The Costs of International Tax Cooperation

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In the international tax arena we often find ideas and initiatives that sound indisputable. After all, how can one object to initiatives to “promote neutrality”, to “reduce double taxation”, or to “protect the welfare state”. One of

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the reasons that make these ideas so attractive is the theme of cooperation that underlies all these initiatives: Neutral policies are perceived as cooperative policies towards global efficiency; (cooperative) treaties are perceived as the ultimate mechanism for preventing double taxation; and the welfare state, we are told, can only be saved through (cooperative) multilateral efforts. A closer look at these initiatives, however, reveals that even such noble causes often bring about completely different (and sometimes undesirable) results. While acknowledging the potential benefits of inter-nation cooperation for some, this article highlights the (sometime hidden) costs of such cooperation for others.

Exposing the potential winners and losers from cooperative strategies is the main goal of this Article. Such winners and losers exist in all three different levels on which international taxation evolves: the unilateral, the bilateral and the multilateral.

On the unilateral level each country designs its international tax policy, using measures to tax its own residents investing abroad as well as foreign investors, often attempting to “alleviate double taxation.” My main argument here is that domestic interest groups tend to win or lose from adopting an (elusive) cooperative strategy as the unilateral mechanisms of their countries.

On the bilateral level pairs of countries negotiate treaties “for the prevention of double taxation”. Here I argue that developing countries tend systematically to lose tax revenue when they enter into the (more cooperative and thus seemingly benign) bilateral treaty regime without gaining any more investments.

Finally, on the multilateral level there have been efforts to establish multilateral cooperation towards harmonization of international tax rules to fight tax competition thus protecting the welfare state. I argue that this emerging multilateral regime, promoted as an all-benefiting cooperative strategy, also creates potential losers both among and within nations.

The following sections offer a closer look at each of these levels. They illustrate the seemingly noble intentions, the less than ideal results, and the
interests being served on each level. Section I discusses the aspired neutrality in the unilateral level; section II considers the goal of preventing double taxation on the bilateral level; finally, section III examines the arguments for multilateral agreement and against tax competition. A brief conclusion follows.

I. Unilateral Tax Measures and Neutrality

Conventional wisdom recommends that in designing their international tax systems, countries should promote neutrality. A globally neutral system, so the argument goes, better allocates resources according to market preferences, thus promoting efficiency that eventually benefits all parties involved. A closer look reveals, however, that neutrality is only an attractive terminology that masks specific domestic interests.

In this section, I consider the way in which a residence country should deal with the problem of double taxation. The typical case of double taxation arises when a taxpayer residing in one country (the home) invests in another (the host). When both the home and the host countries impose taxes, the taxpayer pays “double taxation.” Double taxation is considered one of the most acute problems of international taxation affecting home countries as well as host countries. It curtails cross-border investments and severely limits the economic benefits such investments generate for both host and residence countries. Therefore, countries designing their international tax rules try to avoid it by using various kinds of unilateral mechanisms for the alleviation of double taxation. The most common mechanisms are an exemption for income produced abroad, a credit granted for foreign taxes paid by a country’s residents abroad, and a deduction for such foreign taxes.

Conventional wisdom points to the concept of neutrality as a decisive goal for designing international tax policies, namely, choosing among these
alternative mechanisms. The best mechanism would best promote neutrality.¹ But since global neutrality can only be achieved through international cooperation, no single country can unilaterally achieve global neutrality. Individual countries are thus advised to promote partial neutrality stirring a heated debate among supporters of different kinds of partial neutrality.²

Viewed this way, these partial neutrality policies are merely offsprings of the plausible idea of global neutrality, a kind of “second best” option: since no country can achieve global neutrality, it should at least do its share by promoting partial neutrality. Implied in this argument is the intuition that if all countries cooperated in adopting a neutral policy – a globally neutral (and thus more efficient) system would evolve. A different angle, however, reveals that different types of partial neutrality achieve different economic results, thus supporting the interests of different domestic groups.

A. Preventing Double Taxation

International tax, like almost any tax, brings with it an inevitable inefficiency cost – the cost of placing a wedge between supply and demand for capital, thus preventing some pre-tax efficient transactions from taking place.³ But even greater inefficiency results if the tax not only places a wedge between supply and demand, but also distorts taxpayers’ economic decisions.

Double taxation increases the efficiency costs associated with the tax

¹ See, e.g., Joint Committee on Taxation, 106th Congress, Overview of Present-Law Rules and Economic Issues in International Taxation 3 (Committee Print, 1999); Joint Committee on Taxation, 102nd Congress, Factors Affecting the International Competitiveness of the United States 236 (Committee Print, 1991); David F. Bradford and U.S. Treasury Department Tax Policy Staff, Blueprints for Basic Tax Reform (2nd edn, Arlington, VA, 1984), p 89-90.
² For a recent review of the economic literature bearing on this debate, see U.S. Treasury Department, The Deferral of Income Earned Through U.S. Controlled Foreign Corporations: A Policy Study (Dec. 2000), pp. 25-42.
wedge, since a larger tax means a larger wedge. It also distorts taxpayers’
economic decisions: If a taxpayer pays only one layer of taxation while
investing at her home country – but pays two layers of taxation (one at home
and one in the host country) while investing abroad – then she will have an
incentive to invest at home or to move her home to the place of investment
even if absent double taxation she would prefer to reside in the first country
and invest in the other. Economic theory assumes that the taxpayer’s initial
election (her “neutral” election) is, generally speaking, the more efficient one.
Thus, the fact that double taxation may shift taxpayers’ investment and
residency decisions carries with it an additional efficiency cost.

It is widely agreed that the efficiency costs associated with double
taxation should be eliminated. It is also widely agreed that it is worthwhile for
countries to eliminate double taxation unilaterally, even without cooperation
from other countries. The only debated issue concerns the best mechanism to
eliminate double taxation unilaterally. A country may consider three basic
candidates as unilateral mechanisms for the prevention of double taxation: a
deduction, a credit, and an exemption. Under a deduction mechanism a
taxpayer can deduct foreign tax from her income. The credit mechanism
allows foreign taxes to be credited against a taxpayer’s home-tax liability. An
exemption exempts from home country taxes any income produced abroad.
But how should a country decide whether to provide its taxpayers with a credit,
a deduction, or exempt them altogether? In answering this question experts
turn to neutrality.

