The University of Akron
IdeaExchange@UAkron

Akron Tax Journal | Akron Law Journals

2001

International Tax Competition: An Efficient or Inefficient Phenomenon?

Mitchell B. Weiss

Please take a moment to share how this work helps you through this survey. Your feedback will be important as we plan further development of our repository.
Follow this and additional works at: https://ideaexchange.uakron.edu/akrontaxjournal

Part of the International Law Commons, Taxation-Transnational Commons, and the Tax Law Commons

Recommended Citation
Weiss, Mitchell B. (2001) "International Tax Competition: An Efficient or Inefficient Phenomenon?," *Akron Tax Journal*: Vol. 16 , Article 3.
Available at: https://ideaexchange.uakron.edu/akrontaxjournal/vol16/iss1/3

This Article is brought to you for free and open access by Akron Law Journals at IdeaExchange@UAkron, the institutional repository of The University of Akron in Akron, Ohio, USA. It has been accepted for inclusion in Akron Tax Journal by an authorized administrator of IdeaExchange@UAkron. For more information, please contact mjon@uakron.edu, uapress@uakron.edu.

INTERNATIONAL TAX COMPETITION: AN EFFICIENT OR INEFFICIENT PHENOMENON?

by

Mitchell B. Weiss*

I. INTRODUCTION

"Taxes are what we pay for civilized society."[1] Unquestionably this is true, but in today's technologically driven, globally interwoven world, how much we pay is increasingly being decided by how much the taxes are worth. Not always has this been the case. Taxpayers have always been free to "vote with their feet," so to speak, if the taxes they paid were not worth the mix of services they received. But legal and financial barriers often combined to make this option illusory. Indeed, not too long ago, the U.S. Treasury enjoyed a largely captive tax base: taxpayers lived, worked, and invested in the U.S.; cross-border transactions were scarce, information costly; and even if the taxpayer chose to operate abroad, the taxman still managed to collect his cut, nonetheless. Today, the story is quite different.

The explosive growth in telecommunications technology is fundamentally altering the U.S. tax system in two important and complementary ways. First, because the U.S. tax system is based on the physical — not the virtual — world, it is no longer in sync with the world's emerging electronic economy. Second, this technology boom is fueling an already extant international tax race, a race a growing number of economists are predicting will result in the collapse of the income tax system as we know it.[2] Although similar apocalyptic predictions regarding the Y2K bug proved

* Associate, Sidley & Austin. This article has benefitted greatly from the comments of a number of individuals. I would like to thank in particular: Suresh Advani, Brian Horan, Kevin Pryor, Sharp Sorensen, David Weiss, Janice Weiss, and Jay Zimbler.

[1] Compania General de Tabacos de Filipinas v. Collector of Internal Revenue, 275 U.S. 87, 100 (1927) (Holmes, J., dissenting).

[2] *See* Reuven S. Avi-Yonah, *Globalization, Tax Competition and the Fiscal Crisis of the Welfare State,* 113 HARV. L. REV. 1573, 1586 (2000) [hereinafter, "*Globalization*"] (quoting Richard Bird's prediction that "[i]f something is not done to rectify these problems soon, the future of the income tax is bleak"); Thomas F. Field, *If the Corporate Tax Has No Future, Is Tax Competition a Threat?*, 2000 WTD 42-1 March 1, 2000 (reporting that the Canadian Tax Foundation recently bet on "the date on which the last OECD member country will abolish the corporate

Published by IdeaExchange@UAkron, 2001

utterly ridiculous, and although there is currently no empirical evidence that conclusively supports this prediction, the inference that globalization will at least have a profound affect on the U.S. income tax system is practically unavoidable.

This Article examines the legal and economic implications of this globalization phenomenon. Part I discusses the allocative effect an income tax system has on a particular country's resources. This first part, while focusing only on domestic tax policy, is intended to throw some light on the international issues that are the central focus of this article. So with this background in mind, Part II turns to the international scene, analyzing the efficiency effect international integration is having on the world's income tax systems in general and the U.S.'s income tax system in particular. Finally, Part III considers what the Organisation for Economic Cooperation and Development (OECD) has proposed be done about this "harmful" phenomenon and whether anything can or should be done about it.

II. THE (IN)EFFICIENT INCOME TAX SYSTEM

A. The U.S. Income Tax System Corrects Market Deficiencies

The U.S. income tax system both corrects and exacerbates market deficiencies. The good news, always first: since taxes modify behavior, the income tax system can be (and frequently is) used to correct perceived market deficiencies.[3] Mobilizing the income tax system in this way, how-

---

income tax"; the earliest "bet" was ten years); Roger H. Gordon, *Can Capital Income Taxes Survive in Open Economies,* 47 J. FIN. 1159 (1992); VITO TANZI, TAXATION IN AN INTEGRATING WORLD 65-67 (1995) [hereinafter, "TAXATION IN AN INTEGRATING WORLD"] (citing others).

[3] For example in 1981, Congress estimated that the personal savings rate, when compared to the personal disposable income, had declined from 8.6 percent in 1976 to 5.6 percent in 1980. *See* General Explanation of the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34 (1981). So to encourage greater personal savings, the Economic Recovery Tax Act of 1981 increased the deductible amount an individual could contribute to an individual retirement account, even if the individual was already covered by an employee-sponsored plan. In enacting this tax incentive, however, Congress failed to appreciate the actual inducement this provision would have; rather than creating a savings incentive it actually created a savings disincentive. *See* JOSEPH A. PECHMAN, FEDERAL TAX POLICY 105 (4th ed. 1983) (estimating that this savings incentive created a $3 billion loss in revenue "because it provides a tax benefit even if the individual switches assets from another account to an IRA or borrows the money for the IRA investment.")

ever, is only socially desirable if the targeted activity produces an *uncompensated* benefit or harm on society.

Indeed, in a perfectly competitive market, uncompensated externalities would never exist, and so a market correction would never be necessary. Society would compensate the investor, and the investor would compensate society, for whatever positive and/or negative externalities a particular activity respectively created, but only up to slightly less than the amount the total net benefits from the particular activity exceeded the total net benefits available under the next best investment alternative.[4] But since the market is not (yet?) perfectly competitive, and thus transaction costs often inhibit this self-correcting mechanism, the tax system, or other legal rules, often act as a market surrogate, mimicking what the market would do were it perfectly competitive.

The analysis necessarily begins with the rational taxpayer. From his perspective, the more an activity benefits (harms) society, relative to available alternative activities, the less (more) desirable the activity will appear. So at some point, this externality will skew the taxpayer's incentives, thus creating an inefficient result. This is because the substituted activity will produce a smaller net gain, though a larger personal gain, than the activity the taxpayer would have otherwise chosen. Otherwise, the taxpayer would have initially opted for the substituted activity, and thus maximized society's (and his) wealth, without the need for legal intervention.

Example 1. Assume a rational taxpayer must choose between two investment alternatives, X and Y. X produces a total net gain of $100, and Y $50. If there is a sufficiently large net uncompensated externality, the taxpayer may very well invest in Y, even though X is the socially desirable result. For example, the taxpayer would not invest in X if he could capture all of Y's net benefits (i.e., the full $50) but less than $50 of X's net benefits. Or even if the taxpayer could capture all of X's net benefits (i.e., the full $100), he would still invest in Y if more than $50 of Y's costs were imposed (without reimbursement from the taxpayer) on society.

No matter how the distortion materializes, Congress can neutralize it, and thereby align the taxpayers' incentives with the most efficient outcomes, by (i) taxing those activities that produce negative externalities, (ii) providing tax breaks for those activities that produce positive externalities, or (iii) taxing some and giving incentives for others. Regardless of how this is accomplished, the effect (though probably not the magnitude of the effect) will be the same: the tax dis/incentive will create a substitu-

---

[4] *See* R.H. Coase, *The Problem of Social Cost,* 3 J. LAW & ECON. 1 (1960), *reprinted in* R.H. COASE, THE FIRM THE MARKET AND THE LAW 95, 97-104 (1988).

tion effect. A tax reduction (or refundable credit) will attract more resources to the subsidized activity than would otherwise be the case; and a tax increase will have the opposite effect.

Of course reality is a good deal more complicated than this example suggests. Both X and Y will probably produce uncompensated positive *and* negative externalities, which is why "the proper procedure is to compare the total social product yielded by these different arrangements."[5] Yet it may be difficult, or it may not be cost justified, to make such comparisons, especially when these varying externalities fluctuate over time and among taxpayers. Moreover, and even more troubling, is the unfortunate fact that these inefficiencies are often a byproduct or end-result of other offsetting or complementing inefficiencies.

B. The U.S. Income Tax System Creates Market Inefficiencies

Now the worse news: most scholars believe the U.S. income tax system distorts behavior and is thus, itself, economically inefficient.[6] How inefficient, though, is anyone's guess.

Thankfully, not all increases in utility are taxable. A taxpayer may garner just as much if not more pleasure from basking in the sun than from spending a day's hard earned pay. But only the paycheck is taxable. Likewise, a taxpayer may enjoy spending a dollar today just as much as he enjoys spending whatever that dollar is worth tomorrow, if invested at an appropriate rate. But only the income earned on the dollar is taxable, even if the dollar plus the amount it earned is worth less tomorrow than what a single dollar is worth today.

Since an income tax is not imposed on the utility one receives from leisure or consumption, but is imposed on the income earned from saving or working, an income tax may create a substitution effect: The tax-

---

[5] *Id.* at 142.

[6] *See* Christine Jolls, *Behavioral Economics Analysis of Redistributive Legal Rules*, 51 VAND. L. REV. 1653, 1655 (1998) ("[T]he animating feature of both lawyers' and economists' analyses of tax schemes is their potential to distort people's work incentives."); Louis Kaplow & Steven Shavell, *Why the Legal System is Less Efficient than the Income Tax in Redistributing Income*, 23 J. LEGAL STUD. 667, 669 (1994) ("[T]he income tax distorts work incentives."); Joseph Isenbergh, *The End of Income Taxation*, 45 TAX L. REV. 283, 284 (1990) ("Not only does income taxation distort individual actions to the point that their sum no longer occupies an efficient frontier, but the political process through which we allocate tax costs permits groups to indulge the hope (or the illusion) that they will be able to deflect the costs from themselves to others.").

payer may work less and consume more – a potentially undesirable, inefficient result. The magnitude of this substitution effect, however, depends on at least two factors: the level of the tax rate; and the elasticity of the taxpayer's demand for work or saving.[7] Therefore, it is generally acknowledged that allocative efficiency necessitates a tax rate that inversely tracks the elasticity of the taxed activity.[8] So a head tax is perfectly efficient because the tax base — i.e., one's head — is perfectly inelastic; that is, the tax cannot distort the taxpayer's behavior because he will owe the tax no matter what he does.

