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The Merits of Tax Competition in a Globalized Economy

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The Merits of Tax Competition in a Globalized Economy

DAVID C. ELKINS[*]

Since the turn of the current century, leading transnational organizations and academic scholarship have identified tax competition among countries as one of the scourges of the international tax regime. Both the EU and the OECD have warned that tax competition erodes the tax bases of Member States and impedes their ability to provide essential services. Commentators have argued that unrestrained competition is driving tax rates on mobile sources of income to (or close to) zero, a process that jeopardizes the very existence of the welfare state, exacerbates problems of global poverty, and deprives developing countries of funds that they desperately need in order to improve their physical infrastructure and human capital. Tax competition is also said to misallocate economic resources by driving investment to where the tax rate is lowest rather than to where the return on investment is highest.

Most proposals for reform suggest that, to one extent or another, countries harmonize their tax policies with the aim of mitigating the threat of mutually harmful tax competition. One prevalent theme in reform proposals is that countries be prohibited from offering foreign investors a more lenient tax regime than that which applies to their own residents ("ring fencing"). The argument is that ring fencing is a predatory form of tax competition that allows foreign investors to benefit from government services for which they do not pay, erodes the tax base of other countries, and, by encouraging other countries to follow suit, instigates a "race to the bottom" to the detriment of all.

This Article argues that, not only is international tax competition inevitable, but that free and fair tax competition, far from misallocating resources, is necessary in order to allocate resources efficiently and to maximize global welfare. It argues that limiting tax competition, particularly by restricting ring fencing, will likely exacerbate problems of global poverty and will lead to a more unequal distribution of wealth. Its thesis, therefore, is that tax reform should encourage, rather than discourage, international tax competition and that transnational organizations should focus their efforts on improving the competitive atmosphere.

INTRODUCTION 906
THE CURRENT INTERNATIONAL TAX REGIME 909
THE CHALLENGE OF GLOBALIZATION 911
OVERVIEW 915
I. TAX COMPETITION 916
A. EFFICIENT ALLOCATION OF RESOURCES THROUGH PRICE SIGNALING.... 916
B. HOST COUNTRY TAX AND INCENTIVE POLICY 917

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C. MNE CHOICE OF INVESTMENT VENUE 920
D. TAX SIGNALING AND EFFICIENCY 921
E. TAX COMPETITION LEADS TO INEFFICIENCY? 925
F. COMPARISON WITH THE TIEBOUT MODEL 930
G. OBJECTIONS 933
II. TRANSACTIONAL JUSTICE 938
A. FREE RIDER 938
B. FACTOR PRICES 938
C. USE AND ECONOMIC BENEFIT 940
III. DISTRIBUTIVE JUSTICE 942
A. INTRODUCTION 942
B. DOMESTIC DISTRIBUTIVE JUSTICE 943
C. INTERNATIONAL REDISTRIBUTION 948
CONCLUSION 953

INTRODUCTION

Since the turn of the current century, leading transnational organizations and academic scholarship have identified tax competition among countries as one of the scourges of the international tax regime.[1] Both the European Union (EU) and the

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1. According to commentators, tax competition is not the only malady afflicting the international tax regime. Other oft-cited maladies include the following:
a. Disparate domestic tax rules allow multinational enterprises (MNEs) to engage in tax arbitrage by arranging their affairs in a manner that eliminates or drastically reduces their total tax liability. *See* ORG. FOR ECON. CO-OPERATION AND DEV., ACTION PLAN ON BASE EROSION AND PROFIT SHIFTING 10, 13–19 (2013), *available at* www.oecd.org /ctp/BEPSActionPlan.pdf [https://perma.cc/M3HL-6HHX] [hereinafter OECD, ACTION PLAN]; ORG. FOR ECON. CO-OPERATION AND DEV., HARMFUL TAX COMPETITION: AN EMERGING GLOBAL ISSUE 15 (1998), *available at* www.oecd.org/tax/transparency /44430243.pdf [https://perma.cc/CK7U-WK2K] [hereinafter OECD, HARMFUL TAX COMPETITION] (referring to "unintentional mismatches between existing tax systems"); Steven A. Bank, *The Globalization of Corporate Tax Reform*, 40 PEPP. L. REV. 1307, 1319 (2013); Ilan Benshalom, *How To Redistribute? A Critical Examination of Mechanisms To Promote Global Wealth Redistribution*, 64 U. TORONTO L.J. 317, 338 (2014) [hereinafter Benshalom, *How to Redistribute?*]; Arthur J. Cockfield, *The Limits of the International Tax Regime as a Commitment Projector*, 33 VA. TAX REV. 59, 89–90 (2013); J. Clifton Fleming, Jr. & Robert J. Peroni, *A Hitchhiker's Guide to Outbound International Tax Reform*, 18 CHAP. L. REV. 133, 138–39 (2014); Marc Morris, *United in Diversity, Divided by Sovereignty: Hybrid Financing, Thin Capitalization, and Tax Coordination in the European Union*, 31 ARIZ. J. INT'L & COMP. L. 761, 763 (2014); Julie Roin, *Taxation Without Coordination*, 31 J. LEGAL STUD. S61, S70–S76 (2002) [hereinafter Roin, *Taxation Without Coordination*]; H. David Rosenbloom, Noam Noked & Mohamed S. Helal, *The Unruly World of Tax: A Proposal for an International Tax Cooperation Forum*, 15 FLA. TAX REV. 57 (2014); Daniel Shaviro, *Money on the Table?: Responding to Cross-Border Tax Arbitrage*, 3 CHI. J. INT'L L. 317, 319–21 (2002); Marc D. Shepsman, Comment, *Buying FATCA Compliance: Overcoming Holdout Incentives To Prevent International Tax Arbitrage*, 36 FORDHAM INT'L L.J. 1767, 1769 (2013).
b. Earning-stripping techniques enable MNEs to move earning out of the jurisdiction in which they operate and into countries that impose no income tax ("tax havens") or tax income at

Organisation for Economic Co-operation and Development (OECD) have warned that tax competition erodes the tax bases of Member States and impedes their ability to provide essential services.[2] Commentators have argued that unrestrained competition is driving tax rates on mobile sources of income to (or close to) zero, a process that jeopardizes the very existence of the welfare state, exacerbates problems of global poverty, and deprives developing countries of funds that they desperately need in order to improve their physical infrastructure and human capital. Tax competition is also said to misallocate economic resources by driving investment to where the tax rate is lowest rather than to where the return on investment is highest.[3]

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relatively low rates. *See* Ilan Benshalom, *Taxing the Financial Income of Multinational Enterprises by Employing a Hybrid Formulary and Arm's Length Allocation Method*, 28 VA. TAX REV. 619, 627–28 (2009) [hereinafter Benshalom, *Taxing the Financial Income*]; Jasmine M. Fisher, Note, *Fairer Shores: Tax Havens, Tax Avoidance, and Corporate Social Responsibility*, 94 B.U. L. REV. 337, 342–46 (2014); J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Getting Serious About Cross-Border Earnings Stripping: Establishing an Analytical Framework*, 93 N.C. L. REV. 673, 680–84 (2015); Edward D. Kleinbard, *Stateless Income*, 11 FLA. TAX REV. 699, 703 (2011) [hereinafter Kleinbard, *Stateless Income*]; Edward D. Kleinbard, *The Lessons of Stateless Income*, 65 Tax L. Rev. 99, 112 (2011) [hereinafter Kleinbard, *Lessons*]; Robert T. Kudrle & Lorraine Eden, *The Campaign Against Tax Havens: Will It Last? Will It Work?*, 9 STAN. J.L. BUS. & FIN. 37, 37–42 (2003); Henry Ordower, *Utopian Visions Toward a Grand Unified Global Income Tax*, 14 FLA. TAX REV. 361, 363 (2003); Adam H. Rosenzweig, *Why Are There Tax Havens?*, 52 WM. & MARY L. REV. 923, 936–42 (2010) [hereinafter Rosenzweig, *Tax Havens?*].

c. Lack of effective exchange of information facilitates illegal tax evasion. OECD, HARMFUL TAX COMPETITION, *supra* at 29–30; *see* Council, Conclusions of the Ecofin Council Meeting on 1 December 1997 Concerning Taxation Policy, 1998 O.J. (C 2/01) 1, 6 [hereinafter Conclusions of the Ecofin Council Meeting], *available at* http://ec.europa.eu /taxation_customs/resources/documents/coc_en.pdf [https://perma.cc/BBQ9-DL77]; Allison Christians, *Getting to Yes? Thoughts on a BATNA for International Tax*, 2013 WIS. L. REV. ONLINE 7; Steven A. Dean, *The Incomplete Global Market for Tax Information*, 49 B.C. L. REV. 605 (2008); Miguel González Marcos, *Seclusion in (Fiscal) Paradise Is Not an Option: The OECD Harmful Tax Practices Initiative and Offshore Financial Centers*, 24 N.Y. INT'L L. REV. 1, 11–12 (2011); Chad P. Ralston, Comment, *Going It Alone: A Pragmatic Approach to Combating Foreign-Effected Tax Evasion*, 24 EMORY INT'L L. REV. 873, 894–96 (2010); Julie Roin, *Competition and Evasion: Another Perspective on International Tax Competition*, 89 GEO. L.J. 543, 595–96 (2001) [hereinafter Roin, *Competition and Evasion*]; Rosenbloom et al., *supra*; Adam H. Rosenzweig, *Thinking Outside the (Tax) Treaty*, 2012 WIS. L. REV. 717 [hereinafter Rosenzweig, *Thinking Outside the (Tax) Treaty*].