B. Global Neutrality

A neutral tax system eliminates the efficiency costs associated with the
distortion of taxpayers’ preferences. A globally neutral system would prevail if

5 Richard E. Caves, Multinational Enterprises and Economic Analysis (2nd edn, Cambridge
6 E.g., sources cited in note 1.
taxes would not interfere with taxpayers’ decisions as to where to invest, where to reside and where to incorporate. Taxpayer's preferences will not be distorted if they are subject to the same combined rates of taxation no matter where they reside or where they decide to invest. A perfectly neutral system requires all countries to impose a single rate of taxation (above the cost of useful services they provide) and use the same mechanism for the alleviation of double taxation.⁷

Global neutrality could only be achieved through international cooperation. No single country can unilaterally (without the cooperation of fellow countries) create a globally neutral system. Does this mean that each country should pursue a policy that enhances (global) neutrality? Since national (rather than global) actors make decisions in today's international tax game, national interests (not international ideals) seem more likely to guide them.⁸ Thus, for a single country to promote global neutrality two separate questions should be answered positively: First, whether global neutrality, once achieved, will indeed serve the best interests of such a country. Second, whether cooperation toward such global neutrality is attainable and sustainable. It may be argued that if single countries adopt a neutrality enhancing policy then, with time, international cooperation may evolve thus promoting global welfare. Therefore, it may be argued, a cooperative strategy on the part of each country may serve such country's interests in the long run.⁹ I am doubtful.

⁷ If countries impose different rates of taxation, then presumably taxpayers will have an incentive to reside and invest in the countries that impose lower rates. If some countries provided a credit but others only a deduction, then again taxpayers will prefer residing in the country that allows a credit. The tax-induced incentive to invest or reside in a specific country constitutes a distortion compared to the pre-tax preferences.
⁹ Examples of evolutionary cooperation are often based on the possibility of punishment that may create an incentive for other players to cooperate provided that a player's losses from punishment are larger than her defection gains. One famous example of such punishing strategy in an infinite repeated prisoner's dilemma game is the “tit for tat” strategy in which each player starts the game by cooperating but moves to defection in response to another's defection. The next round will start, again, with cooperation. In experiments made by Robert Axelrod, this strategy was found to be highly efficient in the long run. See Robert M. Axelrod, The Evolution of Cooperation (Basic Books, NY, 1984), pp. 27-54.
For one, it is not at all clear that the achievement of a globally neutral level of taxation would result in the most efficient allocation of global resources. Indeed, competition between countries may achieve more efficient results. As detailed in section III below, competition between countries for investments as well as for residents may entail efficiency gains.

But even if we insist on global neutrality as the optimal goal, the likelihood of achieving it and sustaining it seems trivial. Consider first, the hurdle of attaining coordination. In order to achieve global neutrality all countries should adhere to a single rate of taxation beyond the costs of public goods provided and a single mechanism for alleviating double taxation. Since countries’ decisions regarding tax rates are deeply rooted in the divergent characteristics and beliefs (and sometime simply the means) of their citizenry and leadership\(^{10}\), attaining coordination in the first place appears problematic.\(^{11}\) Second, even if countries were able to agree on a level of uniform tax (beyond the costs of public goods), it is highly unlikely that they will be able to apply such an agreement, because determining the value of public goods provided by each country is bound to be highly controversial. Third, even if such coordination could be achieved, it is hard to see how it could be sustained. Even if overall world welfare would increase if countries promoted neutrality, any given country may derive even greater economic benefits by defecting from such coordination. Defection can take place either by imposing less tax than cooperatively agreed upon in order to attract residents and investors (as in the tax havens case), by providing more public goods without raising the tax rates, or by providing specific economic benefits.\(^{12}\) Another option exists for those countries large enough to affect global prices of capital and attractive enough to keep its residents (if any such countries even exist).

\(^{10}\) The various interest groups affected within each country by its tax rates and policies complicate the picture even further. Generally the greater the number of players the lower the chances for cooperation to evolve, unless interest groups in different countries cooperate in promoting a certain policy. For an analysis of the influence of interest groups on inter-nation conflicts see Eyal Benvenisti, ‘Exit and Voice in the Age of Globalization’ (1999) 98 *Michigan Law Review* 167. A thorough analysis of their influence on the tax treaty regime is beyond the scope of this Article.

By not alleviating double taxation themselves, they may be able to pressure other (host) countries to reduce their taxes instead. Preventing defection requires sophisticated valuation technique and sensitive monitoring mechanisms as well as willingness on the part of all participants to submit to and observe the set sanction for defection. Even if countries were able to measure the public benefits provided, the price of monitoring defection may be very high since it requires on-line inspection of the tax laws, and public expenditure programs of all nations as well as any concessions made either on an individual basis or simply by not enforcing existing norms.

The bottom line is that even if international cooperation towards neutrality is desirable, its attainment and sustainability hurdles make it practically elusive. This conclusion undermines the claim that single countries should unilaterally cooperate to promote global neutrality. It makes sense for a country to promote global neutrality only if it promotes its national interests. Without a strong reason to believe that global cooperation will evolve, or that once evolved, it will necessarily serve the interests of individual countries, there is no special reason for any given country to support partial neutrality, unless it so happens that providing a credit, a deduction or an exemption promotes its national interest.

C. Global Neutrality and Local Interests

Despite these challenges, neutrality recommendations abound in policy debates concerning unilateral mechanisms for the alleviation of double taxation. Since no coordination exists as to any kind of global neutrality, the conventional wisdom supports whatever partial neutrality the country can achieve. Absent official international standard, it is recommended that countries select mechanisms that promote at least some kind of neutrality. The literature discusses three types of neutralities: Capital Import Neutrality,

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Capital Export Neutrality and National Neutrality. Each of these partial neutrality concepts can be achieved by a specific mechanism for the alleviation of double taxation. An exemption promotes CIN, a credit promotes CEN, and a deduction – NN. Such partial neutrality recommendations sound as merely closely related branches of neutrality; a kind of “second best” alternative options – sharing the objective, favoring-all fame of global neutrality. A closer analysis reveals, however, the interests hiding behind the “neutral” terminology.

Each of these mechanisms provides a different incentive for outbound investments (and for expatriating) provided that host countries tax foreign investments. An exemption provides the highest incentive for outbound investment; a credit provides a moderate incentive for outbound investments; a deduction provides the lowest incentive for outbound investment.

Thus, each of these partial neutralities basically takes a stance regarding the optimal level of incentive for resident investments abroad. The debate among the different kinds of partial neutralities is in fact a debate among different levels of outbound investments promoted by the specific mechanisms “for the alleviation of double taxation.”

Section D discusses in further detail the connection between each concept of partial neutrality and the corresponding mechanism. Section E describes the connection between the mechanisms or rather the level of outbound investment they promote and the interests they serve.
D. Partial Neutralities and the Mechanisms that Promote Them

**Capital Export Neutrality** tries to prevent tax consideration from distorting investors’ decisions regarding where to invest. CEN obtains when the total tax imposed by the country of residence and the host country combined equals the tax imposed on domestic investments in the country of residence. CEN supports the claim that (global) welfare will increase if tax considerations do not interfere with investment decisions, because absent tax considerations investments will flow to the country of their most efficient use. In order to prevent tax considerations from distorting decisions on where to invest, CEN seeks to ensure identical after-tax profits for identical pretax rates-of-return, wherever produced. The **credit** mechanism achieves this goal. Under a credit mechanism the home country allows its resident investing abroad to credit the foreign taxes she paid against home country taxes. Thus, under a perfect credit mechanism, the taxpayer will always be subject to her home country taxes, and only to her home country taxes, wherever she invests.\(^{13}\) A credit mechanism promotes CEN because the taxpayer will pay the same total amount of taxes no matter where she decides to invest.

