ECONOMIC ACTIVITY

I would now like to return to the question of how we can determine exactly what the appropriate level of participation is to justify the extended residence basis for taxation. Developing countries regard themselves as having tax bases that include income sources rather than residents with substantial incomes, so they are generally interested in extending the extent of jurisdiction allocated to traditional source taxation. As a result their position provides an interesting perspective from which to look at this question.

A key argument of such countries is that to change the allocation of taxing jurisdiction would undermine their long-established share of tax revenues. Curiously, this share has not been so long established. Consider the following rather stylised view of the way in which the implications of globalisation have arisen. We can think of international economic activity as having developed through the following stages. Initially in the late Middle Ages and the Renaissance there was active trade between specialised centres. Thus England was important for wool production, Flanders for weaving, and Italy provided important markets for finished products. Next comes the period of Colonial trade with the rise of the joint stock trading companies. We can think of a model of primary production taking place in the colonies with manufacturing and consumption concentrated in the centre. Primary production was often exploitative, yielding only limited benefits for the colony. Other colonial consumption would be supported by export, but these exports would often be made to independent distributors.

In more recent times we see local production or sales replacing simple exports.[101] Local production was there, nonetheless, but likely to take place at a location separate from that of the production of raw materials. This may also be thought of as the period of the initial rise of the transnational corporation. Significant reasons for the localisation of production were high tariffs and transport costs. The pattern is one of localised production with sales being conducted by locally based companies, which might or might not be independent of the manufacturers. This is the pattern that appears to form the paradigm for the OECD Model. In particular it seems to be a good description of the pattern of international economic activity in the inter-war period, when the League of Nations was formulating the basic structure of the modern allocation of tax jurisdiction under the guidance of Adams, Stamp, Seligman, Einaudi, Bruins, and Carroll.[102]

The modern phenomenon of globalisation is a move to a pattern of integrated activity. The shift in the location of the source of incomes is a real shift to a pattern where production and distribution are conducted in separate locations from that consumption. Both of the elements of globalisation contribute to this: the liberalisation of finance, and the new technologies. The new technologies affect production directly, but also provide new methods of communication and distribution among producers and between producers and consumers. This includes the growth of e-commerce. In principle, both production and distribution become increasingly dispersed. At the very least we can say that the new methods of production and distribution make increased dispersion possible.

If this is a real shift in the pattern of economic activity, is the real problem for developing countries one of loss of taxation or of loss of the income available for taxation? It is doubtful whether it makes sense to distort the tax system if the true problem lies not in the tax system but elsewhere. The question depends on whether the new locations for production and distribution are being adopted for

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[101] This was particularly exacerbated by the tariff rises following World War I. *See* Williamson, n 1 above, 6.

[102] *See* M.J. Graetz and M.M. O'Hear, 'The "Original Intent" of U.S. International Taxation' (1997) 46 *Duke Law Journal* 1021 for a discussion of the relative roles of these economists.

commercial reasons or tax reasons. The phenomenon of globalisation suggests that the real reasons are commercial, although tax is also clearly an issue.

ANOTHER ASPECT OF GLOBALISATION: DIGITAL GOODS

The idea that economic integration does not necessarily imply the agglomeration of activity, but can also lead to dispersion, is important to understanding the impact of globalisation on the tax system. Quah suggests that the digital age is characterised by the rise of digital goods. He defines digital goods as economically valuable bitstrings. 'Easiest is to think of a digital good as a *recipe*: Encoded in the digital good (and, indeed, identical with it) is a set of economically valuable instructions.'[103] Digital goods include computer programs, videogames, music recordings, digital images, software, telecommunications (including the Internet), biotechnology[104] – and cooking recipes. An important feature of digital goods follows from this: a copy of a digital good is the good itself – the copy is as good as the original. Instead of seeing digital goods as introducing certain inefficiencies into the operation of the market that need to be overcome, Quah considers how digital goods are distinctive in basic economic terms. He identifies five special characteristics of digital goods: they are non-rival, infinitely expansible, discrete, recombinant, and aspatial. The meanings of these terms will not all be immediately obvious,[105] but the one that will prove important here is the aspatial nature.