The focus of the current Article is tax competition and, except in passing, it will not discuss these other issues. Furthermore, it is arguable that tax competition is the most fundamental issue facing the international tax regime. If indeed disharmony, earnings stripping, and lack of information are negative phenomena, it may be that tax competition both creates the necessary framework within which they can operate (e.g., by encouraging countries to lower their tax rates and inviting taxpayers to strip earnings out of higher-tax countries) and prevents their resolution (e.g., by inhibiting efforts toward harmonization and information exchange).

2. Conclusions of the Ecofin Council Meeting, supra note 1, at 6; OECD, ACTION PLAN, *supra* note 1, at 17; OECD, HARMFUL TAX COMPETITION, *supra* note 1, at 14.

3. *See* sources cited *infra* note 71.

The current state of affairs has often been described as a prisoners' dilemma, a situation in which each participant rationally employing its own optimal strategy produces a less-than-optimal result. In the game of international tax competition, the participants are countries. Each would like to maintain a relatively high rate of tax, but cannot afford to do so for fear of losing international investment to countries that offer lower tax rates. Consequently, they all lower their tax rates and each ends up with less funds to spend on public projects.[4]

As countering a prisoners' dilemma requires that the participants coordinate their behavior instead of acting independently, most proposals for reform suggest that—to one extent or another—countries harmonize their tax policies with the aim of mitigating the threat of mutually harmful tax competition. One prevalent theme in reform proposals is that countries be prohibited from offering foreign investors a more lenient tax regime than that which applies to their own residents ("ring fencing").[5] The argument is that ring fencing is a predatory form of tax competition

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4. OECD, HARMFUL TAX COMPETITION, *supra* note 1, at 34 ("[Countries] collectively would be better off by not offering incentives but each feels compelled to offer the incentive to maintain a competitive business environment."); 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, 539 (1999); Peter D. Enrich, *Saving the States from Themselves: Commerce Clause Constraints on State Tax Incentives for Business*, 110 HARV. L. REV. 377, 396 (1996) (describing a similar phenomenon on the state level); Rosenzweig, *Thinking Outside the (Tax) Treaty*, *supra* note 1, at 731–33. In the classic prisoners' dilemma, each of two prisoners is under suspicion of armed robbery, a felony that carries a sentence of ten years in prison. Without a confession or the testimony of one prisoner against the other, the district attorney can prove only illegal possession of a weapon, a misdemeanor that carries a sentence of one year. The district attorney approaches each of the prisoners separately with an offer to cooperate, that is, to confess and to be willing to testify against the other. The terms of the offer: if both cooperate, each will receive a sentence of five years; if only one cooperates, that prisoner will receive a suspended sentence and the other will receive a ten-year sentence. Assuming that neither prisoner is concerned with the other's welfare and that, even if they can communicate, they do not trust each other to abide by any agreement they might make, not cooperating is not an effective option for either of them. Depending upon what the other does, cooperating will result in either a suspended sentence or a five-year sentence, while refusing to cooperate will result in a one-year or a ten-year sentence (the number in parentheses are A's prison time followed by B's prison time):

	A does not cooperate	A cooperates
B does not cooperate	(1, 1)	(0, 10)
B cooperates	(10, 0)	(5, 5)

Despite the fact that by not cooperating the prisoners could have could have gotten away with one-year sentences, by rationally pursuing their own best interests each will receive a five-year sentence.

5. *See, e.g.*, Conclusions of the Ecofin Council Meeting, supra note 1, at 3 (Code of conduct for business taxation); OECD, HARMFUL TAX COMPETITION, *supra* note 1, at 26–28; Reuven S. Avi-Yonah, *Bridging the North/South Divide: International Redistribution and Tax Competition*, 26 MICH. J. INT'L L. 371, 384 (2004); Hedda Leikvang, Note, *Piercing the Veil of Secrecy: Securing Effective Exchange of Information to Remedy the Harmful Effects of Tax*

that allows foreign investors to benefit from government services for which they do not pay, erodes the tax base of other countries, and, by encouraging other countries to follow suit, instigates a "race to the bottom" to the detriment of all.

This Article will argue that, not only is international tax competition inevitable, but that free and fair tax competition, far from misallocating resources, is necessary in order to allocate resources efficiently and to maximize global welfare. It will argue that limiting tax competition, particularly by restricting ring fencing, will likely exacerbate problems of global poverty and will lead to a more unequal distribution of wealth. Its thesis, therefore, is that tax reform should encourage, rather than discourage, international tax competition and that transnational organizations should focus their efforts on improving the competitive atmosphere.

The Current International Tax Regime

The international tax regime, as it evolved in the early decades of the twentieth century, rested upon three primary pillars.[6] The first is that a country is entitled to tax all income derived from sources within its territory.[7] The second is that a country is entitled to tax the worldwide income of its residents.[8] The third is that it is the

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Havens, 45 VAND. J. TRANSNAT'L L. 293, 299 (2012); Yoram Margalioth, *Tax Competition, Foreign Direct Investments and Growth: Using the Tax System To Promote Developing Countries*, 23 VA. TAX REV. 161, 189 (2003); Ruth Mason, *U.S. Tax Treaty Policy and the European Court of Justice*, 59 TAX L. REV. 65, 101 (2005).

6. For a discussion of whether the current international tax regime has acquired the status of international law, see Reuven S. Avi-Yonah, *International Tax as International Law*, 57 TAX L. REV. 483 (2004); Nancy H. Kaufman, *Fairness and the Taxation of International Income*, 29 LAW & POL'Y INT'L BUS. 145, 148 n.23 (1998); H. David Rosenbloom, *International Tax Arbitrage and the "International Tax System,"* 53 TAX L. REV. 137, 166 (2000).

7. Avi-Yonah, *supra* note 6, at 490 ("The right of countries to tax income arising in their territory is well established in international law."); RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW OF THE UNITED STATES § 402(1)(a) (1987).

8. Not all countries exercise their full rights under international usage to tax the worldwide income of their residents. For example, Germany, France, and the Netherlands impose tax only on domestic source income, without regard to the residence of the taxpayer. Yoram Keinan, *The Case for Residency-Based Taxation of Financial Transactions in Developing Countries,* 9 FLA. TAX REV. 1, 12 (2008). On the other end of the spectrum, the United States has stretched the ambit of those subject to tax on their worldwide income beyond that of any other country to include not only resident individuals and domestic corporations but also nonresident citizens. § 61 of the Internal Revenue Code, which defines gross income as "all income from whatever source derived," is not qualified with regard to the identity of the taxpayer or the geographical source of the income. I.R.C. § 61 (2012). § 871 stipulates that, in the case of nonresident aliens, gross income includes only U.S.-source income (or income "effectively connected with the conduct of a trade or business within the United States"). *Id.* at § 871. § 882(b) contains a similar provision with regard to foreign corporations. *Id.* at § 882(b). As neither of these sections applies to nonresident citizens, they are subject to the §61 default rule. (No country other than the United States taxes according to citizenship). *See* JOSEPH ISENBERGH, INTERNATIONAL TAXATION 9–10 (3d ed. 2010); Avi-Yonah, *supra* note 6, at 487. For discussion of the appropriateness of taxing nonresident citizens, see generally Michael S. Kirsch, *Revisiting the Tax Treatment of Citizens Abroad: Reconciling Principle*

responsibility of the home country to alleviate or mitigate double taxation.[9] The 1923 report by a committee of four leading economists to the League of Nations,[10] a report which, although not adopted in its entirety, was largely responsible for the contours of the current international tax regime,[11] relied upon the concept of economic allegiance to grant taxing power to both the host country and the home country.[12] However, by the second half of the century, the literature had abandoned the somewhat nebulous notion of economic allegiance and instead tended to justify the international tax regime in terms of equity and neutrality. Home country taxation of worldwide income was said to accord with the principles of both horizontal and vertical equity: both of these concepts require a determination of ability to pay,[13] and

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and Practice, 14 FLA. TAX REV. 117 (2014); Michael S. Kirsch, *Taxing Citizens in a Global Economy*, 82 N.Y.U. L. REV. 443 (2007); Bernard Schneider, *The End of Taxation Without End: A New Tax Regime for U.S. Expatriates*, 32 VA. TAX REV. 1 (2012); Edward A. Zelinsky, *Citizenship and Worldwide Taxation: Citizenship as an Administrable Proxy for Domicile*, 96 IOWA L. REV. 1289 (2011); Daniel Shaviro, *Taxing Potential Community Members' Foreign Source Income*, (N.Y. Univ. Ctr. for Law, Econ. & Org., Working Paper No. 15-09, 2015), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2625732 [https://perma.cc/Q9AN-NB8Y].

9. To fulfill its obligations under the third pillar, the United States grants its taxpayers a credit for foreign taxes paid in respect of foreign-source income. I.R.C. § 901(a); *see also* U.S. DEP'T OF THE TREASURY, UNITED STATES MODEL INCOME TAX CONVENTION art. 23 (2016), *available at* https://www.treasury.gov/resource-center/tax-policy/treaties/Documents/Treaty-US%20Model-2016.pdf [https://perma.cc/P5C6-VB5J]; ORG. FOR ECON. CO-OPERATION AND DEV. COMMITTEE ON FISCAL AFFAIRS, MODEL TAX CONVENTION ON INCOME AND ON CAPITAL, art. 23A–B, *available at* http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/model-tax-convention-on-income-and-on-capital-2014-full-version/article-23-a-and-23-b-exemption-method-and-credit-method_9789264239081-26-en#page1 [https://perma.cc/3S3M-KP3W] (containing alternative methods for elimination of double taxation: the "Exemption Method" in Article 23A and the "Credit Method" in Article 23B).