While seemingly self-evident, whether an income tax is inefficient is in fact far from clear. Indeed, because of a number of offsetting factors, the empirical evidence on this point is inconclusive.[9] One such factor is the so-called "income effect" a tax may have on the taxpayer's conduct. Rather than focusing on the demand for a particular activity, this theory focuses on the extent to which the supply of a particular activity is responsive to a change in the tax rate. The substitution effect simply assumes that the taxpayer's supply of the taxed activity (i.e., saving or working) is more elastic than his demand for achieving a given after-tax result. In other words, the substitution effect assumes that the taxpayer's supply of, say, capital is more dependent on the amount of pre-tax income that is taxed than on the amount of after-tax income that is received. But the opposite may be true. If the taxpayer desperately needs or wants a fixed amount of disposable income, increasing the tax rate may not dissuade him from achieving his goal, but may merely make that goal more difficult to achieve.[10] Thus, so long as the utility the taxpayer receives from achieving a particular goal (i.e., saving for a vacation) is not less than the disutility he has to endure (i.e., working or saving more) in accomplishing that goal, a tax increase may actually provide an incentive to work or save *more!*

---

[7] *See* TAXATION IN AN INTEGRATING WORLD, *supra* note 2, at 65-67.

[8] *See* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 523-24 (5th ed. 1998) [hereinafter, "ECONOMIC ANALYSIS OF LAW"].

[9] *See* JOSEPH A. PECHMAN, FEDERAL TAX POLICY 77 (5th ed. 1987) [hereinafter, "FEDERAL TAX POLICY"].

[10] *See* William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113, 1173 (1974) ("For one who is saving to meet some particular objective, exemption of savings from the personal income tax would make it easier to meet that goal and would therefore operate to let the individual spend a higher portion of his current income."); FEDERAL TAX POLICY, *supra* note 9, at 76-78.

III. THE (IN)EFFICIENT INTERNATIONAL TAX SYSTEM

This exception to the substitution effect, however, is subject to a further, more significant, exception. An income tax may or may not push the taxpayer into a different activity. It depends on whether the income effect prevails over the substitution effect, and the substitution effect depends on how much tax is imposed and how elastic or inelastic the activity is. While the substitution effect has been around at least as long as there has been an income tax, it has recently adapted to our interconnected world economy.

Taxing an activity today may not only create an incentive to substitute to a *different* activity; it may also create an incentive to engage in the *same* activity in another jurisdiction. Of course, cross-border opportunities have always been available, but political and technological barriers to the movement of goods, services, and capital have, in the past, greatly inhibited their feasibility. That is, even if the taxpayer could earn a higher after-tax return in another jurisdiction, transaction costs often eliminated this inter-jurisdictional earnings differential.

A. International Tax Competition

The picture is vastly different today. Advances in telecommunications technology, coupled with the deregulation of the financial and capital markets, have not only mitigated this concern. They have also redefined the competitive market, promising far greater efficiency than heretofore ever imagined possible. In a perfect market, there would be no entry or exit barriers; all buyers and sellers would simultaneously and instantaneously exchange all relevant information (price, delivery, quality, warranties, etc.); transactions would be consummated in accordance with the best matches; and there would be no transaction costs to boot. However far-fetched this theoretical market may seem, the Internet is rapidly moving the world in this direction — towards a single, perfectly competitive market.[11]

Indeed, it is now just as easy to enter into a cross border transaction as it is a local one. They are both after all just a mouse click away. The Treasury is well aware of this: "Electronic commerce . . . may be conducted without regard to national boundaries and may dissolve the link between an income-producing activity and a specific location."[12] Globaliza-

---

[11] *See Internet Economics: A Thinkers' Guide*, THE ECONOMIST, Apr. 2000, at 65.

[12] Office of Tax Policy, U.S. Dep't of the Treasury, *Selected Tax Policy Implications of Global Electronic Commerce* § 7.2.3.1, at 20 (visited April, 1, 2000) <http://www.fedworld.gov/pub/tel/internet.txt>.

tion has also mobilized much of the world's capital. To be sure, the numbers are staggering. It has been estimated that the total *daily* global capital flows have increased from $15 billion in 1973 to $1.2 trillion in 1995.[13] And this, in turn, is having a profound affect on the world's tax bases. It has increased the elasticity of the income tax base and, with it, the migration of labor and, in particular, capital.[14] Simply put, what was once inelastic is now elastic.

Today's international tax race appears to have started in the U.S. In 1981, the Reagan Administration adopted a new, extravagant approach to promoting economic growth and efficiency. Called supply side economics, the popular version of this approach was a politician's dream, though only in one's dreams could all of its goals be achieved. It promised deep tax cuts *and* an increase in tax revenues. Steep progressivity, the proponents argued, creates crushing work disincentives. So much so, that if the marginal tax rates are reduced, significantly, the revenues gained from the increase in output will more than offset the revenues that are lost from the concomitant tax rate reductions.[15] Needless to say, Congress cut taxes — significantly.[16] Although these tax cuts did increase productivity, on the whole they failed to deliver,[17] thus creating a massive budgetary deficit that could only be financed from abroad.[18]

So in 1984, Congress set out to do just that. It abolished the 30 percent withholding tax that, absent an overriding treaty provision, had

---

[13] *See* Peter D. Sutherland, *Sharing the Bounty: Challenges of Globalization*, BANKER, Nov. 1998, at 16.

[14] The U.S. imposes an expatriation tax on U.S. citizens and certain long-term resident aliens who renounce their citizenship for the principal purpose of avoiding U.S. tax. *See* 26 U.S.C. § 877. This so-called exit or ex-patriot tax was amended in 1995, at which time Congress estimated that approximately $3.6 billion would be lost over the following decade as a result of a number of wealthy individuals renouncing their citizenship. *See* Renee S. Liu, *The Expatriate Exclusion Clause: An Inappropriate response to Relinquishing Citizenship for Tax Avoidance Purposes*, 12 GEO. IMMIGR. L. J. 689, 693 (1998) (Comment); Robert Lenzner & Philippe Mao, *The New Refugees*, FORBES, Nov. 21, 1994, at 131.

[15] *See* VED P. GANDHI, SUPPLY-SIDE TAX POLICY: ITS RELEVANCE TO DEVELOPING COUNTRIES 8-11 (1987); FEDERAL TAX POLICY, *supra* note 9, at 74.

[16] The maximum individual rate was cut from 70 percent in 1980 to 50 percent in 1982; the IRA deduction was extended to employed and self-employed persons; and aggressive depreciation deductions and investment tax credits were provided. *See* FEDERAL TAX POLICY, *supra* note 9, at 122, 160, 301.

[17] *See id.* at 74.

[18] *See Globalization*, *supra* note 2, at 1580.

been imposed on nonresident alien's portfolio interest income; it indirectly eliminated, as a practical matter, the 30 percent withholding tax on capital gains that previously applied to certain nonresident aliens who were present in the U.S.; [19] and it even facilitated the foreign borrowers' tax evasion.[20] While dividends paid to nonresident aliens and foreign corporations are still statutorily subject to this 30 percent withholding tax, rapid advances in derivatives-based technology have made this tax largely

---

[19] Although foreign persons are generally not subject to U.S. tax on their U.S.-source capital gains, there are two exceptions to this result, one real the other illusory. If a foreign person owns more than five percent of any class stock that is regularly traded on an established securities market, the gain from the sale of such stock is subject to U.S. tax. *See* 26 U.S.C. § 897(c)(3). Section 871(a)(2) imposes a 30 percent withholding tax on the U.S. source, net capital gains recognized by any nonresident alien individual who is present in the U.S. during any taxable year for at least 183 days. However, since the enactment of Section 7701(b) as part of the Tax Reform Act of 1984, this tax has been largely, if not entirely, a dead letter. *See* 26 U.S.C. § 7701(b)(3) (stating that, "for purposes of this title," an alien individual is "treated as a resident of the United States" if the sum of the weighted number of days the individual was present in the U.S. during the current and preceding two years equals or exceeds 183 days); *see also* 26 U.S.C. § 865(g) (expanding this definition to include nonresident aliens who have a tax home in the U.S.).

[20] *See* 26 U.S.C. § 871(h)(2)(A) (1994) (defining "portfolio interest" to include certain obligations that are "*not* in registered form") (emphasis added). *See also* 26 U.S.C. §§ 871, 881 (1994); 2 JOEL D. KUNTZ & ROBERT J. PERONI, U.S. INTERNATIONAL TAXATION C1-17-19, ¶ C1.03[2][c] (1996). As a general matter, a debtor cannot deduct its interest payments unless the "obligation is in registered form." 26 U.S.C. § 163(f)(1) (1994). Of course, without this requirement, the Internal Revenue Service would have no way of knowing whether the creditor reported the interest it received. By carving out an exception for foreign creditors, Congress effectively facilitated foreign and U.S. (to the extent foreign entities purchase U.S. debt securities on behalf of U.S. borrowers) tax evasion. But Congress had practically no choice in the matter, for if it prohibited the issuance of all bearer bonds, foreign investors could still achieve anonymity from their home country's tax authorities by simply channeling the proceeds through another country (such as the Cayman Islands) that does not have an information-sharing agreement with their home country. Interposing these investment intermediaries, however, costs money, and thus reduces the effective yield on the U.S. investment. At bottom, Congress had to facilitate the foreign investor's tax evasion, lest it would have limited its ability to compete with those capital-importing countries that permitted anonymous investing.

elective.[21] The cumulative effect of these provisions is clear: when it comes to foreign portfolio investment, the U.S. is undoubtedly one of the world's most lucrative tax havens.