Digital goods raise important questions about pricing. They have a very low marginal cost of production, but a high development cost. If the price is too low the incentive to develop the goods in the first place will be too low. If the price is too high there will be an inefficiently low level of production.[106]

In Quah's analysis digital goods are aspatial (and also atemporal) in the sense that 'they are both nowhere and everywhere at the same time'.[107] Thus it is costless to transport them. This does not mean that location does not matter, but merely that transport costs become irrelevant. Any other reasons for developing them or producing them at any particular geographical location become, if anything, more important. In particular, the development of digital goods requires other inputs, notably human capital.[108] Researchers and those working the creative media benefit from physical proximity, so we see the development of such goods

[103] D. Quah, 'Digital Goods and the New Economy' (Centre for Economic Policy Research Discussion Paper no. 3846, 2003), at <www.cepr.org/pubs/dps/DP3846.asp> (last visited 10 August 2009).
[104] Pharmaceuticals are near digital goods, in that the value is essentially in the formula for the product, compared to which the cost of production is often trivial.
[105] It may be recalled that pure public goods are non-rival and non-excludable.
[106] Because of their infinitely expansible nature, the marginal cost of producing additional copies of digital goods is very low, or even zero. If the price is (significantly) higher than the marginal cost, the amount sold will be lower than the efficient optimum. Quah gives the example of the problems associated with supplying AIDS drugs in impoverished developing countries.
[107] n 103 above, 18.
[108] In a sense digital goods can also be described as information. Quah distinguishes between information that can be encoded digitally, typically the sort of information that can be protected by intellectual property or identifiable trade secrets, and other information ('tacit' knowledge) that he suggests can be termed 'human capital'.

clustering, for instance in Silicon Valley or in Hollywood. The location of development need not, however, be related to the location of other factors, such as sources of finance. Nor does the value of clustering require that the location be in a developed country. Thus clusters can be found in Bangalore, Mumbai ('Bollywood'), China, and Israel.

Quah's approach has implications for taxation. His explanation of the distinctive features of digital goods implies that tax policies should be developed around the characteristics of digital goods, rather than by adapting existing tax rules and trying to pretend that digital goods are merely different in degree from ordinary goods.

Of particular relevance to the present article is the observation of clustering. Indeed, it seems to contradict the idea that globalisation results in the dispersion of production. But this is similar to the way in which it seems to contradict the obvious intuition from the aspatial nature of digital goods. However, the aspatial quality frees the production and development of digital goods from constraints of location that come from costly transport. If the human capital inputs needed for the development of digital goods benefit from clustering, this clustering is, nonetheless, freed from one important constraint. In addition, the development of digital goods typically also uses digital goods as an input. The development of software uses other software and electronic communications as inputs. The aspatial nature of these inputs means that, even if clusters are beneficial, the location of the clusters is less constrained. It is this that makes the establishment of clusters in developing countries entirely feasible.

Support for this argument can be found in the development of the Open Source Software movement. Quah discusses the economics of this movement. The Open Source movement has given rise to a number of successful software packages, among which perhaps the best known are the Firefox Internet browser and the Linux operating system. Open Source Software is made freely available together with its source code, the text of the programme in the quasi-English used by programmers. As users work with the software, they send reports of any defects they find or improvements that suggest themselves to them to a central co-ordinator. The user may include new suggested source code to correct the problem or to implement the improvement. Otherwise the suggestion will be publicised for other programmers to work on. Once the co-ordinators have approved a fix or improvement, it will be incorporated routinely in updates of the software. This entire process will be conducted via the Internet or e-mail, without direct contact between any of the programmers involved. So, in an example of the aspatial nature of software, the programmers can be located anywhere in the world. However, this process takes place without needing a central development plan, a schedule for the development of improvements, or organised searching for defects. Not only are the software, the source code, and the updates distributed free of charge, but users who provide new source code do so without any direct remuneration.