10. ECON. & FIN. COMM'N, LEAGUE OF NATIONS, REPORT ON DOUBLE TAXATION SUBMITTED TO THE FINANCIAL COMMITTEE BY PROFESSORS BRUINS, EINAUDI, SELIGMAN AND SIR JOSIAH STAMP (1923), *reprinted in* 4 JOINT COMM. ON INTERNAL REVENUE TAXATION, LEGISLATIVE HISTORY OF UNITED STATES TAX CONVENTIONS 4003 (1962).

11. After approving the imposition of tax by both the country in which the wealth originated and the country of residence or domicile, *infra* note 12, the Commission considered the foreign tax credit—which it referred to as "the method of deduction for income from abroad"—as a means of mitigating double taxation but rejected it as impractical. ECON. & FIN. COMM'N, LEAGUE OF NATIONS, *supra* note 10, at 4046 (emphasis removed) ("It is to be doubted whether such creditor countries as the United States, Great Britain and the Netherlands, having regard to their interests abroad, would ever agree permanently to put their exchequers at the mercy of all the unknown increases of taxation of foreign Governments.").

12. The report listed four elements of economic allegiance: "the acquisition of wealth, the location of wealth, the enforceability of the rights to wealth, and the consumption of wealth." ECON. & FIN. COMM'N, LEAGUE OF NATIONS, *supra* note 10, at 4027. It went on to state that "the most important factors . . . are . . . the origin of the wealth and the residence or domicile of the owner who consumes the wealth." *Id.* at 4029.

13. David Elkins, *Horizontal Equity as a Principle of Tax Theory*, 24 YALE L. & POL'Y REV. 43, 88 (2006).

ability to pay is a function of one's worldwide income.[14] Home country taxation of worldwide income was also said to prevent tax considerations from influencing a firm's decision in which country to operate ("capital export neutrality" or CEN).[15] Host country taxation was said to permit all firms operating in a given market to compete on equal footing ("capital import neutrality" or CIN).[16]

Whatever its theoretical justification, this regime proved workable in an era in which consumer goods and the means of their production were largely tangible and in which formidable legal and practical barriers inhibited the free movement of capital and goods. Competition among countries for investment was limited. As late as the late 1980s, corporate income tax rates of 60% or higher were not uncommon.[17]

The Challenge of Globalization

Toward the end of the twentieth century, circumstances began to change dramatically. A political resolve to integrate various nations' economies as a bulwark against future military conflict and the growing understanding that international trade is mutually beneficial, and not a zero-sum game, resulted in the lowering of legal barriers to the movement of capital and goods.[18] Technological advances in the fields

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14. For example, all else being equal, a U.S. resident with $100,000 of U.S.-source income and $900,000 of foreign-source income has the same ability to pay as does a U.S. resident with $1,000,000 of U.S.-source income and no foreign-income (horizontal equity) and a much greater ability to pay than does a U.S. resident with $100,000 of U.S.-source income and no foreign-source income (vertical equity). *See e.g.*, J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Fairness in International Taxation: The Ability-To-Pay Case for Taxing Worldwide Income*, 5 FLA. TAX REV. 299, 311–313 (2001); Julie Roin, *Rethinking Tax Treaties in a Strategic World with Disparate Tax Systems*, 81 VA. L. REV. 1753, 1761 n.27 (1995).

15. Reuven S. Avi-Yonah, *All of a Piece Throughout: The Four Ages of U.S. International Taxation*, 25 VA. TAX REV. 313, 324–27 (2005).

16. *See* Reuven S. Avi-Yonah, *Globalization, Tax Competition, and the Crisis of the Welfare State*, 113 HARV. L. REV. 1573, 1605–06 (2000). Other, more recent, concepts of neutrality include capital ownership neutrality (CON), national ownership neutrality (NON), national neutrality (NN), and global portfolio neutrality (GPN). *See generally* CHARLES H. GUSTAFSON, ROBERT J. PERONI & RICHARD CRAWFORD PUGH, TAXATION OF INTERNATIONAL TRANSACTIONS 20–22 (4th ed. 2011); James R. Hines, Jr., *Reconsidering the Taxation of Foreign Income*, 62 TAX L. REV. 269, 273–79 (2009); *Report of the Task Force on International Tax Reform*, 59 TAX LAW. 649, 680–89 (2006). For a critical view of what he refers to as "alphabet soup" and "the battle of the acronyms," see DANIEL N. SHAVIRO, FIXING U.S. INTERNATIONAL TAXATION 14 (2014). *See also* Ruth Mason, *Tax Expenditures and Global Labor Mobility*, 84 N.Y.U. L. REV. 1540, 1574–78 (2009) (introducing labor export neutrality (LEN), labor import neutrality (LIN), labor ownership neutrality (LON), and labor residence neutrality (LRN)).

17. Finland had a corporate tax rate of 61.8% in 1985, Sweden has a corporate tax rate of 60.1% in 1989, and West Germany has a corporate tax rate of 60% until 1989. *OECD Corporate Tax Income Rates, 1981–2013*, TAX FOUNDATION (Dec. 18, 2013), http://taxfoundation.org/article/oecd-corporate-income-tax-rates-1981-2013 [https://perma.cc/T2MU-27GJ].

18. *See* CHRISTOPHER M. DENT, THE EUROPEAN ECONOMY: THE GLOBAL CONTEXT 189 (1997); WILLEM MOLLE, THE ECONOMICS OF EUROPEAN INTEGRATION 41–44 (5th ed. 2006).

of communication and transportation removed many of the practical barriers. As markets opened, competition for investment—and particularly for MNE investment—increased.[19] The result was a drastic lowering of corporate tax rates, including the temporary or permanent waiver of taxation altogether ("tax holidays").[20]

Nor has tax competition been limited to exotic island states, developing countries, or renegade nations. The average corporate income tax rate in OECD countries fell from a high of 48.2% in 1985 to a low of 25.4% in 2012.[21] In several instances, the reduction was much more dramatic. Sweden slashed its corporate tax rate by more than half in a period of just two years, from 60.1% in 1989 to 30% in 1991.[22] In Norway, the corporate tax rate dropped from 50.8% in 1991 to 28% in 1992.[23] Ireland has been particularly aggressive in this regard, introducing a 10% corporate tax rate on manufacturing income (1981) and a 12.5% corporate tax rate on trading income (2003).[24] The United States, while retaining a relatively high statutory corporate tax rate,[25] lowered tax rates to zero on various types of passive income in order to encourage foreign investment. In 1984, it abolished its withholding tax on portfolio interest, effectively exempting foreign corporations and nonresident aliens from tax on such income.[26] Every other major capital-importing country has since followed suit.[27] In 1987, the United States exempted foreign corporations and nonresident aliens from tax on capital gain from the sale of personal property.[28] Since 2000, China and a number of European countries have adopted "Patent Box" or "IP Box" regimes, under which income attributable to patents is subject to tax at exceptionally low

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19. Ming-Sung Kuo, *(Dis)embodiments of Constitutional Authorship: Global Tax Competition and the Crisis of Constitutional Democracy*, 41 GEO. WASH. INT'L L. REV. 181, 186 (2009) ("Tax competition exists in its current state because of the high mobility of capital in the global era."); Rosenzweig, *Tax Havens?*, *supra* note 1, at 943. *But see* Reuven S. Avi-Yonah, *And Yet It Moves: Taxation and Labor Mobility in the Twenty-First Century*, 67 TAX L. REV. 169, 170 (2014) (arguing that for upper-middle and high income taxpayers, expatriation is not significantly more difficult than moving capital abroad).

20. Avi-Yonah, *supra* note 16, at 1577, 1588–92; Kuo, *supra* note 19, at 189.

21. *OECD Corporate Tax Income Rates, 1981–2013*, *supra* note 17.

22. *Id.*

23. *Id.*

24. AIDAN WALSH & CHRIS SANGER, THE HISTORICAL DEVELOPMENT AND INTERNATIONAL CONTEXT OF THE IRISH CORPORATE TAX SYSTEM: A REPORT COMMISSIONED BY THE IRISH DEPARTMENT OF FINANCE 5 (2015), *available at* http://www.budget.gov.ie/Budgets/2015/Documents/EY_Historical_Dev_International_Context_Irish_%20Corporation_Tax.pdf [https://perma.cc/V7NG-7A6Q].

25. § 11 imposes a top rate of 35%. I.R.C. § 11 (2012). This rate is second only to Japan among OECD countries. *OECD Corporate Tax Income Rates, 1981–2013*, *supra* note 17.