The empirical evidence is in accord. In 1983, just one year before Congress abolished its interest income and capital gains withholding tax, the Bureau of Economic Analysis, a sub-unit of the Commerce Department, reported a paltry $17.8 billion in net foreign purchases of U.S. private and public securities. The next year, this figure jumped 226 percent to $40.3 billion.[22] And while this trend tapered off after 1988, during the

---

[21] Indeed, derivatives technology has made it possible to "separate the cash flow characteristics of a fungible asset, such as a publicly-traded security or commodity, from the collateral legal rights that attach to that asset." Suzanne F. Greenberg, *Asset-Based Swaps: Challenges to Traditional Ownership Principles*, 845 PLI/CORP 413, 417 (May 1994). Thus, by entering into an equity swap with the U.S. corporation, the foreign taxpayer can essentially enjoy the economic equivalent of receiving a U.S. dividend without paying the withholding tax. *See* Treas. Reg. § 1.863-7(b) (2000) (providing that swap payments to foreigners are not treated as U.S. source income); Kevin M. Keyes *Notional Principal Contracts*, 484 PLI/TAX 799, 866 (Oct-Nov. 2000) ("[T]he better view under the current regulations is that equity swaps . . . do not trigger tax and withholding under Sections 897 and 1445.").

[22] *See* Department of Commerce, Bureau of Economic Analysis, Table 1-U.S. International Transactions (visited April 15, 2000) <http//www.bea.doc.gov/bea/di/bopa>. [hereinafter "Department of Commerce"]. This dramatic rise in foreign portfolio investments may reflect not the elimination of the 30 percent withholding tax, but rather the elimination of the costs that were previously necessary to circumvent it. Before 1984, U.S. debtors frequently avoided this tax by washing their loan proceeds through a Netherlands-Antilles finance subsidiary. But this maneuver was not only costly to setup, *see* THOMAS P. AZZARA, TAX HAVENS OF THE WORLD 9 (5th ed. 1995) [hereinafter "TAX HAVENS OF THE WORLD"] ("Throughout the 1970's and for most of the 1980's the costs to register an offshore holding company in most any of the world's tax havens were continually on the rise."), but — because of the IRS's insistence on substance over form — was also costly to operate. By requiring that the Netherland-Antilles conduit retain no more than a five-to-one debt to equity ratio, the Treasury essentially charged the debtor a premium for avoiding the withholding tax in this way. *See* Rev. Rul. 69-501, 1969-2 C.B. 233, *revoked by* Rev. Rul. 74-464, 1974-2 C.B. 46. The foreign creditor's return was reduced, and so the U.S. debtor's interest charge was increased, by the tax the Netherland-Antilles government assessed on the income the conduit earned on the minimum capital the Treasury required. Thus, the elimination of the portfolio interest withholding tax eliminated the need to incur this deadweight loss, and thereby precipitated the sharp

second half of the 1990s, when the Internet was suddenly everywhere,[23] the U.S. experienced a remarkable resurgence in foreign portfolio *and* direct investment. Since 1995, net foreign portfolio purchases have increased over 333 percent, from $91.2 billion to $304.1 billion; and over this same time period, foreign direct investment has registered spectacular gains, increasing over 680 percent, from $41.4 billion in 1995 to $282.5 billion in 1999.[24] However, not all of this capital was new, for some of it surely came from other locations. For example, it is estimated that, as a consequence of Congress repealing the portfolio interest withholding tax, the U.S. lured approximately $300 billion away from the Latin American countries.[25]

Thus, not surprisingly, one country after the next responded in kind, introducing measures that not only discouraged the outbound migration of their country's capital, but also encouraged the importation of large amounts of capital from higher-taxing jurisdictions.[26] Some countries created tax-exempt domestic investment opportunities; some relaxed their enforcement efforts; but most followed the U.S.'s lead, exempting their withholding tax on imported interest income and substantially cutting their corporate and individual tax rates.[27]

---

increase in foreign portfolio investment in the United States during 1984 through 1988. *See* Exhibit 2, *infra.*

[23] *See* Timothy Wu, *When Law & the Internet First Met*, 3 GREEN BAG 171-72 (2000).

[24] *See* Department of Commerce, *supra* note 22, and Examples 2 and 3, *infra*, which are based thereon.

[25] *See Globalization, supra* note 2, at 1585-86.

[26] *See* TAXATION IN AN INTEGRATING WORLD, *supra* note 2, at 130-31.

[27] By 1993, the following countries no longer taxed interest earned on bank accounts owned by nonresident aliens: Belgium, Denmark, France, Germany, Ireland, Luxembourg, Netherlands, Spain, United Kingdom, and the United States. *See id.* at 131. With the exception of Ireland and Investment Funds located in Luxembourg, all of these countries impose fairly significant taxes on business profits, but even these rates have been falling over the years. During the 1980s, most of the world's developed and developing countries had, on average, reduced their top marginal individual and corporate rates from 60 to 40 percent and from 46 to 35 percent, respectively. *See* MICHAEL J. BOSKIN & CHARLES E. MCLURE, JR., WORLD TAX REFORM: CASE STUDIES OF DEVELOPED AND DEVELOPING COUNTRIES 282 (1990). Today, these average rates are even lower. Developed OECD countries have an average corporate rate of 34.8 percent; comparatively less developed countries in the Asia Pacific region have an average rate of 31.7 percent; and the even less developed countries in Latin America have an average rate of 28.6 percent. *See* KPMG Corporate Tax Rate Survey — January 1999,

From a U.S. taxpayer's perspective, however, none of these tax-favored foreign investments would seem to matter. After all, the U.S. taxes all of its citizens on their worldwide income.[28] So even if a U.S. taxpayer is not physically present in the U.S., and all of his income is from foreign sources, U.S. tax is nevertheless due? Perhaps. At the outset, it should be noted that U.S. taxpayers typically do not pay more than their U.S. marginal tax rate on their foreign source income. U.S. taxpayers are not double taxed because they receive a foreign tax credit (FTC) for income taxes that are paid (or accrued) to most foreign countries; [29] though this credit is sensibly capped by the amount of U.S. tax that would have been due had the foreign income been earned in the U.S.[30]

Besides encouraging inbound investments, the U.S. has also encouraged its citizens to directly invest abroad. Congress has long recognized that its residency-based taxing regime places its taxpayers at a competitive disadvantage. This is because the U.S. is the only major economic power that taxes its citizens on their worldwide income.[31] A foreign competitor, even if comparatively less efficient, would thus have a decided advantage by merely operating in a tax haven. So to help level the playing field (or to perpetuate the tax race, depending on how you look at it), a number of exceptions to the U.S.'s residency-based taxation regime have

---

(visited April 15, 2000) <http//www.tax.kpmg.net>. Finally, there are of course an abundance of "no-tax" and very "low tax" possessions primarily in the Caribbean. *See generally* TAX HAVENS OF THE WORLD, *supra* note 22.

[28] *See* 26 U.S.C. § 61 (1994); Treas. Reg. § 1.1-1(b) (2000).

[29] *See* 26 U.S.C. §§ 901-08 (1994 & Supp. 2000). Section 901(j) prohibits an FTC for foreign taxes that are paid or accrued to certain blacklisted countries. *See* Rev. Rul. 95-63, 1995-2 C.B. 85 (blacklisting Cuba, Iran, Libya, North Korea, Sudan, and Syria). This "blacklist," moreover, may soon include certain identified tax havens. *See* Part III, *infra.*

[30] *See* 26 U.S.C. § 904(a) (1994). This FTC limitation is indeed sensible. Without it, U.S. taxpayers would be largely – although in some situations, not entirely – indifferent to how much they paid in foreign taxes because the U.S. government would pay the amount that exceeded the U.S. rate. Since there would be no market check on the amount that could be charged, foreign governments would inevitably bilk the U.S. fisc.

[31] The Philippines also taxes its citizens on their worldwide income, and beginning January 1, 2001, Venezuela will too. *See* CHARLES I. KINGSON & CYNTHIA A. BLUM, INTERNATIONAL TAXATION 30 (1998); KPMG, *2 Global Tax News: Venezuela Introduces Worldwide Tax Basis,* No. 22 (November 12, 1999) <http://www.tax.kpmg.net>.

been created.[32]

U.S. corporations often take advantage of foreign tax holidays through the use of controlled foreign corporations (CFCs). As a general matter, the U.S. respects a foreign corporation's separate legal identity, even if U.S. persons own all of its outstanding stock. Consequently, a U.S. parent is not subject to tax on its foreign subsidiary's business profits until such foreign income is repatriated, whether the CFC pays foreign tax on its profits or not. [33] Thus, so long as the U.S. parent does not draw on its CFC's earnings, U.S. tax is generally not due.[34] Yet even when the CFC's earnings are repatriated, studies indicate that even these distributions largely escape U.S. tax. For example, one study of roughly 18,000 CFCs found that "[m]ost CFCs appear to generate no U.S. tax liability on their

---

[32] In addition to the CFC and export provisions discussed below, there are a number of other exceptions to the U.S.'s worldwide taxing regime. For example, U.S. citizens and resident aliens may exclude up to the following amounts of foreign earned income: $76,000 in 2000; $78,000 in 2001; and $80,000 in 2002 and beyond, which will be adjusted for inflation beginning January 1, 2008. *See* 26 U.S.C. § 911(b)(2)(D) (1994). Moreover, U.S. corporations that at least partially operate in the U.S. possessions were practically exempt from all taxation. *See* 26 U.S.C. § 936 (Supp. 1996); Raymond Wacker & Mitchell Weiss, *Restrictions to the Section 936 Credit Imposed by the Revenue Reconciliation Act of 1993*, 20 INT'L TAX J. 24 (1994). While Congress repealed this "tax sparing" provision in 1996, much of it remains available for so called "existing credit claimants." *See* 26 U.S.C. § 936 (Supp. 2000); Raymond Wacker & Julie Sobery, *United States Finally Ends the Puerto Rico and Possession Credit of Code Section 936 — A Decade From Now*, 23 INT'L TAX J. 62 (1997).

[33] *See* 26 U.S.C. §§ 951-60 (1994). There are a number of exceptions to this general rule. For example, the Secretary has the authority under Section 482 to "distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among" the parent and foreign subsidiary in order to approximate what would have been reported had there been an arms-length transaction. Additionally, Subpart F of the Internal Revenue Code subjects the U.S. parent to current taxation on certain forms of income that are earned but not distributed by the parent's foreign subsidiary. *See* 26 U.S.C. § 951(a); Part III, *infra*.