What is remarkable is that this apparently haphazard process results not merely in software of reasonable quality, but software of a quality that can compete with the best proprietary software.[109] Quah suggests ways in which users may indirectly obtain remuneration for their contributions to the development process, but that still does not explain how the process as a whole can be so successful without real co-ordination. Attempts have been made to explain this second aspect in terms of evolution in complex adaptive systems. Biological systems of this type manage complex adaptation through a large number of uncoordinated local actions at a cellular level. Quah notes that this concept is rather similar to the intuition underlying the standard model of the competitive economy. Interestingly, the biological model is also the inspiration for the theory of autopoiesis, which I discussed above. Quah identifies three economic consequences that can be seen as arising out of the economic nature of digital goods. First is that the Open Source Software movement deliberately does not follow the standard scheme of intellectual property protection. The software is distributed at its marginal cost of zero, and other processes are relied on to provide the incentive for development. Second, the uncoordinated development process works because of the involvement of large numbers of programmers around the world, which is directly made possible by the aspatial nature of digital goods. Finally, the recombinant nature of digital goods means that new features can arise from working with combinations of existing digital goods, a description that is not a bad reflection of the process of development of Open Source Software through use.

The importance of the Open Source Software movement for the present discussion is as an example of how such a project can offer opportunities to developing countries, in this case through an efficient alternative to proprietary systems. It is interesting to note that programmers in both China and India have been active contributors to Open Source Software.[110] These are opportunities that arise directly from features of the modern phenomenon of globalisation. Such opportunities serve precisely the goal of creating an environment that attracts more long-term investment or that helps to build the capacity for domestic investment that developing countries particularly need. In contrast the use of cruder mechanisms such as tax holidays may bring much less benefit to a developing country. Much of the tax revenue forgone may go as a windfall to the recipient. The types of (physical) investments that are sensitive to tax preferences of this nature are also likely to be themselves relatively mobile. They are likely to be looking for the next tax break elsewhere, and will be ready to move as soon as they find it.[111]

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[109] Linux has become a serious competitor for Microsoft Windows among business users, and Google's new operating system, Chrome OS, will be based on Linux. B. Hunt and S. Kirchgaessner, 'Cheap and Secure: Europe's Open-source Option' (22 January 2003) *Financial Times*, 17; 'The Technology Explained; Q&A' (9 July 2009) *Financial Times*, 22.

[110] *See eg* Hunt and Kirchgaessner, n 109 above.

[111] This is not to say that tax holidays cannot succeed in attracting investment (*see* Avi-Yonah, n 1 above, 1645), but rather that a significant portion of the surrender of revenues may be supporting investments

SOURCE VS RESIDENCE TAXATION

There is a strong belief in many developing countries, on the part of governments, business people, and tax practitioners, that source taxation is appropriate and justified. The problem is that a developing country relies on foreign investment, which will tend to leave it with substantial net outflows of capital income leading to a persistent deficit on current financial flows. At the moment withholding taxes, the taxation of subsidiaries, and the concept of the permanent establishment provide such countries with the opportunity to obtain a substantial tax base from the outflow of income from capital. This applies both to financial income from capital (interest, royalties, dividends) and to the return on foreign direct investment (business profits). The concern in these countries is that the shift in the location of economic activity implied by globalisation, particularly the growth of e-commerce, will mean that more and more goods and services will be sold in developing countries without the seller needing to have any physical presence in the country.

The discussion in the preceding sections of this paper indicates on the one hand that there are serious questions about the fairness justification for source taxation, and on the other hand that it is not clear that the developing country pessimism about the effect of economic developments is warranted. The new technological developments also offer significant opportunities for developing countries to attract new activities for the development and production of digital goods. In particular the experience of the Open Source Software movement suggests it should be possible to do so without losing the greater part of the benefits in payments for intellectual property rights.

Indeed, one of the key factors behind the concerns of developing countries is the problem of transfer of technology. Part of the problem for developing countries is that developed countries have tended to become insistent that their corporations report the full amount of income from transfers of technology. But is this income from transfer of technology real? The transfers of technology in question are often between related companies, so valuing the income from the transfers is a transfer pricing issue. The current rough consensus on the arm's-length standard for transfer pricing has proved to be a convenient compromise,[112] but it is a standard that is difficult to enforce. Enforcement imposes substantial

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that would have come in any event, or that are always on the look-out for the next, better tax break elsewhere.