26. I.R.C. §§ 871(h), 881(c) (2012).

27. Avi-Yonah, *supra* note 16, at 1576, 1581–83; Keinan, *supra* note 8, at 29; Kuo, *supra* note 19, at 187.

28. I.R.C. § 865 (2012).

rates.[29] In September 2014, the House of Representatives passed legislation that would institute a Patent Box regime in the United States.[30]

This ongoing and multifaceted process has created what some have described as a crisis in the international tax regime.[31] Highly profitable corporations often pay little or no income tax.[32] Some studies indicate that labor now bears a substantially higher percentage of the tax burden than it did previously.[33] Moreover, many analysts have argued that, by skewing MNE investment decisions, tax competition misallocates resources and reduces global welfare.[34]

Responding to these challenges, the EU and the OECD have proposed a number of measures to combat what they term "harmful tax competition." In 1997, the EU's Economic and Financial Affairs Council ("ECOFIN"), following a "wide-ranging debate,"[35] adopted a Code of Conduct for Member States in the field of business taxation.[36] The focus of the Code was on "tax measures which provide for a significantly lower effective level of taxation, including zero taxation, than those levels which generally apply in the Member State,"[37] a phenomenon it referred to as "ring-fenc[ing]."[38] The Code committed Member States to refrain from introducing such harmful measures and, furthermore, to examine their existing law and practices "with a view to eliminating any harmful measures as soon as possible."[39]

In 1998, the OECD published a report entitled *Harmful Tax Competition: An Emerging Global Issue*,[40] which targeted both "tax havens"[41] and "harmful

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29. ORG. FOR ECON. CO-OPERATION AND DEV., OECD ECONOMIC SURVEYS: UNITED KINGDOM 33–35 (2013); Lisa Evers, Helen Miller & Christoph Spengel, *Intellectual Property Box Regimes: Effective Tax Rates and Tax Policy Considerations*, 22 INT'L TAX & PUB. FIN. 502, 505 (2015), *available at* http://link.springer.com/article/10.1007/s10797-014-9328-x [https://perma.cc/CPH3-VYBS]; Rachel Griffith, Helen Miller & Martin O'Connell, *Ownership of Intellectual Property and Corporate Taxation*, 112 J. PUB. ECON. 12, 20–21 (2014), *available at* http://www.sciencedirect.com/science/article/pii/S0047272714000103 [https://perma.cc/T96Q-4ADZ]; Wolfgang Kessler & Rolf Eicke, *The Emergence of R&D Tax Regimes in Europe*, 50 TAX NOTES INT'L 845 (2008); Bret Wells & Cym Lowell, *Tax Base Erosion: Reformation of Section 482's Arm's Length Standard*, 15 FLA. TAX REV. 737, 740–41 (2014).

30. Revitalize American Manufacturing and Innovation Act of 2014, H.R. 2996, 113th Cong. (2014), *available at* https://www.congress.gov/bill/113th-congress/house-bill/2996 [https://perma.cc/474U-FGS6].

31. Avi-Yonah, *supra* note 16, at 1599–1603.

32. Yariv Brauner, *What the BEPS?*, 16 FLA. TAX REV. 55, 57 (2014); Zachary R. Mider, *Ten Percent of S&P 500 Companies Avoid Paying U.S. Taxes*, BLOOMBERG BUSINESS (Apr. 14, 2015, 11:11 AM), http://www.bloomberg.com/news/articles/2015-04-14/how-10-percent-of-s-p-companies-opted-out-of-paying-u-s-taxes [https://perma.cc/5X84-CFSW].

33. Avi-Yonah, *supra* note 16, at 1618–25.

34. *See infra* Part I.E.

35. Conclusions of the Ecofin Council Meeting, *supra* note 1, at 1.

36. *Id.* at 2–5.

37. *Id.* at 3.

38. *Id.*

39. *Id.* at 4.

40. OECD, HARMFUL TAX COMPETITION, *supra* note 1.

41. *Id.* at 21–25. According to the report, the identifying characteristics of tax havens are no or only nominal taxation, lack of effective exchange of information, lack of transparency

preferential tax regimes."[42] As to the identification of harmful preferential tax regimes, the OECD report, like the EU's Code of Conduct, emphasized ring fencing.[43] In 2013, the OECD followed up with an *Action Plan on Base Erosion and Profit Shifting* ("Action Plan").[44] The Action Plan noted that "[t]he underlying policy concerns expressed in the 1998 Report as regards the 'race to the bottom' on the mobile income tax base are as relevant today as they were 15 years ago" and directed the Forum on Harmful Tax Practices (FHTP) "to develop more effective solutions."[45]

The academic community has largely supported international efforts to combat tax competition.[46] Proponents of restricting competition argue that doing so will increase global welfare and lead to a fairer distribution of wealth. One theme prevalent in the literature is that while democratic countries have the sovereign right to determine the size of their government and the level of tax they wish to impose, lenient tax regimes applicable only to foreigners are abusive and should be curtailed.

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in the operation of legislative, legal, or administrative provision, and the absence of a requirement for substantial economic activity. *Id.* at 23.

42. *Id.* at 25–35.

43. *Id.* at 26–28. The other "key factors" in identifying harmful preferential tax regime are similar to the listed characteristics of tax havens: no or low effective tax rates, lack of transparency, and lack of effective exchange of information. *Id* at 27. "Other factors" include an artificial definition of the tax base, failure to adhere to international transfer pricing principles, exemption of foreign source income from residence country tax, negotiability of tax rate or tax base, existence of secrecy provisions, access to a wide network of tax treaties, promotion of regimes as tax minimization vehicles, and encouragement of purely tax-driven operations or arrangements. *Id.* at 30–34.

44. OECD, ACTION PLAN, *supra* note 1. Between 2000 and 2006, the OECD published four updates detailing implementation of its report on Harmful Tax Competition: ORG. FOR ECON. CO-OPERATION AND DEV., TOWARDS GLOBAL TAX CO-OPERATION: REPORT TO THE 2000 MINISTERIAL COUNCIL MEETING AND RECOMMENDATIONS BY THE COMMITTEE ON FISCAL AFFAIRS: PROGRESS IN IDENTIFYING AND ELIMINATING HARMFUL TAX PRACTICES (2000), *available at* http://www.oecd.org/tax/harmful/2090192.pdf [https://perma.cc/X8QM-VA4V]; ORG. FOR ECON. CO-OPERATION AND DEV., THE OECD'S PROJECT ON HARMFUL TAX PRACTICES: THE 2001 PROGRESS REPORT (2001), *available at* http://www.oecd.org/ctp/harmful/2664450.pdf [https://perma.cc/2VZW-QKSA]; ORG. FOR ECON. CO-OPERATION AND DEV., THE OECD'S PROJECT ON HARMFUL TAX PRACTICES: THE 2004 PROGRESS REPORT (2004), *available at* http://www.oecd.org/ctp/harmful/30901115.pdf [https://perma.cc/P6D9-A8N3]; ORG. FOR ECON. CO-OPERATION AND DEV., THE OECD'S PROJECT ON HARMFUL TAX PRACTICES: 2006 UPDATE ON MEMBER COUNTRIES, *available at* http://www.oecd.org/tax/harmful/37446434.pdf [https://perma.cc/87K9-JK3J].

45. OECD, ACTION PLAN, *supra* note 1, at 17.

46. *See*, *e.g.*, Avi-Yonah, *supra* note 16; Avi-Yonah, *supra* note 5; Benshalom, *How to Redistribute?*, *supra* note 1, at 356; Benshalom, *Taxing the Financial Income*, *supra* note 1; Brauner, *supra* note 32, at 61; Christians, *supra* note 1; Fleming & Peroni, *supra* note 1; J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Formulary Apportionment in the U.S. International Income Tax System: Putting Lipstick on a Pig?*, 36 MICH. J. INT'L L. 1 (2014); Keinan, *supra* note 8; Kleinbard, *Stateless Income*, *supra* note 1; Kleinbard, *Lessons*, *supra* note 1; Shepsman, *supra* note 1. Some commentators are more sympathetic to tax competition: *E.g.*, Margalioth, *supra* note 5; Jeffery Owens, *Tax Competition: To Welcome or Not?* 65 TAX L. REV. 173 (2012); Roin, *Competition and Evasion*, *supra* note 1. *See also infra* note 171 and sources cited.

In other words, a country may legitimately adopt whatever tax rate it deems appropriate; may impose different tax rates on different types of income; and may even refrain from taxing certain types of income, but once it does so, it must apply those rates across the board to residents and nonresidents alike.[47] Discrimination in favor of foreigners, or ring fencing, is indicative of an attempt to profit at the expense of another country's treasury.[48] Furthermore, it is argued, ring fencing is ineffective as it merely invites other countries to follow suit, resulting in a race to the bottom in which all countries lose.

Overview

The thesis of this Article is that attempts to reform the international tax regime by restricting tax competition are misguided and would likely be counterproductive. Not only is tax competition a precondition for an efficient allocation of global resources, but restrictions on tax competition and, in particular, restrictions on ring fencing will likely exacerbate, not mitigate, inequality in the distribution of wealth. Rather than attempting to restrict tax competition, transnational organizations and commentators should encourage competition and focus their attention on removing obstacles to free competition among host countries for MNE investment and among MNEs for investment opportunities.

The focus of the current Article is competition for foreign investment. It will not discuss the exploitation of tax havens or of disharmony among the various countries' tax regimes to lower taxable income in an artificial manner,[49] nor, except in passing, the principles that should apply to the taxation of a country's own citizens and residents, whether derived from sources within the country or abroad.

Building on the work of Friedrich Hayek, Part I explains why, in practice, tax competition is necessary in order to achieve an efficient distribution of global resources. It describes how, under a regime of tax competition, the taxes demanded by host countries, the incentives that they offer, and the investment decisions of MNEs convey essential information regarding the availability of resources, consumer preferences, and the expected impact of investments on the residents of host countries and induce behavior that is conducive to the maximization of global wealth. It then suggests some measures that the international community might

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47. *See* OECD, HARMFUL TAX COMPETITION, *supra* note 1, at 15 ("The Committee recognises that there are no particular reasons why any two countries should have the same level and structure of taxation. Although differences in tax levels and structures may have implications for other countries, these are essentially political decisions for national governments.").

48. *See*, *e.g.*, Avi-Yonah, *supra* note 5, at 384 ("The OECD makes a useful distinction between tax competition in the form of generally applicable lower tax rates, and tax regimes designed to attract foreign investors. This distinction is both normatively and pragmatically sound: restricting tax competition should not and cannot mean that voters in democratic countries lose their right to determine the size of the public sector through general tax increases or reductions. Rather, it means that countries should not provide windfalls for foreign investors . . . ."); Javier G. Salinas, *The OECD Tax Competition Initiative: A Critique of Its Merits in the Global Marketplace*, 25 HOUS. J. INT'L L. 531, 541 (2003).