[34] However, even if the foreign profits are repatriated, deferring the tax is the equivalent of receiving an exemption on the income that is earned on the tax that is deferred. *See generally* Merton H. Miller, *Debt and Taxes*, 32 J. FIN. 261-75 (1977), *reprinted in* RICHARD A. POSNER & KENNETH E. SCOTT, ECONOMICS OF CORPORATION LAW AND SECURITIES REGULATION 257 (1980) ("[R]emember that by conventional folk wisdom, 10 years of tax deferral is almost as good as exemption.").

income each year."[35]

The recent international dispute regarding the U.S.'s foreign sales corporation (FSC) provisions also nicely illustrates today's competitive international tax race. European exporters are not normally subject to their countries' value-added tax. The U.S. believed that this situation placed U.S. exporters at a competitive disadvantage; and so in 1984 Congress enacted the FSC provisions, which provided various tax breaks to certain qualifying U.S. exporters.[36] The European Union responded by filing a complaint with the World Trade Organization's Settlement Body (Settlement Body). On March 20, 2000, the Settlement Body formally held that the U.S.'s FSC provisions constitute an illegal export subsidy and thus violate the Agreement on Subsidies and Countervailing Measures.[37] Consequently, the U.S. had until November 1, 2000 to repeal its FSC provisions or face punitive, retaliatory trade sanctions from the European Union. The U.S. chose the former route.[38] But rather than eliminating the malignant provision, the U.S. decided to extend it.[39] The new legislation, which generally applies to all transactions occurring on or after September 30, 2000, provides a broad exclusion for all "qualifying foreign trade income," whether the goods that give rise to such income are manufactured in or outside of the U.S., and whether the taxpayer is an individual or a corporation.[40] The European Union is now challenging this new legislation, arguing that it too constitutes an illegal export subsidy.[41] And so the compe-

---

[35] James R. Hines, Jr. & R. Glenn Hubbard, *Coming Home to America: Dividend Repatriations By U.S. Multinationals, in* TAXATION IN THE GLOBAL ECONOMY 174 (Assaf Razin and Joel Slemrod eds., 1990).

[36] *See* 26 U.S.C. §§ 921-927 (1999).

[37] *See* WTO Appellate Body Report Rejecting U.S. Appeal on FSC Tax Incentives, 2000 TNT 38-12 (Feb. 25, 2000).

[38] *See* Robert Goulder, *U.S. Will Comply With WTO Ruling on FSC, But Details Remain Unclear,* 2000 TNT 70-3 (April 10, 2000) (quoting Rita Hayes, the then U.S.'s Trade Ambassador's, comment that "it is the intention of the United States to implement the recommendations and rulings of the [Settlement Body] in a manner that respects our WTO obligations [but that is also] consistent with our goal of ensuring that U.S. exporters are not placed at a disadvantage in relation to their foreign competitors.").

[39] *See* FSC Repeal and Extraterritorial Income Exclusion Act of 2000, P.L. 106-519.

[40] *See* 26 U.S.C. § 114; Conference Committee Report accompanying the Taxpayer Relief Act of 2000 (H.R. 2614).

[41] *See* Scott Cordia, *U.S. Senate Finance Committee Questions Nominee for U.S. Trade Representative on FSC, Beef and Banana Disputes,* 22 TAX NOTES INT'L. 588 (Feb. 5,

tition continues.

As the foregoing amply demonstrates, the U.S. has openly embraced today's international tax race: it has practically exempted all foreign portfolio investment income from U.S. taxation; and it has created large gaps in its worldwide taxing regime, thus encouraging U.S. taxpayers to go global and thereby escape (or at least defer) U.S. tax on their foreign source income. [42] Right or wrong, the U.S. has practically had no choice in the matter, for if U.S. businesses were subject to U.S. tax on their worldwide income, new multinationals would find it incredibly disadvantageous to incorporate in the U.S.[43] In other words, if you can't beat them, at least join them. So this brings us to the critical question: is international tax competition globally inefficient?

B. Capital Export Neutrality

The answer to this question is by no means simple or clear. From a global perspective, proponents of the capital export neutrality (CEN) theory — a theory that is essentially an adaptation of the substitution effect to the world economy — frequently argue that international tax competition is inefficient.[44] Under this theory, tax competition distorts investment decisions and thereby undermines the efficient allocation of the world's resources. A capitalist country's resources are primarily bound up in its citizens. So if its citizens can earn a greater after-tax return on a for-

---

2001) (quoting Senate Majority Leader Trent Lott's position that "if the Europeans continue to proceed the way they have . . . they're going to have major trouble.").

[42] In fact, the government has recently made it even easier for U.S. corporations to avoid U.S tax on their foreign source income. In 1996, Congress repealed Section 956A, which complemented Subpart F's anti-deferral rules by imposing a current tax on the foreign corporation's excess passive assets. *See* Small Business Job Protection Act of 1996, § 1501(a)(2). And in 1997, the Treasury promulgated its "check the box" regulations, which essentially provide U.S. corporations with the option of deferring U.S. tax on their foreign source business income, even if the foreign affiliate is not characterized as a corporation under the foreign country's laws. *See* Treas. Reg. § 301.7701-1 *et seq.* (2000).

[43] Publicly traded U.S. corporations can no longer avoid Subchapter F by merely reincorporating outside the U.S. *See* 26 U.S.C. § 1248(i) (1994); I.R.S. Notice 94-46, 1994-1 C.B. 356.

[44] *See, e.g.*, Roger H. Gordon, *Can Capital Income Taxes Survive in Open Economies*, 47 J.FIN. 1159 (1992); Michael P. Devereux & Mark Pearson, *European Tax Harmonization and Production Efficiency*, 39 EUR. ECON. REV. 1657, 1660 (1995); *Globalization*, *supra* note 2.

eign investment, but a greater pre-tax return on a domestic investment, the tax differential between these two countries may induce an inefficient allocation of the home country's resources. An example best illustrates this point.

Example 2. A taxpayer has a choice. He can earn a $100 pre-tax return in Country A, his home country, or a $90 pre-tax return on the same amount invested in Country B, a foreign country. Both Countries, A and B, impose a flat 20 percent tax on *only* the income their respective citizens earn in their respective countries; otherwise, no tax is due. Accordingly, the taxpayer will owe Country A $20 if he invests in Country A, but no taxes — to either Country A or B — if he invests in Country B. This latter result occurs because Country B only taxes the income its citizens earn in Country B. While the taxpayer would earn income in Country B, he is a citizen of Country A, not B. Likewise, if the taxpayer invests in Country B, he will not owe tax in Country A because Country A also only taxes its citizens on the income they earn in Country A. So the taxpayer's choice is obvious: he will invest in Country B, where he will receive $10 more on the same amount invested. That is, he will receive $90 in Country B ($90 pre-tax income minus $0 in taxes) but only $80 if he invested in Country A ($100 pre-tax income minus $20 of Country A's taxes).[45]

Many tax scholars would argue that this example demonstrates the inefficiencies international tax competition creates.[46] In an effort to attract each other's capital, neither country, A nor B, has imposed any tax on any income the other country's citizens earn. Capital Export Neutrality is thus violated because the taxpayer's investment decision was (at least partially) based on the different tax treatment each country accords the other coun-

---

[45] It should be noted that this taxing regime will not always produce an inefficient result. For example, assume that Country A offered two investment opportunities, A1 and A2, each of which outperformed B1, Country B's investment opportunity, by $15 and $10, respectively. If the world's supply of capital is fixed, and could only accommodate two of these three investments, the discriminatory tax treatment noted above will distort the world's supply of capital, but only if at least one of these two investments is financed by Country A. In that case, the pre-tax return differential between investing in A1 and B1 is more than offset by the difference in tax Country A imposes on its citizens as opposed to Country B's citizens. If, on the other hand, Country B finances both of Country A's investment opportunities, no allocative distortion will obtain.

[46] *See, e.g.*, Reuven S. Avi-Yonah, *Comment on Peroni, Fleming and Shay, "Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income,"* 52 SMU L. REV. 531, 534 (1999) ("[A]s a pure issue of global efficiency, the current state of the evidence favors CEN").

try's imported capital. Hence, to ameliorate this perceived inefficiency, CEN would require that Country A not distinguish between its citizens' domestic and foreign sourced income — that, in other words, Country A tax its citizens on their worldwide income. In that event, the taxpayer would base his investment decision on a pre-tax basis, and Country A, the seemingly more efficient of the two, would prevail.

Whether this approach in fact produces an efficient allocation of the world's resources, however, is far from clear. Sure, by competing with one another, Country A's resources are being funneled into Country B, the seemingly less productive of the two. But is Country B really less efficient than Country A? Here again, reality is more complicated than this example may suggest. The available pre-tax return is $10 more in Country A than it is in Country B; and this additional $10 will cost the taxpayer $20. That much is clear. But to determine whether this situation is actually inefficient requires a closer look at each country's income tax system.

Country A may only be more efficient than Country B in a first-best world — i.e., in a world in which Country A's tax system does not create other offsetting or exacerbating economic distortions.[47] If Country's A's $20 tax only produces $9 in total benefits, then investing in Country B is the more efficient result. In this case, the total net benefits available in Country A are only $89 ($100 pre-tax return, minus the $20 in tax, plus the $9 of benefits the tax creates), but the total net benefits available in Country B are $90. This possibility is not unlikely. Governments are repeatedly wasting their taxpayers' money, so to speak, by re-channeling it into unproductive or outright wasteful uses. The $20, for instance, may be paid out in the form of a negative income tax, such as the earned income credit,[48] which, depending on how much the recipient could otherwise have earned, may create a work disincentive.[49] If this disincentive materializes, and the welfare recipient foregoes an opportunity that would have provided society with at least an $11 net gain, then Country B — not Country A — is the more efficient of the two.

That the U.S. tax law is mired in inefficiencies is hardly controver-

---

[47] *See* James R. Hines, Jr., *The Case Against Deferral: A Deferential Reconsideration*, 52 NAT'L TAX J. 385-404 (1999) (concluding that the distortions created by the corporate level tax may justify the deferral of business income earned by United States-controlled foreign corporations); Robert A. Green, *The Future of Source-Based Taxation of the Income of Multinational Enterprises*, 79 CORNELL L. REV. 18, 34 (1993).

[48] *See* 26 U.S.C. § 32 (1994).

[49] *See* ECONOMIC ANALYSIS OF LAW, *supra* note 8, at 511-12.

sial. [50] While Professor Avi-Yonah does not deny this, he has argued that this analysis confounds the real issue at hand, namely, whether CEN creates a globally inefficient result.[51] A broken tax system, in other words, should not be fixed by meddling in an area that is not related to the part that needs to be fixed.