**Capital Import Neutrality** focuses on the impact of tax on imported capital. CIN aims to ensure that the total tax imposed on investment returns in a given country is the same irrespective of the residence of the investor. Under CIN, income from all businesses operating in any one locality would be subject to uniform taxation. The nationality of investors in a particular locality would not affect the tax rate. Universal CIN would obtain if, for example, all countries **exempted** their residents investing abroad (and each host country would treat local and foreign investors alike). A single home country that employs CIN by exempting foreign source income promotes CIN and enables its investors - when investing abroad - to compete on equal footing with investors from other countries.

**National Neutrality** focuses on national rather than global prosperity as

\(^{13}\) Most of the countries that grant a credit, however, limit the amount of foreign taxes credited to the amount of domestic taxes imposed on the foreign income.
its target. Indeed, NN does not pretend to be a proxy for global neutrality. National neutrality supporters believe in encouraging investors to invest abroad only if both the investor and the government benefit from such investment. Therefore, NN obtains when the tax revenues of the country of residence as well as the after tax returns of its residents are equal, whether the income arises at home or abroad. A deduction promotes NN because under a deduction a taxpayer will choose to invest abroad only if her after-foreign-tax-return abroad is higher than her pre-local-tax-return in her home country.

E. Mechanisms and the Interests They Support

Each of these three mechanisms provides a different incentive for outbound investment (and for expatriation\textsuperscript{14}). For given home country and host county tax rates (and assuming host taxes are lower than home taxes), an exemption provides the highest incentive for outbound investment, a credit provides a lower level of incentive, and a deduction provides the lowest level of incentive for outbound investment.\textsuperscript{15} Thus, the neutrality debate easily translates into a debate regarding the level of incentive for outbound investment.

The level of outbound investment has many social, political, and economic ramifications. It therefore involves many interests. Thus, for example, a higher level of outbound investment may affect wages,

\textsuperscript{14} As the discussion in Chapter III below notes, the incentive to change one’s residency has to do not only with the double tax prevention mechanism, but also with the level of tax in the residence country. Obviously, non-tax considerations are probably of greater consideration regarding residency. This paper, however, focuses on tax and expenditure considerations assuming other things being equal.

\textsuperscript{15} If, for example, a host imposes 30\% tax and the home country 40\% tax on income produced by the home’s resident in the host country, then under an exemption the taxpayer will be subject only to the hosts 30\% taxes, under a credit, he will be subject to the home 40\% taxes (paying 30\% to the host and another 10\% to his home country – 40\% minus the 30\% credit) and under a deduction will be subject to 30\% taxes in the host plus another 28\% (40\%*70) in the home country.
unemployment and the quality of jobs;\textsuperscript{16} it may affect the division of income between capital and labor.\textsuperscript{17} The way a country treats outbound investment may affect its attractiveness for headquarters, which often provide high paying professional jobs and technological spillovers associated with research and development centers.\textsuperscript{18} By affecting the level of US investments in foreign markets (and possibly driving US investors out of domestic markets), it may affect US dominance in those markets. The level of outbound investment may even affect issues such as foreign policy,\textsuperscript{19} national security or national sovereignty.\textsuperscript{20}

Naturally, many of the local interests will have a preference for one mechanism or another. Thus, for example, in the United States, in the debate between CEN and CIN, labor unions traditionally supported CEN while capital

\textsuperscript{16} Given labor’s relative immobility and assuming that investment abroad comes at the expense of investment at home, investment abroad lowers the productivity of labor at home and thereby lowers wages. See Peggy B. Musgrave, \textit{United States Taxation of Foreign Investment Income: Issues and Arguments} (Harvard Law School, Cambridge, MA, 1969) pp. 14-15. Economists generally believe that investment abroad has no significant effect on overall unemployment levels, but that it can affect the type and quality of jobs (U.S. firms, for example, tend to export low quality jobs) and can lower wages. See Jane Gravelle, ‘Foreign Tax Provisions of the American Jobs Act of 1996,’ (1996) 72 \textit{Tax Notes} 1165, 1166. See also Joint Committee on Taxation, \textit{Staff Description (JCS-15-91)} of H.R. 2889, ‘American Jobs and Manufacturing Act of 1991,’ Relating to Current U.S. Taxation of Certain Operations of Controlled Foreign Corporations, and Related issues (scheduled for Oct. 3, 1991 hearing by House Ways and Means Committee. Released Oct. 2, 1991, reprinted in \textit{Daily Tax Reporter} (BNA), Oct. 3, 1991, pp. L-48 to L-49). (“There are unfortunately few economic studies addressing this issue. One... paper examines the effect of outbound investment on domestic employment and finds some evidence that increases in overseas activities by U.S. multinational corporations reduce their domestic employment. ... The authors attribute it largely to the allocation of more labor-intensive activities abroad and more skill and capital-intensive activities to the United States. Therefore, although multinational corporations may have fewer domestic employees as a result of their overseas production they also provide greater compensation per domestic employee as a result of their overseas production.”).

\textsuperscript{17} If exporting capital does not increase domestic savings, it may reduce the productivity of local labor, thereby lowering wages; at the same time it improves the position of local capital by reducing the amount of capital invested within the country. See, e.g., C. Fred Bergsten, Thomas Horst and Theodore H. Moran, \textit{American Multinationals and American Interests} (The Brookings Institution, Washington, D.C., 1978) p. 177; Gravelle, ‘Foreign Tax Provisions,’ 1166; Joint Committee on Taxation, ‘Factors,’ p. 234.


\textsuperscript{19} To the extent that FDI increases the possession of technology, it may affect diplomatic or military relations. See \textit{Ibid}, 92-3.

\textsuperscript{20} Concern regarding foreign domination of a country is often recognized on the international level. Domination of the country’s strong points, such as its land, defense industry, and natural resources, has a negative effect on psychological and practical levels. See, e.g., Henry J. Steiner, Detlev F. Vagts, and Harold Hongju Koh, \textit{Transnational Legal Problems: Materials and Text} (4th edn, Foundation Press, NY, 1994), p. 51.
owners strongly supported CIN. Simply put, partial neutrality concepts have a lot more to do with promoting interests of domestic groups than with enhancing global welfare through neutrality.