49. *See supra* note 1.

undertake in order to neutralize sources of market failure and thereby create a more effective competitive environment.

Part II considers the claim that tax competition violates transactional justice by making it difficult for host countries, which provide services to MNEs operating in their territory, to receive just compensation for those services. It argues that, via factor prices, MNEs indirectly pay for many of the services that they receive from the government of the host country. Charging them directly would constitute double charging for the same services. With regard to those benefits that are not reflected in factor prices, tax competition will not prevent host countries from receiving full compensation through direct taxation of the MNE.

Part III considers the argument that while a regime of tax competition may be efficient, the consequent "race to the bottom" violates distributive justice by impeding the ability of countries to provide social services and by obstructing the redistribution of resources from wealthy countries to poorer ones. With regard to domestic distributive justice, this Part argues that foreign investors have no obligation to finance the social assistance or the social insurance programs of the host country, beyond paying full market price for the services from which they benefit. It further argues that the prohibition against ring fencing, which lies at the heart of most proposals to restrict tax competition, is likely to exacerbate economic inequality by penalizing those countries that attempt to redistribute wealth or to provide extensive social services. With regard to alleviating international poverty, it posits that the international tax system is both an ineffective and an inefficient means of redistributing wealth.

The Article's final paragraphs summarize the arguments and offer some concluding thoughts.

I. TAX COMPETITION

A. Efficient Allocation of Resources Through Price Signaling

In an important article published in 1945,[50] Friedrich Hayek argued that a centrally planned economy is incapable of optimally distributing resources for the simple reason that no central planning board could possibly have access to all of the relevant information, (i.e., the availability of every resource and every individual's preference regarding the use of those resources).[51] Furthermore, the data are in constant flux, so that even if a central planning board could somehow ascertain the pertinent facts at a given instant, the information would soon become obsolete. [52]

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50. F.A. Hayek, *The Use of Knowledge in Society*, 35 AM. ECON. REV. 519 (1945).

51. *Id.*, at 519–20, 530; *see also* F.A. Hayek, *Two Pages of Fiction: The Impossibility of Socialist Calculation*, 2 ECON. AFF. 135, 137 (1982) (calling the claim that administrators of a socialist could have exactly the same knowledge of production functions as do capitalist entrepreneurs "a blatant untruth, an assertion so absurd that it is difficult to understand how an intelligent person could ever honestly make it.").

52. Hayek, *supra* note 50, at 525–27; Hayek, *supra* note 51, at 137. Hayek also noted that even if one mind could possess all of the relevant information, the calculations necessary to determine the optimal distribution are beyond human capacity, as they involve the simultaneous solution of innumerable equations. Hayek, *supra* note 50, at 525; Hayek, *supra*

As the data are widely disbursed, an efficient allocation of resources requires a decentralization of the decision-making process. However, because no one person could be aware of more than an infinitesimally small portion of the relevant information, effective decision making depends upon speedy communication of information regarding resource availability and consumer preferences and, moreover, a means to induce individuals to adapt their behavior to the incoming data.[53]

Hayek's insight was that the medium via which the market disseminates such information and induces such change in behavior is price. Assume, he argued, that somewhere in the world a new use has been discovered for a certain raw material or, alternatively, that an existent source of supply has been curtailed. Consumers of the material will instantly become aware of the possibility of it being more profitably employed elsewhere and will curtail their use of it. In Hayek's words, "without an order being issued, without more than perhaps a handful of people knowing the cause, tens of thousands of people whose identity could not be ascertained by months of investigation, are made to use the material or its products more sparingly."[54]

As prices are the signals employed by the market to convey information, they need to be free to respond to changing circumstances. Not permitting prices to fluctuate freely impairs the capacity of the price system to direct resources to their most efficient uses (although, as Hayek noted, when prices are fixed, communication often will continue through other elements of the contract).[55]

Seventy years after their publication, Hayek's words are as relevant as ever. The appearance in the late twentieth and early twenty-first centuries of a globalized economy, a state of affairs in which the phrase "global welfare" takes on practical significance, has turned the tens of thousands of people, to whom Hayek referred, into billions. As the world becomes more and more economically integrated and as the use (or misuse) of resources anywhere has a greater and more immediate impact on the welfare of people everywhere, disseminating information regarding local conditions and correlating information from different locales has become more and more crucial. As Hayek so convincingly explained, the best and perhaps the only way to do so is by individual actors responding to the signals conveyed via the price system and altering their behavior accordingly.

B. Host Country Tax and Incentive Policy

Individuals and firms are not the only actors in the global economy. Governments also play a crucial role by representing the interests of their citizens and residents on the world stage and by setting the terms and conditions under which economic activity takes place within their territories. In this Part, we will focus on taxes that governments impose on MNEs engaged in local economic activity, on incentives that governments offer MNEs as an inducement to engage in local economic activity, and on the signals conveyed by these taxes and incentives.

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note 51, at 139.

53. Hayek, *supra* note 50, at 524–25.

54. *Id.* at 527.

55. *Id.* at 526.

From the perspective of the host country, MNE investment entails both costs and benefits. The most obvious costs are those that involve direct economic outlay such as expanding the transportation infrastructure (or experiencing increased traffic and increased wear and tear on existing roads) and providing additional law enforcement, health, and possibly educational services (if, for example, foreigners bring their children to their new place of employment). Foreign investment could impose environmental costs such as increased pollution or damage to the local ecosystem. Costs could also include what the host country considers a threat to local culture, such as the displacement of traditional artisans or the importation of foreign values.

The benefits inherent in MNE investment are similarly many and varied. Perhaps the most obvious is increased employment as MNEs hire local workers and contract with local firms who hire local workers. The beneficiaries of such employment include not only the employees themselves, but also the government, both because it may be relieved of some of the expenses of its social safety net and because it may be able to tax employees' salaries. Increased employment also tends to stimulate further economic activity as employees use their salaries to purchase consumer goods and services from local firms. The importation of technology and other intangibles, exposure to the global economy, and establishment of international contacts could increase the capital base of the host country and assist the country in developing its own industry.[56]

The difference between anticipated total costs and anticipated total benefits is, from the perspective of the host country, the ex ante "net cost" or "net benefit" of the investment (for reasons that will soon become clear, the terms "benefits" and "costs" do not include taxes imposed by the host country on the MNE or grants or subsidies provided by the host country). In any case, it is crucial to note that whether an anticipated effect of foreign investment constitutes a cost or a benefit and the quantification of the cost or the benefit is a subjective determination of the host country. What one country views as a cost another may consider a benefit. What one country regards as a minor nuisance another will judge a catastrophe.

As a sovereign entity, a country is permitted under customary international law to impose tax on foreigners who engage in economic activity within its territory.[57] It may also offer MNEs incentives in the form of direct grants or subsidies. In some instances, it may do both. In any case, we can describe the difference between the anticipated cost of providing the incentives and the anticipated tax revenue as a "net incentive" or a "net tax." Note that the anticipated tax revenue is what the host country estimates it will collect directly from the MNE. Additional tax revenue that it expects to collect as an indirect result of the investment, for example, by taxing the salaries of those employed by the MNE, was included as one of the potential benefits of the investment.

A country for which the anticipated costs of a particular MNE investment outweigh the anticipated benefits would rationally be willing to sanction the investment if and only if the net tax that it anticipates collecting from the MNE is greater than the net cost of hosting the investment.[58] A country for which the

56. Margalioth, *supra* note 5, at 176–80.

57. *See* sources cited *supra* note 7.

58. When the anticipated tax exactly equals the anticipated net cost, the country will be

anticipated benefits of a particular MNE investment outweigh the anticipated costs would rationally be willing not only to exempt the MNE from paying tax but also to provide net incentives. From the perspective of the host country, the investment has positive value as long as the cost of providing the net incentives is less than the net benefit of hosting the investment.[59]

Mathematically, there is no substantive distinction between net cost and net benefit. Each describes a set of points along a continuum: net benefit is simply negative net cost (or net cost is simply negative net benefit). On a line extending to infinite negative net cost on the left and to infinite positive net cost on the right, any point to the left of zero we can term either a net benefit or a negative net cost and any point to the right of zero we can term either a net cost or a negative net benefit:

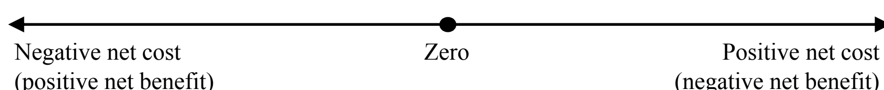

Figure 1. Net cost and net benefit

Similarly, there is no substantive distinction between net taxes and net incentives. On a line extending to infinite negative net tax on the left and to infinite positive net tax on the right, any point to the left of zero we can term either a net incentive or a negative net tax and any point to the right of zero we can term either a net tax or a negative net incentive:

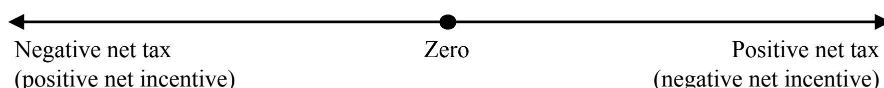

Figure 2. Net tax and net incentive

Describing net benefit and net incentive as, respectively, negative net cost and negative net tax permits the analysis to flow more freely and emphasizes the fact that there is no particular significance to the point marked "zero" on each of the above lines. Zero does not represent a singularity, but rather one of an infinite number of points along a smooth continuum.[60] We can now state in simple terms two important propositions:

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indifferent to the investment.

59. If the inducement is equal to the net benefit, then the investment has zero (i.e., neither negative nor positive) value for the host country.