This would be convincing if only it were true. A tax system's redistributional function is inextricably tied to its revenue raising function. Taxation is primarily about the redistribution of wealth — from the private sector or the middle and upper class to the government or the lower class, respectively. And there are essentially two ways this can be accomplished: The government can collect and redistribute the revenue; or it can skip this last step and simply encourage the private sector to directly redistribute its own wealth.[52]

In fact, the U.S. income tax system uses both of these approaches. By only taxing a taxpayer's *net* income, the government not only collects revenue; it is also subsidizes many of those activities for which a deduction is permitted. A deductible expense, after all, only costs the taxpayer one minus the taxpayer's marginal rate times the cost incurred. So if the deductibility of a particular cost creates a substitution effect in either kind or degree, it is economically no different than if the government disallowed the deduction, collected the additional tax, and then at least partially redistributed it to the affected recipient.[53] This notion of an implicit

---

[50] For example, the American Law Institute has insistently called for the elimination of the net operating loss limitations. *See, e.g.*, ALI Fed. Income Tax Project, Tentative Draft No. 5, 20 (April 28, 1980) ("[A]n inducement might be created to carry on the business even if there were no hope whatever of profitable operation, just in order to preserve the benefit of the loss carryover against other profits."); ALI Fed. Income Tax Project, Mem. No. 7, 262-63 (June 7, 1976) ("[T]he requirement seems often to create an inducement to uneconomic behavior . . . Nothing significant can be said in favor of this result); ALI Fed. Income Tax Project, Mem. No. 2, 87 (October 30, 1974) (same).

[51] *See Globalization, supra* note 2, at 1604-05.

[52] *See, e.g.*, 26 U.S.C. §§ 1391-96 (Supp. 1996) (providing employers with a credit for wages paid to certain employees who lived and worked in designated poverty-stricken areas).

[53] Whether this tax subsidy is only partially redistributed depends on the incidence of the tax — that is, which party would have ultimately bore the burden, had it not been subsidized. There is yet no consensus on this issue, only debate. For a sampling of the classic debates, see R.A. Musgrave et al., *Distribution of Tax Payments by Income Groups: A Case Study for 1948*, NAT TAX JOURNAL, 1-53 (March 1951); JOSEPH A. PECHMAN & BENJAMIN A. OKNER, WHO BEARS THE TAX BURDEN?

redistribution creates a significant exception to the CEN model.

While some governments, such as the U.S., decide who receives these implicit redistributions, others do not. In fact, some governments may encourage implicit redistributions by simply exempting all or some forms of income from taxation, leaving it up to the private sector to work out the exact terms of the country's social compact. Not who decides but how much has been redistributed is what is important.

Returning to Example 2, an implicit transfer payment may already be impounded in Country B's $90 pre-tax return. It is important to remember that this $90 pre-tax return is already net of all costs except the tax. Thus, earning this $90 may, for example, require that the taxpayer educate Country B's workforce, improve its infrastructure, or undertake a whole host of other activities Country B's government could have performed itself. If this is the case, as it almost always is to some extent, comparing pre-tax returns is plainly amiss. Country A may use the $20 it would receive in taxes to improve its infrastructure, whereas Country B, for whatever reason, may have exempted its income from taxation, knowing that the $90 pre-tax return necessitates a similar $20 infrastructure investment. In that event, Country B would again be more efficient: on a pre-tax, pre-redistributional basis, Country B would produce a $110 return ($90 pre-tax return, plus the $20 infrastructure investment incurred), whereas Country A would only produce its $100 return on the same amount invested.

Perhaps this analysis is objectionable in that it conflates the two cornerstones of any income tax system, namely, the principals of efficiency and equity.[54] Equity or fairness, it might be argued, justifies the redistribution of wealth, and that is what happens when the government either collects and redistributes its tax revenue or provides a substitution inducing tax preference, not when the government merely exempts some income and then allows the market forces to decide who gets what. In the latter case, there is no redistribution, only the market forces are at work. But in

---

(Brookings Instit. 1974); JOSEPH J. MINARIK, WHO DOESN'T BEAR THE TAX BURDEN, *reprinted in* HENRY J. AARON & MICHAEL J. BOSKIN, THE ECONOMICS OF TAXATION, 55-68 (Brookings Instit. 1980).

[54] *See* GEORGE F. BREAK & JOSEPH A. PECHMAN, FEDERAL TAX REFORM: THE IMPOSSIBLE DREAM? 4-10 (1975). Some commentators posit a third aim: simplicity. However, few can seriously contend that this objective has been (or in today's sophisticated world can be) accomplished without gravely jeopardizing both horizontal and vertical notions of equity. Moreover, simplicity is more properly characterized as a subset of efficiency, for the simpler a tax system is, the cheaper it is to administer, and thus the smaller its dead weight loss.

the end, are these two principles, efficiency and equity, all that distinct from one another?[55]

The first category is about increasing the size of the "pie" — calibrating the economy in a way that makes at least someone better off while, at the same time, leaving everyone else no worse off (often-called a Pareto-superior move).[56] This very rarely happens, for someone is almost always made worse off. Nonetheless, if a particular legal rule produces more gains than losses, a Pareto-superior state would still obtain if the winners compensated the losers. And it is this efficiency variant (often-called Potential Pareto-superior or Kaldor-Hicks efficiency)[57] that bridges the gap between efficiency and equity. A particular tax regime may be efficient but only if some of the gains are redistributed.

Indeed, whether the private or public sector actually administers a country's redistributional system may merely turn on which one has achieved economies of scale. In a competitive environment, groups — i.e., firms, communities, countries, etc. — are formed in response to economies of scale. It is either necessary[58] or cheaper for a number of members to pool together their resources, and so groups are formed.[59] Thus, whether the government or a multinational firm should redistribute the country's wealth should necessarily depend on which one can do it more efficiently; that is, which one has achieved (but not exceeded) economies

---

[55] Under a postmodernist/antifoundationalist approach, Professor Crawford believes they are not. *See* Patrick B. Crawford, *The Utility of the Efficiency/Equity Dichotomy in Tax Policy Analysis*, 16 VA. TAX REV. 501, 534 (1997) ("The efficiency/equity dichotomy may be a less useful analytic scheme for approaching tax policy issues than is currently acknowledged."); *see also* Daniel J. Frisch, Comment on Hugh J. Ault & David F. Bradford, *Taxing International Income: An Analysis of the U.S. System and Its Economic Premises*, *reprinted in* ASSAF RAZIN AND JOEL SLEMROD, TAXATION IN THE GLOBAL ECONOMY 50 (1990) ("I agree . . . that equity is basically irrelevant to international tax policy.").

[56] *See* JEFFRIE G. MURPHY & JULES L. COLEMAN, PHILOSOPHY OF LAW 182 (rev. ed. 1990).

[57] *See id.* at 186-87.

[58] It is necessary whenever the benefits of a public good or service cannot be adequately metered out in proportion to the amounts contributed to finance it. Because everyone would have an incentive to free-ride off of each other, if these goods or services were not centrally administered, a sub-optimum level of public goods or services would inevitably be provided. *See* ECONOMIC ANALYSIS OF LAW, *supra* note 8, at 523.

[59] *See* PATRICIA APPS, A THEORY OF INEQUALITY AND TAXATION 43-44 (1981).

of scale.[60] Answering this question, however, is difficult, if not impossible, because the size of each country varies and the presence of multinationals come and go.

Yet what is clear is that there exists little justification for a country to tax income that is earned on imported portfolio capital. So long as the foreign investor remains outside the host country, and its tax benefits do not spill over into the taxpayer's country, the taxpayer obviously cannot benefit from the host country's public expenditures, however they are administered.[61] Indeed, this may explain (or at least justify) why the U.S., for the most part, does not tax foreign portfolio investment income.

C. Capital Import Neutrality

This Article has thus far only considered the efficiency effect international tax competition may have on the demand for a particular country's resources. The bottom line is mixed. On the one hand, residency-based taxation eliminates the effect cross-border tax differentials may have on a taxpayer's decision *where* to invest; but on the other hand, there are a number of reasons why this approach may produce economically inefficient results. What's more, CEN completely ignores the effect international tax competition may have on the world's *supply* of investment capital. Indeed, it just assumes that the world's supply of capital is fixed, unresponsive to available returns.[62] This cannot be true, as a number of supply-side economic studies indicate.[63]

---

[60] At some point beyond this optimum size, it becomes increasingly more costly for the group to coordinate its efforts. *See* R H. Coase, *The Nature of the Firm,* ECONOMICA (n.s.) 4 (1937), *reprinted in* R.H. COASE, THE FIRM THE MARKET AND THE LAW 43 (1988). The United States, at least in some respects, has quite clearly exceeded this point. *See, e.g., The Turn Against Taxes,* THE ECONOMIST: THE WORLD IN 2000, Dec. 31, 1999, at 106 [hereinafter "*Turn Against Taxes*"] (concluding that because "governments spend their money less carefully and less efficiently than [the private sector], [f]ully funded personal pension plans, based on an individual's savings, are sweeping away the poorly funded public pensions promised by governments."); *The Fans of Mars,* THE ECONOMIST, Mar. 11, 2000 at 85-86 (concluding that because the private sector is "better organised, more adaptable, . . . and ma[kes] better use of the latest technologies," the first manned mission to Mars will probably be privately financed).

[61] *See* TAXATION IN AN INTEGRATING WORLD, *supra* note 2, at 69.

[62] *See* PEGGY G. MUSGRAVE, UNITED STATES TAXATION OF FOREIGN INVESTMENT INCOME 30 (1969).

[63] *See* VED P. GANDHI, SUPPLY-SIDE TAX POLICY: ITS RELEVANCE TO DEVELOPING COUNTRIES 188 (1987) (concluding that the "data are consistent with the exis-

Capital Import Neutrality (CIN) accommodates these concerns by treating foreign and domestic taxpayers alike. Since a country can only tax its *own* citizens on their worldwide income, this approach boils down to a source-based method of taxation: regardless of where the taxpayer resides, each country will only tax the income that is earned within its borders. Capital Import Neutrality is thus appealing because it optimizes the supply, though not necessarily the allocation, of the world's resources.

The cost of a firm's capital is largely dependent on its performance.[64] So the more profitable a firm is, the cheaper it should be to finance. At least relative to CEN, CIN furthers this fundamental financial theory. In a CIN world, for any given investment opportunity, the after-tax return would be the same for all competing investors, wherever they happen to reside. Thus by treating all investors alike, CIN eliminates what CEN at times creates: external barriers to investing in a particular country.[65] Even if the world's supply of capital is relatively inelastic, the most promising ventures will attract the most financing opportunities; and the fiercer the competition is to finance a particular venture, all else equal, the cheaper the venture's cost of capital should be.