In sum, policy debates concerning the optimal policy on the unilateral level highlight neutrality - presumably as a cooperative step towards efficiency - as a central goal for individual countries to promote. In reality, however, individual countries do not and cannot achieve neutrality, and cooperation towards such neutrality remains far from being reached. The theories of partial global neutrality derive their validity from the concept of total global neutrality. It therefore makes sense to promote partial neutrality only if it promotes global neutrality. But if total global neutrality cannot realistically be achieved then theories of partial neutrality have no particular validity. Neutrality is thus fancy terminology for certain domestic interests that are affected by levels of outbound investments. Thus, what is usually framed, as a neutrality debate is, in reality, a battle of interests. Although the neutrality debate seems to focus on ways to enlarge the global welfare pie – we are in fact dealing with an internal distribution of resources.

II. Bilateral Treaties for the Prevention of Double Taxation

Tax treaties are often viewed as the mechanism for preventing double taxation. Policy makers assume that tax treaties benefit everyone involved. By cooperatively eliminating double taxation, these treaties facilitate the free movement of capital, goods and services and help achieve allocational efficiencies. Although countries are required to forgo potential tax revenues,

21 See Bergsten, et al, American Multinationals, p. 177, noting that “[i]n the early 1970s, the AFL-CIO lobbied hard, but unsuccessfully, to get Congress to eliminate both deferral and the foreign tax credit... The unions hoped that this double taxation would limit American firms' willingness to invest abroad and enhance the unions' bargaining strength in wage negotiations."). See also Dagan, ‘National Interests,’ 386, fn 57 and accompanying text.
Treaties, however, often just replicate the mechanism that countries use unilaterally to alleviate double taxation. This is not just a surprising contingent fact. Rather, an analysis of the interaction between the unilateral policies of different types of countries demonstrates that treaties are not likely to offer any significantly greater degree of double taxation prevention than the mere interaction of unilateral policies. Thus, on the double taxation prevention front, treaties cannot be preferred to unilateral mechanisms of double taxation prevention. In fact, treaties reach results that are very similar to the results reached by unilateral mechanisms. Even the techniques employed by such treaties -- most often a credit or an exemption -- are similar to the unilateral mechanisms. One striking difference, however, distinguishes the unilateral solution from the treaty mechanism: While the most common unilateral solutions tend either to eliminate all taxes (exemption) or allow host countries

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22 See, e.g., American Law Institute, *Federal Income Tax Project, International Aspects of United States Income Taxation II, Proposals on United States Income Tax Treaties* 2 (1992), in which the reporters state that “[t]he loss (or potential loss) of revenue which this entails is accepted as the price of obtaining the perceived benefit to the participating countries . . . .”; Committee on Fiscal Affairs, Organization for Economic Cooperation and Development, *Model Tax Convention on Income and on Capital*, at I-1 (1997), declaring that eliminating the “harmful effects” of double taxation is the main purpose of the OECD Model Tax Convention.

For some notable exceptions, see Elizabeth A. Owens, *‘United States Income Tax Treaties: Their Role in Relieving Double Taxation’* (1963) 17 *Rutgers Law Review* 428, 430, arguing that “U.S. income tax treaties play a very marginal role in relieving double taxation . . . [since] the U.S. has unilaterally provided for the avoidance of double taxation for its own citizens, corporations, and residents through the foreign tax credit provisions of the Internal Revenue Code.”; Joseph Isenbergh, *International Taxation: U.S. Taxation of Foreign Persons and Foreign Income* (2nd edn, Little, Brown, Boston, MA, 1996), p. 55:2, noting that “income tax treaties can easily be taken as measures designed to confer tax relief on certain individuals or enterprises. In fact that is rarely their function. Tax treaties are principally concerned with the apportionment of tax revenues between the treasuries of the treaty countries . . . .”; Julie A. Roin, *‘Rethinking Tax Treaties in a Strategic World with Disparate Tax Systems’* (1995) 81 *Virginia Law Review* 1753, 1763, stating that “[t]hough some of these [treaty-based] source tax reductions are intended to benefit investors through the elimination of ‘excessive taxation,’ many are intended to effect a roughly neutral exchange of tax revenues between the source and residence countries.”; Pierre Gravelle, *‘Tax Treaties: Concepts, Objectives and Types’* in 42 *Bulletin for International Fiscal Documentation* (1988), p. 523, stating that “[w]hile the elimination of double taxation is an objective which is usually stated in its title, in reality a treaty is more correctly described as an instrument which refines and improves existing provisions in the domestic legislation which are designed to accomplish that end . . . .

to collect tax revenues (credit), tax treaties usually allocate the revenues more to the benefit of home countries. This revenue disparity is probably insignificant between two developed countries. But in treaties between developing and developed countries (usually host and residence countries, respectively), preserving the credit mechanism while reallocating tax revenues means a regressive redistribution of wealth, benefiting developed countries at the expense of the developing ones.

The next sections develop this analysis in further detail. Subsection A concentrates on the interaction of unilateral policies and envisions what a world without tax treaties might look like. Subsection B compares such a world to the existing one under tax treaties.

A. A World Without Tax Treaties

Imagine a world in which, for some reason, tax treaties were not an option. The conventional rhetoric of tax treaties implies that absent tax treaties, double taxation would prevail. The truth, however, is that individual countries have an incentive to prevent double taxation unilaterally even absent tax treaties. The reason is that host and home countries benefit from cross-border investments. Because excessive taxes limit such benefits, both countries have an incentive for unilateral action.

Host countries have an incentive to lower tax rates in order to attract as much investments as possible\textsuperscript{24}. Home countries have an incentive to reduce double taxation unilaterally in order to enable investors to use their resources more efficiently. We have seen in Section I that the specific mechanism of preventing double taxation in each country would be determined according to its preference as to the level of desired cross-border investment. It will also be influenced by the country’s predictions as to various host countries’ reactions.

\textsuperscript{24} See, e.g., Mark Gersovitz, 'The Effects of Domestic Taxes on Foreign Private Investment' in David Newbury and Nicholas Stern (eds.), \textit{The Theory of Taxation for Developing Countries}
In a world without tax treaties, the interaction between the policies of host and home countries would yield a stable equilibrium. Elsewhere\textsuperscript{25} I provide a detailed game-theoretical analysis of the possible preferences and equilibria. For the purposes of my current argument, it is enough to highlight my conclusions briefly:

Generally speaking, a host country’s interest is to reduce to the greatest extent possible the total level of taxation on foreign investors investing in their country. The lower the total tax burden on foreign investors, the more foreign investments will be made in the host country. More foreign investment means better use of the local factors of production (mainly labor and land). Sure, lower taxes also mean lower governmental revenues, but economic theory teaches us that the local gains from foreign investments are larger than the potential losses from lowering taxes.\textsuperscript{26} Thus, the standard recommendation for a small open economy is not to tax foreign investors.