[112] Avi-Yonah, n 36 above, 132-133 presents evidence of how widespread the agreement is on the principle that transfer pricing should be governed by the arm's-length principle, but it is clear, even from his exposition, that there is far less agreement on the content of the arm's-length principle. Consider also the extent of the debate on the transfer pricing of intellectual property in the 'supply chain', which currently has a focus in the OECD's work on business restructurings. *See* A. Bullen, A. Gerten, and B. Stürzlinger, 'A Report on the OECD Discussion Draft on Business Restructurings' (2009) 53 *Tax Notes International* 997; and Organisation for Economic Cooperation and Development, Committee on Fiscal Affairs, 'Transfer Pricing Aspects of Business Restructurings: Discussion Draft for Public Comment', at <http://www.oecd.org/dataoecd/59/40/41346644.pdf> (last visited 24 August 2009).

costs, both on taxpayers and on tax administrations. These costs are that much more burdensome for a developing country that has neither a large tax administration, nor a substantial body of skilled administrators readily able to apply this subtle test to complex transactions.

Some developing countries, such as Brazil, have experimented with solutions such as the use of presumptive income or withholding taxes as substitutes for the costly arm's-length approach to transfer pricing. The US super-royalty rules could be regarded in a similar light. Baistrocchi has proposed using advance pricing agreements (APAs) as a basis for building up a body of international jurisprudence on arm's length pricing reasonably quickly, so as to provide a way of reducing the enforcement costs.[113]

Are these potential solutions, or can they at best serve as stopgaps that could provide partial relief in the hope of the eventual establishment of a regime based on formulary apportionment? Formulary apportionment could greatly ease the problem of administrative cost for developing countries. The problem is that in order to work fairly for taxpayers, formulary apportionment would require some measure of international agreement on the formula. Developing countries that are sanguine about their prospects in the negotiations on such a formula need only look at the current WTO Doha Round for a reason for caution. An unfavourable formula might make it easier to determine the portion of income to which a developing country was entitled, but at the cost of reducing the developing country's entitlement. The proposal to use formulary apportionment to allocate revenues under the common consolidated corporate tax base (CCCTB) being considered for the European Union shows that, while an international agreement is not impossible, the problems in agreeing on a formula are very real.[114] Moreover, solving the transfer pricing enforcement problem is no solution if the real problem is one of production moving away from developing countries.

Formulary apportionment also still does not answer the question of the justification of source taxation. It could arguably be harder to find a fairness justification in such a formula than in the arm's length concept, although that depends on the formula. A formula that recognised the concept of participation in choosing the factors to include and the weights to be given could meet this hurdle.

Suppose, however, that these problems can be overcome, and source taxes can be collected. There is still the question of whether, from an economic perspective, they will be borne by the foreign investors. If the market shifts the burden onto consumers in the developing country, the result could simply be a tax on consumption. Economic analysis suggests that this would be the consequence if capital were perfectly mobile, so that after-tax returns were fixed in world markets (at least from the perspective of an economically small developing

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[113] E. Baistrocchi, 'The Transfer Pricing Problem: A Global Proposal for Simplification' (2006) 59 *Tax Lawyer* 941.

[114] *See eg* J.M. Weiner, 'News Analysis: Formulary Apportionment: The Way to Tax Profits in the EU' (2007) 47 *Tax Notes International* 322; J.M. Weiner, 'Aujean Maintains Support for CCCTB' (2008) 52 *Tax Notes International* 15.

country). As I have discussed, it is not clear that there is such a wholesale shifting onto consumers, but to the extent that some shifting occurs, the result is similar to a tax on consumption. If that were the result, it would arguably be more economically efficient to use a VAT to tax the consumption directly, as the indirect taxation of consumption by taxing corporate profits would involve the additional deadweight loss from the implicit shifting of the incidence of the tax.

FAIRNESS TO DEVELOPING COUNTRIES

It is well established, as Graetz argues, that the international taxation norm recognises a right of source countries to tax income arising within their national territory. Graetz attributes this to some nebulous form of benefit theory. He quotes the reference of Thomas S. Adams in 1921 to 'taxes which *fairly* belong to this country (the United States)'.[115] The problem with this is that it only justifies the allocation of taxes between countries. It provides no justification in fairness for the *taxpayer* being subject to taxation by the source country. My argument in this paper starts from the point that we normally justify the imposition of income taxes on the basis of some concept of ability-to-pay. Although there are a number of concepts of ability-to-pay, our understanding of fairness in taxation grounds taxation imposed to raise general revenues for government in some concept of ability-to-pay.