Returning to Example 2, in addition to violating CEN, since both countries, A and B, discriminate in favor of the other country's citizens, CIN is also violated. Country A's taxpayers are not subject to Country B's tax, and vice versa. It is quite possible that Country A is the more efficient of the two — its pre-tax return, after all, is $10 more than Country B's. But by only taxing its citizens, Country A may have systematically increased its taxpayers' cost of capital. As discussed in Part II(B), the taxpayer will not invest in Country A because, even though Country A's pre-tax return is $10 more than Country B, he will *receive* $10 more if he invests in Country B. Therefore, in order to attract its taxpayers' capital, the pre-tax return in Country A will have to exceed $112.50 ($90 after tax re-

---

tence of a Laffer curve in Jamaica").

[64] *See* Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 AM. ECON. REV. 261 (1958), *reprinted in* RICHARD A. POSNER & KENNETH E. SCOTT, ECONOMICS OF CORPORATION LAW AND SECURITIES REGULATION 237-45 (1980); FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 176 (1991) (stating that a firm's capital structure "matters only when it affects some other variable, such as taxes, or the probability of bankruptcy (with attendant costs of restructuring or fighting over spoils), or when it changes the incentives of investors to monitor the managers").

[65] Of course internal barriers, such as excessively high taxes, may still distort a particular firm's ability to raise capital.

turn in Country B divided by 80 percent — one minus Country A's tax rate). In other words, by discriminating against its own taxpayers, and thereby limiting the competition over the supply of its capital, Country A has made it more costly for *its* taxpayers to finance Country A's operations. But whether this discriminatory treatment increases Country A's cost of capital depends on which country, A or B, finances Country A's investment opportunities. For the reasons just stated, if the capital comes from within, Country A's taxing regime will (relative to a tax-free environment) increase its taxpayer's cost of capital. But by encouraging inbound investment, Country A's taxing regime may actually decrease Country A's cost of capital.

Example 3. Assume taxpayers in Country A and B are considering where to invest. At an intuitive level, it may appear that this hypothetical makes it more costly for Country A to finance the venture. Each taxpayer will invest in the other country, and thus competition over the price charged for these two investments will be limited. Yet as it turns out, limiting competition in this way decreases Country A's cost of capital.

Because each country only taxes its own citizens on their domestic source income, Country B's taxpayers will always outbid Country A's taxpayers. The former will agree to finance Country A's investment as long as its pre-tax return exceeds $72, their opportunity cost of investing in Country B, whereas Country A's taxpayers will never go lower than $112.50, their grossed-up opportunity cost of investing in Country B. If, however, both countries taxed all of their domestic source income at a flat 20 percent rate, Country A's cost of capital will actually increase. This is because both taxpayers would forego the same after-tax opportunity cost of investing in Country B. There, they would both receive $72 after tax, and would thus insist on nothing less than a $90 pre-tax return in Country A.[66]

Example 4. Although, as the preceding example illustrates, CIN may increase a country's cost of capital, it may also expand the aggregate supply base. Assuming Country A is the more efficient of the two, if the facts in Example 2 are flipped, no allocative distortion would result. If a citizen of Country B had to decide between investing in Country A or B, he would surely choose A. There, he would earn $100 both before and after tax ($100 pre-tax minus $0 taxes), whereas in Country B he would

---

[66] *See* Assaf Razin & Efraim Sadka, *Integration of International Capital Markets: The Size of Government and Tax Coordination, in* TAXATION IN THE GLOBAL ECONOMY, supra note 51, at 331-48 (finding that the liberalization of the capital markets reduces the cost of public funds, and thus increases the optimal level of public goods and services).

only earn $90 before tax and $72 after tax ($90 pre-tax minus 20 percent). In this scenario, the tax competition does not distort the efficient allocation of the world's resources — it encourages it!

Whether CIN increases the world's supply of capital, however, depends on how responsive such supply is to a change in the world's after-tax returns.[67] Capital Export Neutrality frustrates this "supplementary" effect. A taxpayer may be willing to postpone more of his current consumption if he can earn an after-tax return of, say, ten percent. A tax haven may exactly satisfy this investment objective, but if the taxpayer is taxed on his worldwide income, he will not achieve his investment goal, and he will thus forgo this additional savings opportunity. Yet CIN is no panacea. If all countries adopt a non-discriminatory source-based system of taxation, but their tax rates vary, CIN will reshuffle the attractiveness of the world's investment opportunities, so that those which offer the highest after-tax returns will be the most attractive, even if, on a pre-tax basis, they happen to be the least attractive. Capital Export Neutrality, at least in a first-best world, prevents this from happening.

In short, both CEN and CIN have their difficulties. If all countries taxed their citizens on their worldwide income, their citizens would be unaffected by tax holidays and other enticements unrelated to the investment's market potential. However, such an approach may stifle savings, assumes a first-best world, and ignores the possibility that a country's transfer payments may already be impounded in its available pre-tax returns. Since CIN looks to the after-tax bottom line, it avoids all of these difficulties, though at the cost of a new one. If the world's tax rates vary, as they nearly always do, source based taxation may funnel capital into comparatively less productive ventures, simply on account of a tax break.[68]

---

[67] *See* MUSGRAVE, *supra* note 62, at 32 ("Foreign investment, at least to some degree, will be an addition to, rather than a substitute for, domestic investment.").

[68] Additionally, source-based taxation is getting increasingly more difficult to administer. *See, e.g.*, Selected Tax Policy Implications of Global Electronic Commerce, *supra* note 12 at § 7.1.5 ("In the world of cyberspace, it is often difficult, if not impossible, to apply traditional source concepts to link an item of income with a specific geographical location. Therefore, source based taxation could lose its rationale and be rendered obsolete by electronic commerce."). This is a problem onto itself, and one that has already received much commentary. *See, e.g.*, DAVID E. HARDESTY, ELECTRONIC COMMERCE: TAXATION AND PLANNING ¶¶ 10.01 - 13.05 (1999); Charles E. McLure, Jr., *Taxation of Electronic Commerce: Economic Objectives, Technological Constraints, and Tax Laws*, 52 TAX L. REV. 269 (1997); Adrian J. Sawyer, *Electronic Commerce: International Policy Implications for Revenue Authorities and Governments*, 19 VA. TAX. REV. 73 (1999); Arthur J. Cockfield, *Bal-*

Of course it would be ideal if the world could somehow adopt only the best of these two approaches, but that would require a worldwide uniform rate of taxation — a feat that has heretofore never been accomplished.[69]

IV. THE WORLD'S RESPONSE

A. The Tax Base Erosion

Globalization has undoubtedly intensified international tax competition; and as is so often the case, those who are on the losing side often try, futilely, to impede its progress. The OECD is no exception. On April 9, 1998, the OECD approved a report, entitled "Harmful Tax Competition: An Emerging Global Issue" (OECD REPORT).[70] This report, as its title gives away, is the OECD's latest attempt to root out "harmful tax havens" and "preferential tax regimes" that are eroding the member states' tax bases and are thus "reduc[ing] the tax that would otherwise be payable to them."[71]

Before turning to the substance of this report, it should be noted that the existing data does not conclusively corroborate the OECD's concerns.[72] In fact, the OECD concedes as much.[73] Yet the data that is available is in accord. Substantial amounts of capital are increasingly being channeled into tax havens. The OECD Report, for example, indicates that in 1994 the G7 countries invested over $200 billion in various Caribbean

---

ancing National Interests in the Taxation of Electronic Commerce Business Profits, 74 TUL. L. REV. 133 (1999).

[69] *See* Thomas Horst, *A Note on the Optimal Taxation of International Investment Income,* 94 Q.J. OF ECON. 793, 795 (1980).

[70] *See* ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, HARMFUL TAX COMPETITION: AN EMERGING GLOBAL ISSUE (1998) [hereinafter "OECD REPORT"].

[71] *Id.* at 37.

[72] *See Globalization, supra* note 2, at 1597 ("[T]here is no evidence that overall revenue from the personal or corporate income tax in OECD member countries has declined either as a percent of GDP or of total tax revenue from 1965 to 1995."); *A Survey of Globalisation and Tax,* THE ECONOMIST, Jan. 29, 2000, at 17 [hereinafter "*Globalisation and Tax*"] ("[I]n most developed countries tax revenues as a proportion of GDP have in fact *risen* over the past 30 years, and the share of taxes on corporate profits in overall tax revenues has remained much the same.") (emphasis added).

[73] *See* OECD REPORT, *supra* note 70, at 17 ("The available data do not permit a detailed comparative analysis of the economic and revenue effects involving low-tax jurisdictions.").

and South Pacific islands — a more than 500 percent increase over the aggregate amount invested in 1985.[74] Moreover, while traditional tax havens only account for 1.2 percent of the world's population, and only three percent of the world's GDP, they account for 26 percent of U.S. multinationals' assets and 31 percent of their net profits.[75] That the international tax base is eroding thus seems clear, lest there would be little need to invest such large amounts in these small islands.

B. The OECD's Suggested Solution

The OECD Report is the developed countries' latest response to their depleting revenue bases. This report, which binds no one, is broken out into three chapters. Chapter One gives a brief overview of the purported deleterious effects globalization is having on the member states' tax bases. Chapter Two attempts to distinguish between those tax practices that are deemed "harmful" and those that are not. And Chapter Three sets forth 19 guidelines the 27 member states[76] have agreed to respect; and it creates a body (the "Forum on Harmful Tax Practices") to review the member states' tax practices and to encourage non-member states to "associate themselves with" these guidelines.[77]

---

[74] *See id.*

[75] *See Globalisation and Tax, supra* note 72, at 17.

[76] There are actually 29 member states, but Luxembourg and Switzerland abstained. They could have vetoed the agreement, in which case the remaining member countries' ability to vote on the OECD's recommendations would fall. *See* OECD Report, *supra* note 70, at 78.