One important exception arises when the home country levies taxes. These, of course, are taxes that the host country cannot unilaterally reduce. Therefore, where home countries tax their residents investing abroad, the optimal policy for the host country depends on the mechanism the home country employs for alleviating double taxation: If the home country provides a credit for foreign taxes paid by its residents, the optimal policy for the host would be to collect taxes equal to the home country’s taxes.\textsuperscript{27} This way the total level of taxation would not be affected by the tax imposed by the host country. The host, however, would be able to collect taxes.\textsuperscript{28}

\textsuperscript{26} Gersovitz, ‘Effects,’ 616.
\textsuperscript{27} Ibid, 649. In fact, an even better policy for the host would, as Gersovitz shows, be to tax and pay the tax revenues back to the investors as a subsidy. For our purposes, I will assume that residence countries can effectively fight this option by mechanisms like the “specific economic benefit” exceptions. See e.g., Treas. Reg. § 1.901-2(a)(2)(ii)(B) (1983).
\textsuperscript{28} Assume, for example that the home country imposes 30% taxes and grants a credit for foreign taxes. If the host country does not collect any taxes – the taxpayer will pay the host 0 and the home 30%. A 30% tax imposed by the host under these circumstances would mean that the taxpayer pays the same 30% to the host but pays nothing to his home country (the 30% he pays the host are credited against the 30% he owes the home country).
If, on the other hand, the home country exempts foreign income produced by its taxpayers or allows only a deduction for foreign taxes, the optimal policy for the host country would be to exempt the foreign investors. Under an exemption mechanism in the home country, an exemption by the host would mean total elimination of any tax burden and thus the maximum amount of foreign investment and benefits.\textsuperscript{29} Under a deduction at the home country, an exemption at the host would mean at least a reduction of the total tax burden, which is the best the host can do under these circumstances.\textsuperscript{30}

**Residence countries’ policies** will depend on the level of incentive they wish to provide their residents investing abroad. As detailed in section I above, the more outbound investment that a residence country is interested in and the more tax revenues per investment it is willing to sacrifice for that purpose, the more “generous” double taxation prevention mechanism it will provide to its residents. A residence country interested in encouraging more investment abroad will provide an exemption, a country preferring less outbound investment will grant a credit, and the lowest incentive for outbound investment will be achieved through a deduction.

**The interaction** of the unilateral policies of host and residence countries has interesting results. No matter what the residence country’s preference, the interaction between the unilateral policies of residence and host countries yields an equilibrium devoid of double taxation. These equilibria are stable because none of the countries has an incentive to change its policy given the other country’s policy.

To be more precise: In case the home country prefers the higher tax revenues (but lower outbound investment) offered by a deduction mechanism, the interaction of its policy with the host country’s policy results in an equilibrium of a deduction allowed by the home country and no taxes levied in the host. Under this equilibrium, double taxation is prevented and the residence country gets to collect all tax revenues.

\textsuperscript{29} Gersovitz, ‘Effects,’ 617-618.
\textsuperscript{30} Ibid, 619.
If, on the other hand, the home country is interested in encouraging more outbound investment even at the price of tax revenues, thus granting a credit for taxes paid by its residents to the host country, another stable equilibrium emerges -- credit at the home country and full taxation in the host -- achieving the same moderate level of cross-border investment and devoid of double taxation. However, under this assumption, the host country collects the tax revenues.

The third scenario occurs when the home country is interested in encouraging the maximum possible level of outbound investment and exempts all foreign income. Again, equilibrium is reached when the host country does not tax foreign investment and the residence country allows an exemption. In this case, neither country collects any taxes on cross-border investments.

Thus, whatever assumption we adopt as to the optimal policy for a residence country, the result in terms of double taxation is the same: when countries operate unilaterally to best promote their national interests with regard to outbound investments and tax revenues, a stable equilibrium emerges under which double taxation is prevented.

This hypothesis is not merely theoretical. An examination of the existing international tax rules of host countries indicates -- contrary to conventional wisdom -- that treaties are not necessary for alleviating the burden of double taxation on cross-border investments. The reason for this is that most countries apply unilateral mechanisms to prevent double taxation in addition to whatever tax treaties they sign. Most of the major developed countries (which are usually residence countries for investors) alleviate double taxation by granting a credit for foreign taxes paid by residents or by altogether exempting income produced abroad. Only a handful of home countries grant their residents only a deduction for their foreign taxes. The

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31 As mentioned above, Greece, Iceland, Italy, Japan, New Zealand, Spain, Turkey, the U.K., and the U.S. all grant a credit for foreign business income. See Report on Company Taxation, p. 267.
32 Austria, Belgium, France, Finland, Luxembourg, the Netherlands, and Switzerland all exempt foreign business income unilaterally. See ibid.
33 Only Ireland, Portugal and Switzerland allow only a deduction for non-business income. Switzerland exempts foreign business income. ibid.
majority of these home countries have included in their tax treaties the same (or roughly the same) mechanism as the one they were already using unilaterally.34

Moreover, some empirical work recently found “insignificant or even negative, effects of these treaties on FDI (foreign direct investment, T.D.) activity…. This is consistent with the hypothesis that tax treaties are intended to reduce tax evasion rather than promote new investment.35

Thus, even without tax treaties, double taxation is not the dreaded beast it is often made out to be; unilateral measures are already effectively preventing double taxation. If double taxation is being prevented even without tax treaties, what is the role of tax treaties?

B. Unilateral vs. Bilateral Solutions

There are important similarities, but no less significant differences, between the equilibrium achieved by tax treaties and the alternative unilateral equilibria described above. As I have mentioned, most countries include in their treaties the same mechanisms they have allowed unilaterally. But the equilibria reached under treaties still differ from the equilibria that result from the interaction of unilateral policies. The main difference is in the way in which tax revenues are distributed.

Treaties often limit the ability of host countries to collect taxes.

34 See ibid. Belgium, Greece, Spain, France, Luxembourg, the Netherlands, United Kingdom, Austria, Japan, and the United States all treat dividend and interest income in the same way, whether it has been produced in a treaty country or in a non-treaty country. See ibid; Denmark, Germany, Italy, Canada, and Sweden all treat interest income in the same manner and grant a credit for dividend income. Only Ireland, Portugal and Switzerland adhere to the traditional story and provide a deduction when a treaty does not exist and a credit when a treaty is signed. As for business income produced by a foreign permanent establishment, most of the reported countries allow their residents to credit their foreign taxes unilaterally, while some exempt it altogether.