Underlying the concept of ability-to-pay is, however, as I have discussed above,[116] a special type of benefit taxation argument. For various reasons it is not possible assign a portion of the cost of general government services (including both public goods and redistribution) to individual taxpayers by determining some value for those services to the taxpayer. Instead, the amount of tax based on ability-to-pay has to be understood as being the appropriate amount for the taxpayer to pay for general government services according to the social consensus reached through the country's political institutions. One advantage of this extended benefit concept, the participation principle, is that we can use it to provide a fairness justification for general taxation in an international setting. Furthermore, if we understand that this discussion of the fairness justification of taxation takes place in and is central to the policy discourse on taxation, we can understand that economic concepts such as efficiency are concepts that are foreign to this discourse. They can only be relevant in this discourse, if they are first reframed in the fairness terms that are comprehensible in this discourse.

The basic inferences for international taxation that can be drawn from the participation principle are, perhaps fortunately, not so far removed from the existing structure. The implication is that, in order to justify taxing the income of a person who is not resident in a country, that person must have a sufficient degree

[115] Quoted in Graetz, n 3 above, 1395.
[116] See section 'Fairness in Taxation: The Participation Principle' beginning at text to n 37 above.

of participation in the country to be considered to be a sufficient beneficiary of the general government services. Once again, however, being a beneficiary is not to be understood in the precise terms of the traditional benefit theory of taxation, but in terms of the justification, relevant to general government services, that supports the application of ability-to-pay. The nature of general government services means that we cannot quantify in a useful way the actual benefit received by any person present in the society. Nevertheless, the fact that we understand that the concept of participation is being used to justify the application of ability-to-pay in this way gives content to participation. On this basis we can see that the taxation of an appropriate range of business profits can be justified under the participation principle, but it is hard to see a justification for taxing income from financial capital. This is, of course, not far from the allocation of tax competence under the OECD Model. The difference is that the participation principle provides a distinct, more cogent basis on which to try to draw the lines.

At first glance the participation principle does not seem to be very attractive for developing countries because it asserts that there is no fairness justification for source taxation. The participation principle, however, says that there are some taxes that we have described as source taxes in the past that can be justified as extended residence taxes. What is needed is to identify the appropriate factors that will give evidence of sufficient participation in the society by the non-resident. The nature of what will constitute sufficient participation is something that needs development. There is only space here to suggest something of the flavour of it. Traditional concepts such as the presence of personnel, the use of land, and the use of physical equipment still seem relevant. On the other hand, the identity of particular legal entities and the contractual and proprietary relationships between particular legal entities, look more like distractions from the process of identifying sufficient participation.

Again at first glance the participation principle also does not appear to be very helpful to developing countries' concerns about the impact of globalisation and e-commerce. But the participation principle comprises two elements in the international context. There is both the requirement of sufficient participation, and the application of the measure of ability-to-pay.[117] One of the implications of Quah's description of digital goods is that traditional intellectual property rights tended to result in an overpricing of digital goods.[118] This understanding can provide the basis for an argument that where profits arise in connection with production and development activities for such goods, a greater amount of profit can justifiably be taxed in the country where those activities occur, even if the profit is not directly associated with ownership of intellectual property used or produced by those activities.

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[117] This is comparable to the taxation of business profits under the OECD Model: that depends both on the definition of permanent establishment and on the calculation of the amount of business profits when there is a permanent establishment.
[118] n 103 above.

A good example of this is the treatment of royalties. I have so far implicitly accepted the treatment of royalties in the OECD Model, which in effect classifies them as financial income. As the OECD's study on the classification of income from e-commerce shows, this is not uncontroversial.[119] That study generally limited any extension of the definition of royalties for treaty purposes. This can be seen as against the interests of developing countries as technology importers, since income falling into the alternative category of business profits has to meet the permanent establishment test before it can be subject to source taxation. Under the participation principle classification as business profits makes the taxation of such business profits in the host country potentially justified in fairness. The discussions of comparable scenarios of 'traditional' commerce and e-commerce in the OECD's 2001 report on the *Attribution of Profit to a Permanent Establishment Involved in Electronic Commerce Transactions*, and their 2005 follow-up extending the analysis to transfer pricing, provide an interesting indication of how these activities can be analysed.[120] What is needed is to consider them from the perspective of fairness.[121] It would be entirely reasonable to ask whether alternative scenarios that make sense in the context of a developed country are also appropriate in determining how particular types of income from e-commerce or digital goods should be taxed in the context of a developing country. In the policy discourse, it can be quite logical to argue that formal discrimination in the treatment of income according to the nature of the host country is necessary in order to achieve substantive non-discrimination. That is, after all, the premise for the coexistence of the OECD and UN Models[122] for double tax treaties.