[77] *Id.* at 57. Significantly, the OECD Report only covers geographically mobile activities, such as financial and other service activities; it does not deal with those interest-bearing obligations that currently anonymously float tax-free throughout the world. Since most of the world's governments do not tax foreign portfolio interest income, *see* Part II(A), *supra,* but (from a fiscal budgetary perspective) would like to, the OECD's inability to deal with this "problem" is not surprising. It at least superficially resembles a stag hunt game: each country will be better off if it re-introduces its withholding tax, but it will be worse off if not all of the remaining countries do the same. *See generally* DOUGLAS G. BAIRD ET AL., GAME THEORY AND THE LAW 35-36 (1994). But this game is actually embedded in a larger, more dynamic game. *See id.* at 191-202. The world fisc may be better off but will the world market? Restricting the free flow of the world's capital is hardly a potentially Pareto superior move, for it will increase the world's cost of capital; it will induce costly shifts to non-member states; and, if the tax rates vary, it will distort the efficient allocation of the world's capital.

Of central focus is the OECD's request that member states "consider" adopting CFC and foreign investment fund (FIF) regimes "in a fashion consistent with the desirability of curbing harmful tax practices."[78] The CFC regime taxes the domestic shareholder(s) on certain types or sources of income that are earned by its controlled foreign corporation. In some countries (e.g., the U.S. and Germany), this deemed dividend only applies to certain forms of passive income, regardless of where such income is earned. But in other countries (e.g., Japan, France and, the UK), the parent corporation is currently taxed on its foreign corporation's income if the latter is primarily engaged in a particular type of business, regardless of what types of income such businesses earn.[79] Drawing on the U.S.'s passive foreign investment company (PFIC) provisions,[80] the FIF proposal either taxes individual shareholders on their proportionate share of the FIF's passive income or charges them interest in an amount that approximates their proportionate share of the FIF's current income.

The OECD's attempt to curb tax competition is obviously weak and doomed to fail. A basic, obvious flaw that runs throughout the OECD Report is its waffling definition of "harmful tax competition," an umbrella term that apparently includes "harmful tax practices" and "tax preference schemes." While the OECD has acknowledged that low or no income taxes "can never . . . constitute harmful tax competition," and that other factors are necessary, it nevertheless fails to enunciate what factors definitively tip the scale or what relative weights should be attached to these varying factors. After enumerating a number of factors, such as refusing to exchange information, separating foreign from domestic investors, and insubstantial activities, the OECD Report is then peppered with qualifiers: "the concept of 'tax haven' does not have a precise technical meaning";[81] "it may be difficult to gather the information necessary to answer these questions";[82] and "a subjective evaluation" is necessary.[83]

Chapter One is equally unavailing. There, the closest the OECD Report comes to defining this term is found on pages eight and 14:

---

[78] OECD REPORT, *supra* note 70, at Appendix 67, recommendations 1 and 2. The member states that have not yet enacted these provisions are indeed taking the OECD's recommendations seriously. *See* Stefano Guiso-Gallisay, *Italy Proposes CFC Legislation*, 2000 WTD 31-5 (February 11, 2000).

[79] *See* OECD REPORT, *supra* note 70, at 20; *U.K Inland Revenue Publish Budget Note on Proposed Budget 2000 CFC Legislation*, 2000 WTD 59-31 (March 21, 2000).

[80] *See* 26 U.S.C. §§ 1297-98 (Supp. 2000).

[81] OECD REPORT, *supra* note 70, at 20.

[82] *Id.* at 34.

[83] *Id.* at 35.

> [harmful tax practices] affect the location of financial and other service activities, erode the tax bases of other countries, distort trade and investment patterns and undermine the fairness, neutrality and broad social acceptance of tax systems generally. . . . [Tax preference schemes create] potential distortions in the patterns of trade and investment and reduce global welfare . . . These schemes . . . may . . . shift[] part of the tax burden from mobile to relatively immobile factors and from income to consumption . . . and may hamper the application of progressive tax rates and the achievement of redistributive goals.

The problem, of course, is that there is hardly an income tax system that does not satisfy either of these descriptions, the qualifications notwithstanding.

Definitional problems aside,[84] the OECD Report's fatal flaw is that it is structurally deficient. Besides its non-binding nature, this agreement only applies to member states. Non-member states, which include most of the world's "tax havens," as that term is generally (although not concretely) understood, are in no way bound, and will thus, ironically, become the main benefactors of this agreement — an agreement their financial (and sovereign) existence is designed to adversely affect.

If all OECD states enact CFC and FIF provisions, an OECD individual or corporate shareholder may[85] be currently taxed on certain types of income, but only if the FIF or parent corporation is located in an OECD member state. Thus, the OECD Report will merely induce a shift away from the OECD member states. An OECD FIF shareholder can evade, and sometimes avoid,[86] the imputation of offshore profits by either interposing a tax haven conduit or by directly investing in a multi-tiered CFC/FIF affiliated arrangement. Before the member state can de-

---

[84] *See* Lee A. Sheppard, *News Analysis — U.S. Budget Business Provisions: A Blacklist for Havens*, 2000 WTD 35-1 (February 11, 2000) ("Tax havens are not like obscenity. OECD waffling notwithstanding, we can readily define them and identify them.").

[85] Even the U.S.'s CFC and PFIC provisions, which provide perhaps the world's most sophisticated and stringent anti-deferral regime, are nevertheless fertile ground for tax avoidance. *See* Part II(A), *supra*. It is thus unrealistic to suppose that this recommendation will definitively plug the member states' depleting tax bases.

[86] *See* TAX HAVENS OF THE WORLD, *supra* note 22, at 31 (explaining how a U.S. shareholder of a Bahamian real estate company can avoid imputation of both active and passive income, even though the latter, along with a Bahamian grantor trust, owns 100 percent of a Bahamian-based PFIC).

termine if its anti-deferral provisions are applicable, it must first have access to the foreign entity's books and records, and that is something virtually every tax haven will not provide.[87] Likewise, a CFC's parent corporation is not subject to these anti-deferral rules if it is permanently established in a country that does not recognize this anti-deferral regime. The net effect of all this will be a proliferation of tax haven-based CFCs, FIFs, and related conduit vehicles; and so it is not surprising that some tax havens "regard the whole exercise as a welcome bit of free advertising."[88]

Now of course the OECD member states are not helpless. Indeed, they have two potent tools that they can and actually are beginning to use: the carrot and the stick. Since tax havens will not willingly stop "poaching" their larger neighbors' tax bases, the OECD's Committee on Fiscal Affairs is currently considering buying them off.[89] From a national budgetary perspective, this approach makes ample economic sense. The incorporation and administrative fees tax havens receive are but a speck in relation to the mammoth amounts of taxes the OECD member states are losing every year.[90] Moreover, the U.S. may soon use the stick as well. As part of its 2001 budget proposal, the Clinton Administration recently proposed blacklisting certain identified tax havens. If enacted, this measure would scale back a taxpayer's otherwise allowable FTC to the extent its income is attributable to certain identified tax havens.[91] Thus, the OECD's plan may be effective after all; or will it?

Assuming all non-member states capitulate, what remains is essentially a "world tax organization" (WTO). While each country's allocative share of the world's tax revenues will vary, the aggregate amount will depend on their collective agreement — a cartel of global dimensions.[92] And like all cartels, this one also "carries the seeds of its own destruc-

---

[87] *See generally id.*

[88] *Globalisation and Tax, supra* note 72, at 18-19.

[89] *See OECD Wants to Help Small Economies Satisfy International Anti-Tax-Haven Standards,* 2000 WTD 47-24 (March 9, 2000); *Globalisation and Tax, supra* note 72, at 19 (reporting one OECD official's opinion that "[i]t would make sense for the bigger countries to buy them off").

[90] *Compare* TAX HAVENS OF THE WORLD, *supra* note 22, at 78, 126, 158 (reporting annual fees of no more than $6,000) *with Globalization, supra* note 2, at 1600 (estimating that in 1997 the United States alone lost $2.2 billion in corporate income taxes).

[91] *See* Robert Goulder, *U.S. Budget Would Blacklist Tax Havens,* 2000 WTD 27-1 (February 9, 2000).

[92] *See* Arthur W. Wright, *Review: OECD Harmful Tax Competition Report Falls Short,* 98 TNI 158-11 (August 17, 1998).

tion."[93] Cartels are rife with creation and enforcement problems. The more members in a cartel, and the more complex its collusive agreement is, the more costly it becomes to communicate and police its strictures. Given the world's wildly varying income tax systems, this obstacle alone makes a WTO's existence inherently unstable.

But there is more. International competition is obviously not limited to tax incentives; countries compete with one another on numerous other fronts. So if the worldwide pool of tax revenues is fixed, each member will naturally try to engross its share by providing its "customers" with other non-tax incentives.[94] The existing international tax competition, in other words, will simply take on a new character. Tariffs, quantitative import controls, technical regulations, minimum environmental and safety standards, certification systems, and a whole host of other trade obstacles will inevitably come into play.[95] Thus at the end of the day, the result will be substantially the same: the cartel's tax base may remain partially intact, but its offsetting costs will be spread out through all sectors of society.

Professor McIntyre has argued against this characterization. He claims that the OECD agreement is not a cartel because, unlike a "classic cartel," the OECD members will not reduce their output. In fact, their output may actually increase. Once the tax race is called off, the member states will have much more revenue to work with, and so the aggregate amount of public goods and transfer payments will rise, not fall.[96]

This reasoning is unsound. Now it is true that each member's "output" might rise, but it hardly follows that this cartel variant will not be just as unstable. The underlying goal of any cartel (or monopolist) is the extraction of a transfer payment. By reducing its output, and thereby increasing its price, a cartel increases its profits, so long as its new profit margin multiplied by its new (smaller) sales quantity exceeds its old profit margin multiplied by its old (larger) sales quantity. While the members of a WTO will not reduce their output, they don't have to because they are monopolists in the purest sense of the term. Rather than manipulate supply and demand, they need only activate their powers of coercion to extract this transfer payment; and as long as there is nowhere their "customers" can hide, the outcome is just the same.

---

[93] RICHARD A. POSNER, ANTITRUST LAW: AN ECONOMIC PERSPECTIVE 28 (1976).

[94] *See id.* at 52-53.

[95] *See generally* Jonathan Coppel & Martine Durand, *Trends in Market Openness: Economics Department Working Papers No. 221* (OECD ECO/WKP(99)13) (August 12, 1999).

[96] *See* Michael J. McIntyre, *McIntyre Finds Fault with Wright's Analogy*, 98 TNI 239-11 (December 14, 1998).