Sometimes the jurisdiction to tax is granted exclusively to the home country.\textsuperscript{36} In other cases, treaties limit the level of home country taxes on certain kinds of income, especially passive income.\textsuperscript{37} When a treaty adopts a credit mechanism, limiting the tax rates on passive income means that the treaty reduces the host country’s share in the tax revenues. Such a reduction in host country taxation does not translate into a larger volume of foreign investment, but rather amounts to no more than a revenue shift.\textsuperscript{38} Therefore, under the credit mechanism the country of residence collects taxes that the host country has foregone.\textsuperscript{39}

Therefore, although treaty-based credits and unilateral credits achieve approximately the same total reduction in taxes, they allocate tax revenues between the contracting states differently. Essentially, in reducing host countries’ taxation, such tax treaties allow home countries to take a larger bite of the tax-revenue pie.

Surely, tax treaties have other important advantages for both parties such as: improved compatibility between the tax rules of the signatory countries; reinforcing investor certainty; and potential cooperation in tax enforcement among nations.\textsuperscript{40} These advantages are significant and can partially explain why nations sign tax treaties. Not one of these benefits, however, is as heroic a purpose as the prevention of double taxation. Simply put, the function of preventing double taxation attributed to tax treaties is highly overrated.

\textsuperscript{36} E.g., business income when no Permanent Establishment exists, income from personal services. See Philip Baker, \textit{Double Taxation Conventions and International Tax Law} (Sweet and Maxwell, London, 1994), 18: “If, on the other hand, no permanent establishment exists, the host will usually cede taxing jurisdiction to the residence country. Income from personal services, to take another example, is typically taxed by the host country without limitation except in special cases specified in the treaty, such as situations involving, \textit{inter alia}, students and trainees, and diplomatic staff.”

\textsuperscript{37} Baker, \textit{ibid}: “Passive income, which usually consists of income from interest or dividend payments, is ordinarily taxed by the country in which the payment originates, the "source" country, but the rate of taxation by the source country is limited.”

\textsuperscript{38} Except in cases where tax sparing is granted. Tax sparing allows investors to credit taxes that were not in fact collected by the host country.

\textsuperscript{39} See, \textit{e.g.}, Roin, ‘Rethinking Tax Treaties,’ 1765, noting that “[r]eductions below a ‘reasonable’ level of tax, by contrast, have generally been perceived as benefiting a foreign taxpayer’s country of residence rather than the taxpayer when that residence country, like the U.S., uses a tax credit system to ameliorate duplicative taxation.”

\textsuperscript{40} Blonigen and Davies, ‘Effects,’ pp. 5-6.
Instead of preventing double taxation, treaties have much more to do with the allocation of taxes between home and host countries as well as with the other more technical advantages. Instead of reducing the total level of taxation, treaties reduce the host country’s tax revenues while increasing the residence’s tax revenues.

This may be a deal worth making in a “symmetrical treaty” – where each country is both a host and a residence country, and its profits as a residence country can compensate for the losses it incurs as a host country. However, in asymmetrical treaties, countries that are predominantly host countries – which is the case for most developing countries – tend to lose revenues by entering into a treaty without increasing the incentive for cross-country investments. Although conventional rhetoric praises treaties as benefiting both countries involved by preventing double taxation, as far as developing countries are concerned, this explanation is incorrect. Thus, the question remains: If signing a treaty is such a bad deal for host countries, why do (some) still get into it? One explanation may be that host countries, do not, for some reason (lack of information, officials with self-serving interests etc), act rationally on this matter. Another explanation may be that some developing countries simply value other advantages treaties offer. The administrative simplicity, taxpayer certainty, and international legitimacy the treaty regime provides may prove more important for developing countries than for developed countries. In other words, unlike the benefits that accrue to developed countries, the main benefit for developing countries is increased legitimacy on the international level and, at times, a more robust foreign policy. However, developing countries -- unlike developed ones (that receive symmetrical benefits) -- pay a price in tax revenues for signing treaties.

Thus, treaties whose main claim is to benefit all signatory countries by reducing overall rates of taxation and facilitating cross-border investment do not reduce double taxation any better than would the unilateral interaction of policies. Not only do tax treaties not achieve their stated goal, they do achieve another covert outcome – redistribution of tax revenues from developing to developed countries.
To conclude, the tax treaties’ claim to fame is “preventing double taxation”. However, interaction of unilateral policies would probably yield the same prevention of double taxation with more tax revenues ending up in the hands of the governments of developing countries. In the current, bilateral treaty regime, developing countries, unlike developed countries (which receive symmetrical benefits), make a sacrifice in the guise of tax revenues in order to become members of the “treaty club”.

III. Multilateral Tax Agreements - Protecting the Welfare State

Countries in the international arena compete for residents, for investments and for tax revenues. Host countries are trying to attract investments by lowering their tax rates on foreign residents; residence countries pursue foreign individuals as well as multi-national enterprises by offering them attractive taxing and spending deals. The result, so it is often claimed, is a “race to the bottom” in which residence as well as host countries keep reducing their tax rates, undermining their ability to sustain the welfare state.41

Policymakers and scholars in the international tax field are highly bothered by this phenomenon, often offering a cooperative multilateral solution - “coordination” or “harmonization” -- that will enforce multilateral standards of taxation.42 Harmonization, it is often argued, will prevent “harmful tax

42 Harmonization can, basically, be thought of as two separate concepts: harmonizing nominal tax rates (e.g., all countries impose, say 30% income taxes) or harmonizing distributive tax rates, that is: taxes above the payment for benefits provided by the government (say, all countries impose benefit taxes plus 5%).
competition” and enable countries to collect enough taxes to sustain (or restore) the welfare state. Such a multilateral tax agreement is justified, according to its supporters, for efficiency as well as for equity reasons.43

A multilateral tax agreement is viewed as more efficient than a regime of tax competition because it generates neutrality. If all countries are taxing residents and investors similarly, then investment decisions as well as residency decisions are “neutrally” made, ignoring tax considerations.44 Harmonization further promotes efficiency, so it is claimed, because it protects countries from racing their taxes to a sub-optimal level.45 Absent harmonization, countries are unable to tax mobile factors and thus are unable to finance public goods they find necessary.

A multilateral tax agreement is viewed as more equitable because it shifts taxes back from less mobile labor to more mobile capital46 and because it allows countries joining such an agreement to finance their welfare states, making (local) redistribution something that countries can afford.47

All this sounds like an indisputable good. But again, a closer analysis demonstrates that this is not necessarily the case. A multilateral agreement has its disadvantages as well. While it may indeed preserve some countries’ ability to maintain their welfare state, it would, at the same time, limit the ability of other countries to choose their “proper” level of welfare state. Harmonization might also generate some efficiency losses, and might distribute resources in a disturbing way. The move from current tax competition to a multilaterally negotiated stage may shift powers to countries that have preferential negotiation positions.

Equating nominal rates makes no sense where countries vary in the services they provide. I will therefore refer to the second. It is extremely hard to apply such harmonization since countries are bound to disagree on the valuation of benefits conferred by fellow countries. My goal here, however, is to argue that even if it were feasible, such harmonization is not necessarily desirable.