The participation principle can be used to evaluate some of the alternative international tax systems that have been proposed. Avi-Yonah has suggested an interesting tax system.[123] It is intended for developed countries, but there is no reason why other countries could not join in. Under this system there would be two key components. The first is a high withholding tax on financial payments. It would be refundable if the taxpayer showed that she had declared the income where she resides. As a result it is essentially a residence-based tax. The second

[119] Organisation for Economic Cooperation and Development, Treaty Characterisation TAG (Technical Advisory Group on Treaty Characterisation Issues arising from E-Commerce), *Tax Treaty Characterisation Issues Arising from E-Commerce Report to Working Party No. 1 of the OECD Committee on Fiscal Affairs* (Paris: OECD, 2001).

[120] Organisation for Economic Cooperation and Development, Business Profits TAG (Technical Advisory Group on Monitoring the Application of Existing Treaty Norms for the Taxation of Business Profits), *Attribution of Profit to a Permanent Establishment Involved in Electronic Commerce Transactions* (Paris: OECD, 2001); Organisation for Economic Cooperation and Development, *E-Commerce: Transfer Pricing and Business Profits Taxation*, OECD Tax Policy Studies No. 10 (Paris: OECD Publishing, 2005).

[121] Some attempt at this was made by the OECD Business Profits TAG (*see* n 120 above, 81-87). The TAG agreed (ibid, 85) that fairness, and in particular inter-nation equity, was important, but noted that there are no agreed principles of inter-nation equity beyond accepting both residence and source taxation, and thought that fairness between taxpayers was essentially a matter of non-discrimination.

[122] United Nations, *Model Double Taxation Convention between Developed and Developing Countries* (New York: United Nations, 2001).

[123] n 1 above.

element is a withholding tax on gross sales. This would be reduced to a tax on net profits if the seller filed a tax return declaring its income. The tax on sales, or the substitute tax on income, would be payable in the country where the sales took place, so it would effectively be a source-based tax. Avi-Yonah does not explain how one would justify this tax, beyond his view that it would be a way of successfully taxing the business income of multinationals. In terms of the participation principle the tax would have to be justified as reflecting the extended residence basis.

In looking at the treaty rules applicable to business profits from e-commerce, the OECD Business Profits TAG saw the existing treaty rules as reflecting a supply-based approach with profits being considered to originate where factors of production are employed. It looked at the alternative of a 'supply-demand' approach in which profits are treated as arising from the interaction of supply and demand, but thought that historically demand had not been recognised as a sufficient basis for taxing business profits.[124] This alternative was taken from Schäfer and Spengel, who also rejected the supply-demand approach as a basis for taxation.[125] Their concern was that the place of demand (ie consumption) would frequently be hard to identify, especially in the case of e-commerce. As the Internet has become less anonymous, and as we have seen the effectiveness with which websites can identify a user's (purchaser's) location through the address of their ISP (Internet service provider), this perhaps seems less of a concern today. In any event, the supply-demand approach provides an interesting logic for treating sales as sufficient participation, but much depends upon what would be included in the income that would be taxed as the alternative.

Indeed, in Avi-Yonah's scheme the objective is to ensure that all income from production is taxed somewhere, rather than to transfer the location of taxation to the jurisdiction where sales take place. Thus he would disallow deductions for payments to parties located in other jurisdictions that offer tax incentives targeting foreigners. If we regard it as important for the concept of ability-to-pay that everyone should be taxed on a comparable measure of their total income (horizontal equity), this tax can be seen as being simply a method of ensuring this across jurisdictions. The question of allocation remains unanswered.

Another alternative is the dual income tax that has been implemented in a number of Scandinavian countries. This tax comprises a progressive tax on labour income together with a flat-rate tax on all income from capital. The tax would apply to interest and royalties. Corporation profits would be taxed at the same rate. The taxation of dividends would be fully integrated. One complexity is that, strictly speaking, the profits of unincorporated businesses need to be divided into their underlying constituents of labour and capital income. This tax raises serious questions about the fairness justification of applying a different non-progressive

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[124] n 120 above, 85-86.