C. The Inevitable "Solution"

International tax competition is not unlike other forms of competition. Governments offer various goods and services; and their citizens and/or their dollars are free to choose that location that best satisfies their needs. This does not necessarily mean a race to the bottom. It just means the taxes charged must be worth the public goods and services that are received. Viewed from this angle, tax competition is desirable. It disciplines governments.[97]

Of course there are a number of complicating factors with this analysis, the most important of which turns on the disproportionate impact tax competition has on different classes of taxpayers. Mobile taxpayers, it might be argued, are free-riding on less mobile taxpayers, receiving the benefits provided by high-tax jurisdictions while paying low or no taxes. This is only partially true. Since high-bracket taxpayers earn a disproportionate amount of the world's capital income, shifting it to low-tax jurisdictions merely reduces the progressivity of the world's tax bases. This argument thus has very little to do with free-riding, a morally charged, conclusory term, and very much to do with progressivity. Indeed, if the tax law took free-riding seriously, progressivity would be nonexistent.

A further difficulty with this argument is that it assumes the magnitude of the benefits one receives from a tax system increases as one's income increases and then, at some point, increases even more rapidly. This is obviously not the case. Even the costs of providing the purest forms of public goods, i.e., administering the government, national/local defense, public parks, etc., do not vary with the level of the taxpayer's income.[98]

But taxation is not just about efficiency; it is also about the inextricably related goal of redistributing society's wealth. If by reducing its taxes, a country can no longer finance its social safety net, its citizens will not put up with this for long. Soaking the rich is always a distinct possibility whenever a government is based on majority rule.[99] But in order to do

---

[97] *See* Charles Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416, 422 (1956).

[98] *See* WALTER J. BLUM & HARRY KALVEN, JR., THE UNEASY CASE FOR PROGRESSIVE TAXATION 35-37 (1953).

[99] *See id.* at 19 ("Under any progressive system today the higher surtax rates are almost certain to apply only to a minority of voters. This means that a majority are allowed to set the rates which fall exclusively on the minority."). As it turns out, this has already occurred. *See Age of Fiscal Socialism*, THE ECONOMIST, Apr. 15, 2000, at 30 ("Twenty years ago, America's super-rich — the wealthiest 1% of taxpayers — paid 19% of all federal taxes. Now they pay a third. The share paid by

that, the focus of the world's taxing systems will unavoidably have to shift to less mobile bases, such consumption, labor, and particularly land. Although these tax bases minimize the various distortions discussed above, they also greatly complicate the redistribution of society's wealth.

It is this de-emphasis on redistribution that concerns Professor Avi-Yonah. He has argued that the world's shrinking tax base, coupled with the world's aging population, has placed the world's public pension programs in grave danger. But rather than accept the inevitable, a shift to privately funded pensions,[100] Professor Avi-Yonah supports the status quo, since he believes the alternative is even worse: "[G]lobalization results . . . in increased job insecurity, income volatility, and income disparities that exacerbate rather than reduce the need for government-provided social insurance."[101] This dire prediction, however, is a quantum jump from what has actually happened thus far.

Foreign firms consistently out-pay and out-employ their domestic counterparts. In the U.S., for example, foreign firms paid their employees 4 percent more than the national average in 1989 and 6 percent more in 1996.[102] Foreign firms also create more jobs than their domestic counterparts. From 1989 to 1996, the U.S. workforce employed by foreign firms increased 1.4 percent per year, while over this same time period, the U.S. domestic workforce only increased .8 percent per year.[103]

As for the widening income disparities among the world's richest and poorest countries, that too is undergoing sea changes. A recent study by Professor Lucas[104] indicates that globalization is having a profoundly beneficial effect on the redistribution of the world's wealth. Worldwide income inequality has no doubt increased over the past two centuries; but the same process that created this disparity is now beginning to eliminate it. As a result of capital migration, and informational and technological

---

the merely wealthy — the top 5% — has risen from just over a third to just over half during the same period."). Although labor is much less mobile than capital, at some point, shifting the tax burden toward the rich will induce "brain drain" — that is, the country's most talented individuals will emigrate elsewhere, and thereby take with them the massive positive externalities that their efforts create. *See* TAXATION IN AN INTEGRATING WORLD, *supra* note 2, at 36-37.

[100] Since Chile privatized its pension plan in 1981, numerous other countries have followed its lead. *See Turn Against Taxes, supra* note 60, at 106.

[101] *Globalization, supra* note 2, at 1638.

[102] *See Globalisation: Foreign Friends,* THE ECONOMIST, Jan. 8, 2000, at 71, 74.

[103] *See id.*

[104] *See* Robert E. Lucas, Jr., *Some Macroeconomics for the 21st Century,* 14 J. ECON. PERSP. 159 (2000).

Akron Tax Journal, Vol. 16 [2001], Art. 3

spillovers, less developed countries are now growing at a *faster* rate than the world's leading economies.[105] Thus globalization is not just reducing the world's income gap, it is eliminating it: "sooner or later everyone will join the industrial revolution, . . . all economies will grow at the rate common to the wealthiest economies, and [the] percentage differences in income levels will disappear."[106]

International tax competition furthers this desirable process. Taxpayers seek to maximize their after-tax return, potential inefficiencies notwithstanding. But as the low-tax jurisdictions' employees become more efficient, and their countries/islands more accommodating, the pre-tax return on the amount invested will rise in relation to what that same amount would earn on a pre-tax basis in the taxpayer's home country. As a result, the pre-tax returns that are available in both countries will converge, and thus the aforementioned inefficiencies, if any, will diminish.

V. CONCLUSION

The income tax system is a vestige of the past. It is not only based on the physical world, but it also presupposes a relatively closed economy in which it operates. Today, capital can traverse the world in a matter of nanoseconds; information is immediately accessible; and Western capitalistic principles are sweeping throughout most of the formerly centrally planned economies. A byproduct of this phenomenon has been international tax competition, not necessarily a race to the bottom, but a competitive race nonetheless. This has certainly created some short-term distortions, but how much is anyone's guess.

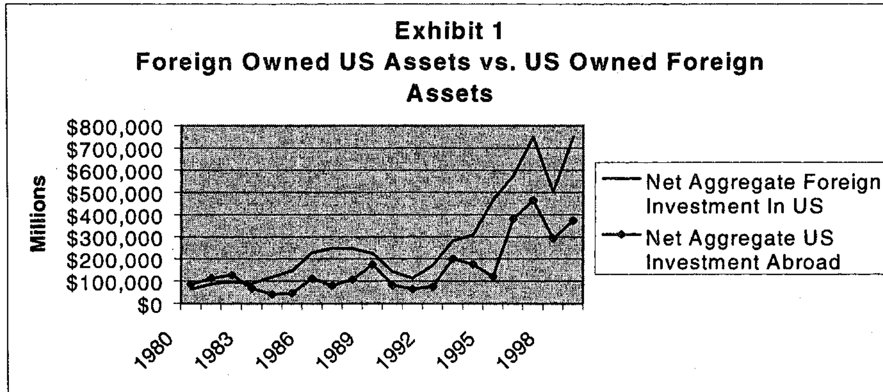
The OECD is not so much concerned about these inefficiencies as it is the erosion of its member states' tax bases. As their tax revenues shrink, as they undoubtedly will, the OECD member states will soon face political disequilibrium over their inability to finance their welfare states. Their response to this looming problem was predictable: Rather than adapting their tax systems to this New World, they are attempting to adapt this New World to their tax systems. This, however, will require the establishment of a world tax organization, which, absent a single, worldwide political institution, is doomed to fail.

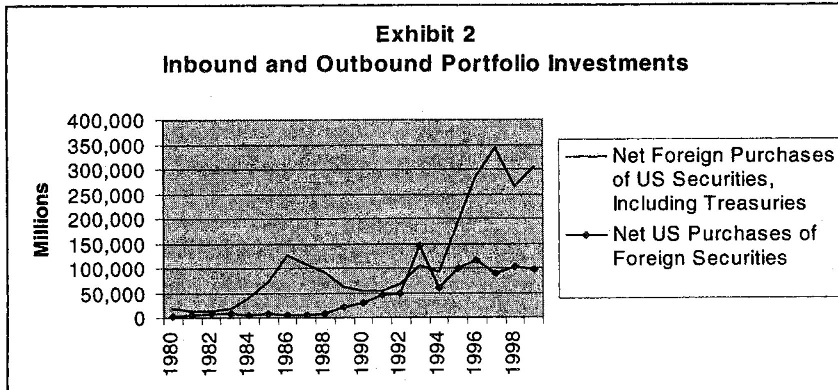
Although there is little that can be done, there is nothing that should be done about this phenomenon. Developing countries are surely "begging their neighbors'" tax bases, and they may even be less efficient, but this is only a temporary shortcoming of globalization. Eventually, the world's knowledge base, and thus its efficiencies, will converge. In the

[105] *See id.* at 160, 164.
[106] *Id.* at 166.

Weiss: International Tax Competition: An Efficient or Inefficient Phenom

meantime, the world's leading economies should begin to adapt their income tax systems to the inevitable rather than attempt to postpone the unavoidable.





Published by IdeaExchange@UAkron, 2001

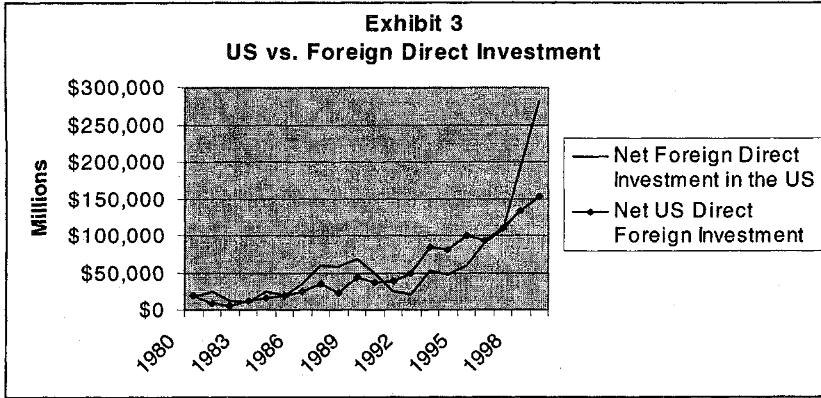


Exhibit 3
US vs. Foreign Direct Investment
$300,000
$250,000
$200,000
$150,000
$100,000
$50,000
$0
Millions
1980
1983
1986
1989
1992
1995
1998
Net Foreign Direct Investment in the US
Net US Direct Foreign Investment