60. The literature seems to attach significance to the point of zero tax. *See* Steven A. Dean, *More Cooperation, Less Uniformity: Tax Deharmonization and the Future of the International Tax Regime*, 84 TUL. L. REV. 125, 153 (2009); Wallace E. Oates & Robert M. Schwab, *Economic Competition Among Jurisdictions: Efficiency Enhancing or Distortion Inducing?*, 35 J. PUB. ECON. 333, 339–41 (1988); Roin, *Competition and Evasion*, *supra* note 1, at 553–54; Rosenzweig, *Tax Havens?*, *supra* note 1, at 942.

a. A rational country will welcome investment by an MNE if and only if the net tax that it anticipates collecting from the MNE is greater than the net cost of hosting the investment.

b. By presenting to MNEs a regime of taxes and incentives, the country signals that, from its perspective, the anticipated net tax exceeds the anticipated net cost. (Because "net tax" and "net cost" can each represent negative values, this proposition also means that, when a country offers incentives that exceed the amount of the anticipated tax revenue, it signals that the anticipated net benefits exceed the anticipated net incentives.)

Proposition (b) is critical. In Hayekian terms, the taxes and incentives that a country offers to MNEs constitute a means of conveying information regarding local resources and local preferences to those for whom such information might be relevant and of inducing them to change their behavior accordingly. The target of such information is not only the MNEs themselves, but also—and more importantly—the consumers or ultimate consumers of products produced by the MNE.

C. MNE Choice of Investment Venue

When deciding whether to invest in a given country, an MNE considers the benefits and the costs of doing so. Costs include both actual outlays and opportunity costs, that is, the profit that the MNE could have earned with the best alternative investment. The benefits that the MNE expects the investment to generate ultimately reflect consumer preferences. Consistent with the methodology we implemented in analyzing the investment from the perspective of the host country, cost and benefit do not include taxes payable to the host country or incentives that the MNE might receive from the host country.[61]

If benefits are greater than costs, the difference is the net advantage, from the perspective of the MNE, of its operating in the country. If costs are greater than benefits, the difference is, again from the perspective of the MNE, the net disadvantage. Here, too, the difference is quantitative and not qualitative. Net advantage, zero advantage, and net disadvantage constitute a continuum:

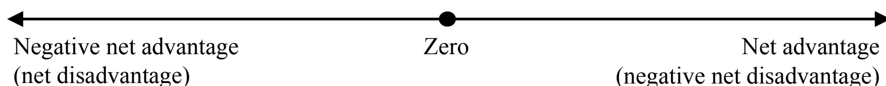

Figure 3. Net advantage

61. *See supra* Part I.B.

We can now state the following two propositions which describe MNE behavior and the signals it sends:

c. An MNE will be willing to invest in a country if and only if the net advantage is less than the expected net tax.

d. By investing in a country, the MNE signals that the anticipated net advantage exceeds the net tax it expects to pay. (Because "net advantage" and "net tax" can each represent negative values, this proposition also means that, when an MNE receives incentives to invest in a country, it signals that the anticipated net incentives exceed the anticipated net disadvantage.)

Here, proposition (d) is critical. In Hayekian terms, decisions that MNEs make with regard to the location of their investments constitute a means of conveying information regarding consumer preferences.

D. Tax Signaling and Efficiency

In a competitive market, the signals sent by potential host countries and those sent by MNEs will intersect and will produce a pattern of investment that will maximize global welfare.[62] To demonstrate, let us begin with a relatively simple example.[63] Assume that MNE1 has decided to construct a manufacturing plant and is considering three countries as potential venues:

Country A is an underdeveloped country. Were it to invest in Country A, MNE1 would incur large expenses in preparing the necessary physical infrastructure, training employees, and so forth. MNE1 estimates that its profit from the investment would be about 40 (all numbers are stated in terms of present value). From its perspective, Country A would benefit greatly from the spillover effects of such an investment. It estimates the value of the spillover effect as about 80. In other words, were it not only to exempt MNE1 from any tax but also provide it with incentives equal to 80, the investment would neither raise nor lower the welfare of its residents. We can describe net tax of negative 80 as Country A's "indifference point."

Country B is an emerging economy with a moderately well-developed infrastructure. MNE1 estimates its profit from investing in Country B to be 140. Country B would benefit from the investment and its indifference point is net tax of

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62. *But see* Peter D. Enrich, *Saving the States from Themselves: Commerce Clause Constraints on State Tax Incentives for Business*, 110 HARV. L. REV. 377, 398 (1996) ("[T]he net effect of the incentive competition is . . . far worse than zero-sum."); Tracy A. Kaye, *The Gentle Art of Corporate Seduction: Tax Incentives in the United States and the European Union*, 57 U. KAN. L. REV. 93, 115 (2008) ("Tax incentive competition is at best a zero-sum game; it merely moves economic activity from one state to another with no net gain on either the national or local level.").

63. Later in this Subpart we will introduce a complication into the fact pattern by hypothesizing an additional MNE competing for the investment opportunity. *See infra* notes 66–68 and accompanying text.

negative 60, that is, it would rationally be willing to exempt MNE1 from tax and provide incentives of up to 60.

Country C is a developed economy that does not particularly need the manufacturing plant and looks with disfavor on the potential overburdening of its infrastructure. Its indifference point is net tax of positive 45, that is, were MNE1 to pay tax of any less than 45, the result would be a net reduction in the welfare level of Country C's residents. MNE1 estimates its pretax profit from investing in Country C to be 170.

Which investment would constitute the most efficient use of resources? Investing in Country A would increase global welfare by 120 (Country A would be better off by 80 and MNE1 would be better off by 40). Investing in Country B would increase global welfare by 200 (Country B would be better off by 60 and MNE1 would be better off by 140). Investing in Country C would increase global welfare by 125 (Country C would be worse off by 45 and MNE1 would be better off by 170):

Table 1. MNE1 investment's effect on global welfare

	Country A	Country B	Country C
(Cost)/benefit to host country	80	60	(45)
Pretax benefit to MNE1	40	140	170
Total	*120*	*200*	*125*

To one who has access to all of the pertinent information, it is clear that the most efficient use of resources would be for MNE1 to invest in Country B. The practical question is how to achieve this result.

One way would be to establish a benevolent international regulatory agency with access to all of the necessary information and with broad power to direct investments. It would compile the data listed above and direct MNE1 to invest in Country B. I hope the reader did not take this suggestion seriously. Aside for the doubts that we might entertain regarding the bona fides of such an agency and our reticence to entrust it with that kind of power, such an agency would, as Hayek observed with regard to central planning boards, simply be incapable of collecting all of the relevant data.[64] The decision-making process must be decentralized, and the key to such a decentralized process is the signaling provided by tax competition.

In our example, Country A could signal its desire for the investment by agreeing to exempt MNE1 from tax and providing it with incentives of slightly less than 80. Any more than that and hosting the investment would no longer be worthwhile. Country C could signal its position by agreeing to impose tax slightly in excess of 45. From the perspective of MNE1, its after-tax, after-incentive profit from the investment would be no more than 120 in Country A and no more than 125 in Country C.

Similarly, Country B could signal its desire for the investment by agreeing to exempt MNE1 from tax and offering incentives (i.e., imposing a negative net tax)

64. Hayek, *supra* note 50, at 519–20, 530; Hayek, *supra* note 51, at 136–41.

of slightly less than 60. In such a case, MNE1 would invest in Country B and earn close to 200. As we have seen, this is the most efficient use of resources and confirms that free tax competition would encourage an efficient investment pattern.

Having confirmed that the investment in Country B is the most efficient use of resources, we now turn to the distributional question of identifying who, under a regime of free tax competition, will benefit from the additional efficiency. We saw that Country B's indifference point is net tax of negative 60. Were it in fact to impose net tax of this amount, MNE1 would capture the entire benefit of the additional efficiency. However, as the site of the most efficient investment, Country B could offer quite a bit less, capture a greater share of the efficiency savings, and still outbid its competitors.

The maximum net tax that Country B could charge and still outbid its competitors is a function of the net advantage MNE1 would secure by investing in that country. Recall that (a) net advantage is benefits minus costs and (b) costs include opportunity costs, that is, the profits the MNE could earn with the best alternative course of action. We know that MNE1 estimates its pretax profits from investing in Country B to be 140. The best alternative course of action is investing in Country C and earning 125.[65] In other words, by investing in Country B, MNE incurs an opportunity cost of 125. From its perspective, the net advantage that it will secure by investing in Country B, prior to the imposition of tax by that country, is 15. Consequently, Country B could outbid each of its competitors for the investment as long as it was willing to impose a tax on MNE1 of less than 15, leaving MNE1 with an after-tax profit of at least 125. As neither of its competitors could offer a more attractive deal, Country B would succeed in enticing MNE1 to construct the factory in its territory and would increase the welfare of its residents by 75, equal to the sum of the spillover effect (60) and the net tax it expects to collect (15).

It is worth noting that even if the pretax profits that MNE1 expected to earn from investing in Country B were only 100, Country B would still be able to outbid its competitors by agreeing to impose net tax of negative 25, that is, by exempting MNE1 from taxation and offering incentives worth just over 25. Here, too, the after-tax profit of just over 125 is more than any other country can offer. The only difference is that Country B's national welfare would increase by just under 35 (the spillover effect of 60 minus the incentive of just over 25). However, the increase in global welfare of 160 is still greater than could be achieved by MNE1 investing either in Country A or in Country C.