43 For a detailed description of these arguments and a convincing critique, see Julie Roin, ‘Competition and Evasion: Another Perspective on International Tax Competition’ (2001) 89 Georgetown Law Journal 543, 549-86.
45 Roin, ‘Another Perspective’, 552, citing proponents of the claim.
A. Tax Competition and Efficiency

Tax competition, at least in theory, drives tax rates down. Assuming perfect competition - tax rates will race to the bottom - until no taxes (other than taxes that merely pay for the benefit of governmental services) are paid.\(^\text{48}\) Collecting benefit taxes (rather than not collecting any taxes) is required on efficiency grounds, because provision of public goods and services without having their consumers pay for them entails a subsidy, which, like a positive tax creates deadweight loss.

A world without taxes (other than benefit taxes) is more efficient\(^\text{49}\) than a world with an extra layer of taxes intended to redistribute income, even if these taxes are imposed in a perfectly neutral fashion. The reason is that while neutral taxes indeed eliminate the inefficiency costs associated with misallocation of resources, zero taxes (other than benefit taxes) do even better from the point of view of economic efficiency. They do not only eliminate such misallocation of resources, but also eliminate the tax wedge, and with it the deadweight costs associated with almost any tax.

Supporters of harmonization argue that the race to the bottom will be destructive, driving tax rates “too low;” they treat the efficiency gains of tax competition as negligible.

There are, to be sure, a few reasons to be suspicious respecting the desirability of tax competition.\(^\text{50}\) The more serious reason is that spillovers impair the efficiency of competition; the other reason is the fear that with no

\(\text{48} \) For an explanation of why the floor of a race to the bottom would be marginal cost of public services rather than zero, see Roin, ‘Another Perspective’, 555-7.

\(\text{49} \) Efficiency here refers only to maximization of worldwide available resources. To include distributive goals in the meaning here will only obscure the analysis.

\(\text{50} \) See Roin, ‘Another Perspective’, 549-54.
harmonization, strategic behavior will make countries pursue strategies that harm them.  

Spillovers arise when those who benefit from the public goods offered by a specific country are not paying for these benefits. This can occur either because the beneficiaries avoid taxes imposed by the country providing the benefits (e.g., by moving their capital to tax havens) -- which is an enforcement problem -- or because of the nature of the public goods offered, that are not limited in use to those who actually pay the taxes (e.g., investments in human capital that later on leave the country, hence the famous "brain drain" problem). The enforcement problem will not necessarily be solved by harmonizing tax rates, but rather by cooperation among governments on enforcement matters. Such cooperation may or may not take place under either tax competition or harmonization. As for the other spillover effect -- having foreign countries and foreign residents benefit from public goods provided by other countries -- it too will not be resolved by harmonizing the tax systems of countries. A country would still have a disincentive to invest in public goods that would spill over to other countries, even if its tax rates are higher. The strategic consideration envisions a situation under which countries that otherwise would prefer higher taxes are forced to lower their tax rates only because of the strategic game's downward pressures. This consideration, however, is usually based on the assumption that the tax levels preferred by countries absent competition is normatively desirable. Although harmonization would certainly allow governments to collect more tax revenues, this is not necessarily a normatively desirable outcome. Curtailing tax competition has the same effects as a cartel -- creating inefficiency losses due to lack of competition. Governments who harmonize

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51 Roin also notes the problem of governmental agents' inability to set the "right price" for the public goods they offer (owing to challenges such as the monetarization of non-monetary costs and benefits, optimism, and agency costs), but convincingly explains why these concerns do not outweigh the benefits of tax competition. See ibid, 563-8.

52 ibid, 594-603.

53 See Avi-Yonah, 'Fiscal Crisis', 1583 ("The current situation resembles a multiple-player assurance ("stag hunt") game: all developed countries would benefit if all re-introduced the withholding tax on interest because they would gain revenue without the risk that the capital would be shifted to another developed country. However, no country is willing to attempt to spark cooperation by imposing a withholding tax unilaterally; thus, they all "defect" (that is, refrain from imposing the tax) to the detriment of all.").
their tax rates might act less efficiently since they will have no incentive to limit “governmental waste.” As Daniel Shaviro puts it: “...just as businesses need not please customers as assiduously if they can form cartels to limit supply, so governments use tax harmonization to loosen their competitive constraints. Once exit from the reach of their harmonized rules has become impossible, only internal political dynamics can limit their power to coerce and expropriate as they choose.”  

Julie Roin has recently made a convincing argument explaining the benefits of tax competition in setting the optimal level of public goods: Roin claims that not every departure from noncompetitive tax levels is unduly low. She shows that tax competition leads to “a diversity of governmental and tax regimes” thus promoting locational efficiencies. When governments compete for residents and investors, they offer packages of services for certain amounts of taxes. Faced with competition by other countries, different countries offer different services for different taxes based on the services that may prove attractive for the residents and investors they wish to attract. Since different countries have different needs and preferences, competition has the benefit of drawing investment to the location that values it most. Roin convincingly concludes that “tax competition is not a negative sum game, either from the perspective of participating countries or global welfare as a whole, when viewed from a strictly economic perspective...”

The bottom line is that tax competition is beneficial in important senses such as reducing the tax wedge, creating a diversity of governmental and tax

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55 Roin, ‘Another Perspective’, 553.
56 *Ibid*, 561, stating that “[i]n sum, advocates of tax harmonization overstate their case by implicitly assuming the fungibility of governments and jurisdictions. Countries are not like bushels of corn, indistinguishable from one another. Instead, they vary along many different dimensions, some of which are quite important to investors. As a result, instead of leading to a pure “race to the bottom”, tax competition has and is likely to continue to result in market segmentation, as investors and countries look for good partners. Just as we believe that society benefits from the availability of Chevy Cavaliers, Camrys, Lexuses, and Porches, so too can it benefit from the diversity of governmental and tax regimes encouraged by tax competition—benefits that would be lost under a strict form of harmonization. At least in an ideal world, then, tax competition can create locational efficiencies.”
regimes, and racing “governmental waste” to the bottom. While there are, as we have seen, costs associated with tax competition -- the most serious of which is the inability of governments to collect taxes for public goods that entail spillovers -- there is no reason to celebrate the costs and downplay the benefits.58

In any case, as cumbersome as the costs of tax competition may be, we must ask ourselves whether harmonization is the right way to deal with the problem. This is especially so in today’s world where the only way to achieve harmonization is a shift from tax competition to multilateral negotiations.