[125] A. Schäfer and C. Spengel, 'ICT and International Corporate Taxation: Tax Attributes and Scope of Taxation' (ZEW Discussion Paper no. 02-81, 2002), at <ftp://ftp.zew.de/pub/zew-docs/dp/dp0281.pdf> (last visited 25 August 2009).

rate to capital income, since it appears to be against both horizontal and vertical equity, whether or not one favours the application of progressive rates. There are, however, various arguments as to why the breach of equity is not as great as it appears. The main argument is that the flat rate makes it possible to collect at least some tax on income from capital (even in the face of perfect capital mobility), and that it does so neutrally between different forms of income from capital. The concern is that a progressive tax on income from capital on a residence basis may collect very little tax, so that in practice a dual income tax may end up being more progressive. The dual income tax is again formally residence-based, but the use of a single rate for capital income suggests a potential basis for harmonisation. A flat-rate tax on capital income could easily be shared between residence and source countries. All countries would potentially gain because of a greater ability to collect the tax. So the dual income tax is also an alternative that principally provides benefits in terms of collectability, but leaves open the question of the exact scope of taxation for source countries.

Another issue that remains open is the question of the basis for the taxation of corporations under the participation principle. The issue of the definition of corporate residence is becoming of increasing concern. The participation principle suggests that one solution may be to abandon the traditional concept of corporate residence and to focus on the test of participation. The implication is that the focus would shift from trying to tax legal entities to trying to tax the interests of investors as shown by the activities of corporations. This does not necessarily mean that the tax system would ignore the existence of legal entities, since they do represent the existence of certain genuine legal rights. But it does suggest that the recognition of legal entities may no longer be the right starting point for the development of the legal system.

CONCLUSION

Globalisation is an important phenomenon, but it is not one that has to prevent us from moving forward in developing national tax systems. It is not obvious that tax competition is as serious a problem as some suggest. In any event the form in which it does give rise to concern is as an economic problem. In trying to find productive ways to develop international tax policy, we need to understand that there are many discourses of taxation, of which the economic, while important, is only one. The policy discourse is based around a language of fairness closely related to that of the legal system. Arguments of economic efficiency have a place in it because they indicate something of the cost of adopting particular policies. The extensive analysis of the issue of tax competition similarly provides useful information about the costs of particular policies.

When we apply the language of fairness to international tax policy, it seems hard to understand the basis for source-based taxation *per se*. Taxes to raise general revenues to pay for general government services cannot easily be justified on a pure benefit principle. Instead we measure such taxes according to an ability-to-pay concept. Ability-to-pay is best seen as being a socially agreed measure of the appropriate amount that a taxpayer should pay for the benefit provided by general government services. This implies that the taxpayer must in some sense be present within the jurisdiction in order to benefit from those services. In other words the ability-to-pay principle is in fact an extended benefit principle, which I have called the participation principle. Furthermore, ability-to-pay is most consistent with residence-based taxation. But a person can be present within a jurisdiction to a degree that does not amount to residence and still obtain some benefit from general government services, even though we may think that it is less than the full benefit obtained by a resident. This can justify on fairness grounds the taxation of the incomes of non-residents if they have a sufficient degree of participation in the society. Taxes that can be justified on this extended residence basis will include many of the taxes that have traditionally been regarded as source-based taxes. The advantage of applying the participation principle is that it gives us a fairness justification for these taxes, which can be used productively in determining exactly how far they should extend.

For many developing countries the idea that there is no fairness justification for source taxation will not seem a welcome one. In fact the participation principle can provide interesting approaches for the elaboration of what have traditionally been source taxes. Furthermore, it can provide a context within which to adapt the tax system to the developments of the digital age. In any event, I argue that developing countries should not see tax policy as being premised on their being forevermore dependent on receiving outside capital and on taxing outflows of capital income. The new digital goods do not merely shift the location of production, development, and distribution activities, they also create new activities with a new economic basis. Exploring the nature of these goods using the participation principle can provide creative solutions that may offer opportunities, rather than just problems, for developing countries in the present age of globalisation.