A reasonable objection to this analysis is that MNE1 might not be willing to allow the host country to benefit from the entire efficiency gain. True, the net positive tax of just under 15 in the first scenario and the net negative tax of just over 25 in the second scenario will enable MNE1 to profit more by investing in Country B than anywhere else. Nevertheless, MNE1 might engage in a game of

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65. Note that when considering opportunity cost, the cost of not undertaking an alternative investment is the after-tax (or after-incentive) anticipated profit from that investment. *See generally* EUGENE F. BRIGHAM & JOEL F. HOUSTON, FUNDAMENTALS OF FINANCIAL MANAGEMENT 542 (concise 2d ed.1999).

economic chicken by threatening to invest in Country C even at a lower expected profitability, unless Country B allows it to retain a larger portion of the efficiency bonus.[66] The problem here is that the simplified fact pattern containing three countries and only one MNE effectively gives the MNE monopoly power, which it can exploit to dictate terms. Introducing competition on the demand side also will largely alleviate this issue.[67]

Assume that MNE2 is interested in pursuing a similar investment opportunity and that it expects to earn 45, 135, and 165 in Countries A, B, and C respectively for the sake of simplicity we will assume that each country can support only one investment or that the marginal advantage of a second investment is significantly lower than the first:

Table 2. MNE2 investment's effect on global welfare

	Country A	Country B	Country C
(Cost)/benefit to host country	80	60	(45)
Pretax benefit to MNE2	45	135	165
Total	*125*	*195*	*120*

Before the introduction of MNE2, the lack of competition meant that the distribution of the efficiency gain was unclear and that the actual tax imposable by Country B would be somewhere between negative 60 (in which case MNE1 would capture the entire efficiency gain) and 15 (in which case County B would capture the entire efficiency gain). Now, however, MNE2 will be willing to pay tax of up to 10 in order to invest in Country B.[68] Consequently, in order to outbid MNE2, MNE1 will need to offer to pay tax of between 10 and 15. Of course, here too MNE1 and Country B might play a game of economic chicken, each threatening to adopt suboptimal behavior in order to secure a better deal for itself. However, due to the forces of competition, the zone of possible agreement[69] is much smaller and Country B will be able to capture the lion's share of the efficiency bonus.[70]

66. In terms of negotiation theory, the range between Country B's indifference point and the maximum tax it could impose while still outbidding Country C is the zone of possible agreement (ZOPA). Any arrangement that falls within the ZOPA will improve the welfare of both participants relative to their best alternative to negotiated agreement (BATNA), but by threatening to resort to its BATNA each party will attempt to induce the other to allow it to retain a greater share of the ZOPA. *See generally* DEEPAK MALHOTRA & MAX H. BAZERMAN, NEGOTIATION GENIUS 20–24 (2007).

67. International cooperation may be necessary to ensure an effective competitive environment. *See infra* notes 109–114 and accompanying text.

68. MNE2's best alternative is investing in Country A, where it could earn no more than 125 (Country A would not rationally be willing to provide incentives of greater than 80). As it expects to earn 135 in Country B, MNE2 could afford to pay tax of up to 10.

69. *See generally supra* note 66.

70. MNE2 will be relegated to its next best alternative, in this case Country A. To prove that MNE1 investing in Country B and MNE2 investing in Country A will maximize global

Summing up our discussion so far, a regime of free tax competition in which all parties seek to promote their own self-determined self-interest will result in the efficient exploitation of economic resources and a maximization of global welfare. In distributing the efficiency benefits, the country that is home to the most efficient investment opportunity will capture at least some of the benefit of the efficiency differential between it and the MNE's most profitable alternative venue.

E. Tax Competition Leads to Inefficiency?

Recent literature seems to accept almost as a truism that tax competition results in an inefficient allocation of economic resources.[71] The idea is that tax competition artificially distorts behavior and that maximizing global welfare requires that investments flow to where they would have gone in the absence of such competition.

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welfare, the following chart compares the total contribution to global welfare of the possible alternative investment patterns:

		MNE1		
		Country A	Country B	Country C
MNE2	Country A	—	Country A 80 Country B 60 MNE1 140 MNE2 45 *Total* *325*	Country A 80 Country C (45) MNE1 170 MNE2 45 *Total* *250*
	Country B	Country A 80 Country B 60 MNE1 40 MNE2 135 *Total* *315*	—	Country B 60 Country C (45) MNE1 170 MNE2 135 *Total* *320*
	Country C	Country A 80 Country C (45) MNE1 40 MNE2 165 *Total* *240*	Country B 60 Country C (45) MNE1 140 MNE2 165 *Total* *320*	—

71. *E.g.*, RICHARD A. MUSGRAVE & PEGGY B. MUSGRAVE, PUBLIC FINANCE IN THEORY AND PRACTICE 569 (5th ed. 1989); SHAVIRO, *supra* note 16, at 114; Avi-Yonah, *supra* note 16, at 1578; William B. Barker, *Optimal International Taxation and Tax Competition: Overcoming the Contradictions*, 22 NW. J. INT'L L. & BUS. 161, 175 (2002); Fleming et al., *supra* note 46, at 12–13 & n.43; Michael J. Graetz, *Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 TAX L. REV. 261, 285 (2001); Keinan, *supra* note 8, at 34–35; Avi Nov, *The "Bidding War" To Attract Foreign Direct Investment: The Need for a Global Solution*, 25 VA. TAX REV. 835, 844 (2006); Oleksandr Pastukhov, *International Taxation of Income Derived from Electronic Commerce: Current Problems and Possible Solutions*, 12 B.U. J. SCI. & TECH. L. 310, 325–26 (2006); Rosenzweig, *Tax Havens?*, *supra* note 1, at 931, 946–47; Fadi Shaheen, *International Tax Neutrality: Revisited*, 64 TAX L. REV. 131, 133 (2011); Joel Slemrod & Reuven Avi-Yonah, *(How) Should Trade Agreements Deal with Income Tax Issues?*, 55 TAX L. REV. 533, 554 (2002).

The argument usually proceeds as follows: Assume that an MNE can invest in Hightaxland and earn a 15% pretax return on its investment, while by investing in Lowtaxland it can earn only a 12% pretax return. Clearly, so goes the argument, the investment in Hightaxland is a more efficient use of the MNE's resources. However, now assume that the corporate tax rate in Hightaxland is 30%, while the corporate tax rate in Lowtaxland is only 5%. The MNE's after-tax return from investing in Hightaxland will be 10.5%, while its after-tax return from investing in Lowtaxland will be 11.4%. Consequently, it will invest in Lowtaxland even though such an investment is, from the perspective of global welfare, inefficient. To prevent such a misallocation of resources, commentators propose coordinated efforts to combat tax competition and promote what is commonly referred to as "capital export neutrality."[72] Proposals range from (a) convincing countries that refraining from tax competition is in their own interest,[73] to (b) inducing countries to avoid harmful tax competition by promise of reward or threat of sanction,[74] to (c) encouraging countries to tax their corporations' foreign-source income via effective controlled-foreign-corporation regimes so that whatever the corporation saves by investing in a low-tax country will increase its tax liability to its home country.[75]

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72. *See supra* note 15 and accompanying text.

73. Avi-Yonah, *supra* note 16, at 1658.

74. Dean, *supra* note 60, at 132–33; Kudrle & Eden, *supra* note 1, at 46–47; Rosenzweig, *Tax Havens?*, *supra* note 1, at 933. *See also* OECD, HARMFUL TAX COMPETITION, *supra* note 1, at 57–58 (recommending that countries that have close legal, economic, or political ties with havens use those ties to reduce harmful tax competition).

75. OECD, HARMFUL TAX COMPETITION, *supra* note 1, at 40–43. For example, assume that USCorp expects a 10% pretax return from investing in Country X (corporate income tax 30%) and an 8% pretax return from investing in Country Y (corporate income tax 5%). Although the pretax expected return in Country X is higher, the after-tax in Country Y is higher (7.6% versus 7%). Under the presumption of this analysis—a presumption that the text will challenge—the tax rate differential will induce a misallocation of resources: USCorp will invest in Country Y even though the investment in Country X is more efficient. One way to negate the effects of the tax differential is for USCorp's country of residence to impose tax on all of USCorp's income from wherever derived and to credit any foreign taxes paid. Assume that USCorp is subject to tax at the rate of 35% in its country of residence. Were it to invest in Country X and earn $100,000, it would pay tax of $30,000 to Country X and an additional $5,000 ($35,000 minus a foreign tax credit of $30,000) to its country of residence, leaving it with after-tax profit of $65,000. Were it to invest in Country Y and earn $80,000, it would pay tax of $4,000 to Country Y and an additional $24,000 ($28,000 minus a foreign tax credit of $4,000) to its country of residence, leaving it with after-tax profit of $52,000. High resident-country tax coupled with the foreign tax credit produces capital export neutrality. The reason that the OECD emphasized the controlled-foreign-corporation regime is that in our scenario, USCorp could avoid home-country tax by establishing a subsidiary in Country Y. A controlled-foreign-corporation regime requires USCorp to pay tax, not only on its own income, but also on the income of any foreign corporations that it controls, such as YSub.

The U.S. rules for taxation of income derived from controlled foreign corporations appear in I.R.C. §§ 951–965 (2012) ("Subpart F"). The main weakness of the U.S. regime is that with respect to MNEs, it only applies to passive income. In our example, assuming that YSub is engaged in real business activity in Country Y, Subpart F would not apply. The United States would tax YSub's profits only upon its repatriation or deemed repatriation.