B. Undesirable Distributional Effects of Tax Competition

The distributive case against tax competition is straightforward. Tax competition limits the ability of countries to redistribute income. Under tax competition, countries try to attract (and keep) investors and residents. In order to do so they have to offer, among other things, attractive packages of taxing and spending. This means, on the one hand, lowering the taxes on these mobile factors to the lowest possible level and, on the other hand, offering them the public goods and services they will find most attractive. Driving down tax rates on the mobile factors of production moves the tax burden to the less mobile (most importantly low skilled labor).59 On the expenditures side, investors as well as high-income mobile residents will be interested in services that the government can supply more efficiently than the free market (such as infrastructure, security, rule of law etc), but presumably less interested in governmental functions aimed at helping the weaker segments of society (such as welfare, public health, perhaps education, etc.).60 Thus, tax competition is indeed likely to push countries towards

58 Ibid.
59 Avi-Yonah, ‘Fiscal Crisis’, 1624, stating that “…a shift in the tax burden from capital to labor tends to render the tax system more regressive. Such a tax system is also less capable of redistributing resources from the rich to the poor.”
60 Some differences may arise between features that are attractive to prospective residents (clean environment, public parks, etc.) and future investors (that might find lower environmental standards attractive), but they are not part of my interest in this paper. The
limiting the redistributive functions of taxes and limit their taxes to benefit taxes, thus hurting the social welfare net within the country. The painful result is that tax competition indeed curtails the ability of countries to redistribute income among their residents.

C. Undesirable Distributional Effects of a Multilateral Agreement

Surprisingly, however, curtailing tax competition may also have some very disturbing distributive affects.

First, harmonization might force countries that may not be interested in higher tax rates to increase their tax rates in order to be able to adhere to the international standard. This may not raise a distribution problem unless such countries have more pressing needs than establishing a social welfare net.

Second, in the absence of a global government, the terms of such multilateral agreement will be set by multilateral negotiations. The main problem in a multilateral accord is the shift from competition to negotiation. This shift is not insignificant. In multilateral negotiations countries are no longer relatively small players guided by the invisible hand of the market, but rather, their relative negotiation power is influenced by many other factors (including their respective cultural, diplomatic and army powers). Imagine, for example, the relative power of the US in such negotiations vis-à-vis its power in the market place. In a multilateral bargaining process developed countries are not only likely to have greater individual powers vis-à-vis developing countries, but also will probably have more power as a group over developing countries for two reasons: because of their relatively superior position in the international community; and because the resource they compete for (residents) is a lot less mobile than capital sought for by developing countries.61 This preferred bargaining power may be used by such countries

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61 Thus, developed-residence countries are much less vulnerable to defection by fellow residence countries. That is, the risk of one developed country lowering its tax rate in order to...
in order to obtain a larger share of the collectively imposed tax revenues. If residence countries as a group have superior bargaining power, they might be able to raise capital prices by collectively levying a residence-based tax (and not granting a credit), much like a cartel of capital suppliers. The taxes collected may indeed help developed countries redistribute wealth within their countries, but the host countries will end up effectively paying for the redistributive function of home countries’ taxes. If developing countries will indeed end up paying the price of redistribution in developed countries, the combined redistribution affect may not be exactly what we were hoping for.

Moreover, even if developed-home countries are superior neither in their cooperative abilities nor in their bargaining power, a multilateral tax agreement might still have disturbing distributional effects on a global level due to another difference between host and residence countries, namely, the different local groups that gain and lose due to cross-border investments and the tax thereof.

A tax limits cross-border investments, thus creating a welfare loss that affects groups within each country differently. While in capital-exporting (residence) countries governments will, due to the multilateral agreement, be better able to collect taxes from capital owners (thus able to redistribute wealth), the case in capital-importing (host) countries is different. In capital-importing countries, local factors of production (most importantly labor) are the ones that benefit most from foreign investments.62 Local capital owners in developing countries actually lose from a higher supply of capital from foreign investments. A tax imposed on cross-border investments (and the tax wedge it creates) reduces the level of foreign investment. By doing so, it prevents larger gains from getting into the hands of the host's local factors of production (read: labor). Instead, such tax allows the government of the host country to collect tax revenues that are lower than the gains that labor could

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have collected from more foreign investments (at least this is the case if residence and host countries are sharing the tax revenues).\textsuperscript{63}

The most problematic aspect of this outcome is that labor in particular is exactly the group in need of redistribution. Even if the government uses all of the tax revenues it collects for redistribution purposes, thus paying them back to labor, labor as a group loses, because it would have gained more had the government not levied a tax in the first place. The only way in which developing countries can gain is when developed countries give up (at least part of) their tax revenues. This way (assuming the dead-weight loss from imposing the tax is smaller than the revenues collected by developing countries), redistribution from developed to developing countries will prevail.

But even if developed countries give up potential tax revenues in order to facilitate inter-nation redistribution there is still the risk that the host government will not be very efficient in redistributing these revenues to the people who need them most, and that it would use those funds to benefit other groups and not necessarily the needy.

Again, we can see that the noble cause -- helping countries finance their welfare state -- is not necessarily all good in the international tax arena. Curtailing tax competition may prove inefficient when examined more closely from an international angle. The inefficiency losses created by the imposition of taxes as well as the losses created by not having governments compete with each other reduce the global welfare pie. Moreover, a multilateral agreement may force some countries into standards that they cannot afford. And finally -- probably most disturbing -- such an agreement might mean financing developed countries' welfare states out of the pockets of developing countries' or (even worse) their weakest residents.

\textsuperscript{63} This complies with the view of governments as rent-seekers, seeking first and foremost to maximize their revenues. For the classic statement of this view, see Geoffrey Brennan and James M. Buchanan, \textit{The Power to Tax: Analytical Foundations of a Fiscal Constitution} (Cambridge University Press, 1980), I-33.
IV. Conclusion

Some of the prevailing arguments in international taxation sound indisputable. At least with respect to the arguments discussed in this paper, however, such first impressions prove dubious. A Pareto rhetoric masks the fact that behind these seemingly noble ideals lie interests of specific groups and countries.

The underlying theme of these prevailing arguments is the often-praised value of cooperation in the international tax game. Cooperation is used in support of the conventional wisdom on all three levels at which international tax evolves. On the unilateral level, countries are encouraged to follow “neutral” policies as a cooperative strategy towards global neutrality; on the bilateral level, countries are encouraged to cooperate in order to eliminate double taxation; on the multilateral level they are encouraged to cooperate in order to harmonize their taxes in an effort to save the welfare state.

But cooperation is not necessarily desirable. It is far from clear that multilateral cooperation can evolve and that, if it can evolve, it can be sustained. It is also not clear that multilateral cooperation would be normatively desirable even if it could evolve. Nevertheless, cooperative strategies sound indisputable. Thus they serve as useful rhetorical tools that support a certain contingent policy choice, but obscure other, potentially important, considerations and alternatives.

Most importantly, supporters of cooperation in international tax downplay the heterogeneity of the international community. In international tax, every policy chosen potentially affects different people, groups, and nations in different ways. Identifying the winners and losers of cooperative policies is thus necessary in order to evaluate such polices. Cooperation cannot be and is not the ultimate goal in international tax policy.