The problem with this argument is its presumption that investing at the maximum pretax rate of return necessarily produces an efficient distribution. Under the Kaldor-Hicks definition of efficiency,[76] Distribution D_1 is more efficient than Distribution D_2 if and only if it is possible, using Distribution D_1 as a starting point, to redistribute wealth and arrive at Distribution D_3, in which no individual is worse off and at least one individual is better off than they would have been in Distribution D_2. Distribution D_1 is efficient (in the absolute sense) if and only if there is no achievable Distribution D_2 such that Distribution D_2 is more efficient than Distribution D_1.[77]

All else being equal, higher expected rates of return will reflect a more efficient use of resources. In other words, beginning with the distribution of resources following an investment at a higher rate of return, it will be possible to redistribute wealth so that no one is worse off and at least one person is better off relative to what their economic situation would have been following an investment at a lower rate of return. However, in order to constitute an effective indication of efficiency, the rates of return must reflect the preferences of all those who are likely to be affected by the investment, including residents of the host country. As the potential impact of the investment upon the residents' welfare is substantial, direct, and immediate, no reasonable measure of efficiency can afford to ignore their preferences. Furthermore, as the primary means at their disposal for signaling their preferences is the package of tax and incentives that they offer investors, it is not the pretax return but rather the after-tax return that is the more accurate measure of efficiency.[78]

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76. J.R. Hicks, *The Foundations of Welfare Economics*, 49 ECON. J. 696 (1939); Nicholas Kaldor, *Welfare Propositions of Economics and Inter-Personal Comparisons of Utility*, 49 ECON. J. 549 (1939).

77. To demonstrate, assume that the maximum amount that X would pay for an item is $100 and the maximum amount that Y would pay is $70. Y's possession of the item (Distribution D1) is less efficient than X's possession of the item (Distribution D2), because from Distribution D2 we can transfer $90 in cash from X to Y and create a situation (Distribution D3) in which both X and Y are better off than they were in Distribution D1 and nobody is worse off.
The Kaldor-Hicks definition differs from the earlier definition proposed by Vilfredo Pareto. Under the Pareto definition, Distribution D1 is more efficient than Distribution D2 if and only if no individual in Distribution D1 is worse and at least one individual is better off than in Distribution D2. Distribution D1 is Pareto-efficient (in the absolute sense) if there exists no Distribution D2 such that Distribution D2 is more efficient than Distribution D1. T.W. HUTCHISON, A REVIEW OF ECONOMIC DOCTRINES 1870–1929, at 225 (1953) (translating VILFREDO PARETO, MANUEL D'ECONOMIE POLITIQUE app. at 617–18 (1909)). In the example above, the relative Pareto efficiency of Distribution D1 and Distribution D2 would be undetermined as Y would prefer Distribution D1 and X would prefer Distribution D2. Because of the limited applicability of the Pareto definition, economists tend to prefer the Kaldor-Hicks definition. For critique of the Kaldor-Hicks definition as a criterion for determining economic policy, see AMARTYA SEN, ON ETHICS AND ECONOMICS 33 n.4 (1987). *See also* Ronald M. Dworkin, *Is Wealth a Value?*, 9 J. OF LEGAL STUD. 191, 197–201 (1980).

78. Arguing that global welfare would be improved by neutralizing the effect of tax differentials is similar to an argument that global or national welfare would be improved by neutralizing the effect of rent differentials. The fact that, ignoring rent differentials, building a factory in Manhattan is more profitable than building one in Duluth, does not mean that the

Investing at a higher pretax rate of return might or might not constitute an efficient use of resources. To make such a determination, we would need to know not only the MNE's pretax rate of return, but also the effect of the investment on the welfare of the residents of each of the countries. If Lowtaxland is desperately in need of the investment for purposes of employment or development, while from the perspective of Hightaxland the investment would contribute little to its economy or perhaps even constitute a net drain on its resources, investment in Lowtaxland may indeed maximize global welfare. In our previous example, absent tax considerations, MNE1 would have invested in Country C (which promised a pretax return of 170 versus a pretax return of 140 in Country B) even though the investment in Country B was a more efficient use of resources. The only practical way for Hightaxland and Lowtaxland to signal their attitudes toward the investment is by means of the taxes they propose to impose on the MNE. That Lowtaxland is willing to impose a lower rate of tax indicates that it values the investment much more than does Hightaxland.

The fact that the MNE's decision where to invest given the tax differential was different from what its decision would have been absent the tax differential, a fact pattern considered a smoking gun in much of the literature, is hardly an indictment of tax competition as a means of promoting efficiency. To the contrary, signals are only valuable to the extent that they are capable of changing behavior.[79] In ordinary circumstances, reduced supply or increased demand causes prices to rise. From an efficiency perspective, the advantage of the price rise is precisely that it curtails use of the commodity. In Hayekian terms, the price rise signals that the marginal use of the commodity is more valuable than it was previously and encourages consumers and firms to adapt their behavior accordingly.[80] Lowtaxland's higher after-tax rate of return indicates that, weighing the preferences of all those who are likely to be affected by the investment, the investment in Lowtaxland is probably a more efficient use of global resources.[81]

In a recently published book, Daniel Shaviro takes issue with a prevalent theme in the academic discourse: that the goal of the U.S. international tax regime should be the maximization of global welfare.[82] His position is that the primary focus of the U.S. tax regime should be the welfare of U.S. citizens and residents.[83] In particular,

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former option is a more efficient use of the nation's resources. The higher rent in Manhattan is a signal conveyed by the market that others value the use of that land more than they do the use of land in Duluth. Consequently, if the convenience of locating the factory in Manhattan versus locating it in Duluth does not justify the extra rent, this is a strong indication that locating the factory in Manhattan is not an efficient use of that particular piece of land.

79. Margalioth, *supra* note 5, at 182 ("[T]ax incentives are meant to distort behavior.").

80. Hayek, *supra* note 50, at 524–25.

81. As with any other supplier of goods, services, and opportunities, Hightaxland may simply refuse to compete against Lowtaxland. Its reasons are its own. Perhaps it feels that such competition is beneath its dignity. Perhaps it has determined that by refraining from competing in this particular case and retaining its high tax structure it will secure more tax revenue and a higher standard of living for its residents. In any case, the after-tax return of investment in Hightaxland will reflect this preference not to compete, just as after-tax return of investment in Lowtaxland will reflect that country's willingness to compete for the resources that it expects will improve the lives of citizens and residents.

82. SHAVIRO, *supra* note 16.

83. *Id.* at 108–09.

he claims that the foreign tax credit, which unilaterally, although subject to numerous restrictions, grants U.S. taxpayers a dollar-for-dollar credit for foreign taxes paid, is overly generous.[84] The literature tends to justify the foreign tax credit as necessary in order to achieve allocative efficiency by neutralizing the effect of disparate foreign income rates.[85] Shaviro argues that while the credit promotes global welfare, it does so at the expense of the U.S. treasury and U.S. interests.[86] Consequently, if the United States does permit a foreign tax credit, it should only do so on the basis of reciprocity: a quid pro quo to those countries that are willing to commit to grant their own taxpayers a dollar-for-dollar credit for taxes paid to the United States.[87]

Of course, Shaviro's view that the U.S. international tax regime focus on promoting U.S. interests as opposed to amorphous global interests is not a case of U.S. exceptionalism. By implication, other countries are also justified in seeking to advance their own interests in the field of international taxation.[88] Should every country act in such a manner, the picture that emerges might appear to be one of a dog-eat-dog world in which global welfare is the victim of individual countries' egocentric pursuit of their own self-interest: a Hobbesian free-for-all that stands in direct conflict with the idealized world of multilateral cooperation for the benefit of all.[89]

However, our analysis has shown that not only is selfish behavior on the part of individual countries not an impediment to the promotion of global welfare, it is in practice a precondition of global welfare maximization. Only when countries signal their preferences via the package of taxes and incentives that they offer can the market accurately determine which investment is likely to result in the most efficient use of resources. Paradoxically, the harmonization of tax rates and other aspects of domestic tax regimes with the goal of improving global welfare by directing investments to their most efficient uses will tend to produce the opposite result.[90]

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84. *Id.* at 110.

85. *Id.* at 109.

86. *Id.*

87. *Id.* at 110.

88. If anything, because the United States often serves as a role model for other countries when they design their international tax regime, there is a case for the United States to adopt a more global perspective in the anticipation that others will follow suit. *Id.* at 112. Nevertheless, Shaviro argues that because "the United States . . . is no longer in a position to dictate rules that others will generally follow," it is justified in pursuing its own self-interest in the field of international taxation. *Id.* Other countries, whose international influence is less, would certainly be justified in so doing.

89. THOMAS HOBBES, LEVIATHAN 178 (The Floating Press 2009) (1651) (characterizing the state of nature as "Warre of Every One Against Every One").

90. Particularly apt is Adam Smith's observation in this regard:

> As every individual, therefore, endeavours as much as he can both to employ his capital in the support of domestic industry, and so to direct that industry that its produce may be of the greatest value; every individual necessarily labours to render the annual revenue of the society as great as he can. He generally, indeed, neither intends to promote the public interest, nor knows how much he is promoting it. . . . By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it. I have never known much good done by those who affected to trade for the public good. It is

Of course, one could argue that while tax competition may encourage the efficient use of resources, the resulting distribution is not necessarily equitable and that limiting competition is necessary to achieve distributional justice. However, this is a different issue, one that will be addressed in Part III. At present, I am simply attempting to refute the argument that tax differentials create inefficiencies by diverting investment away from those countries in which they would have been made in the absence of those differentials.

F. Comparison with the Tiebout Model

The proposal presented in this Article bears a superficial resemblance to Charles Tiebout's model of local taxation.[91] Musgrave and Samuelson had previously claimed that the absence of a market mechanism precludes the possibility of achieving an optimal level of expenditure for public goods.[92] Tiebout argued that while their analysis was valid for federal expenditures, it did not necessarily apply to expenditures by local government.[93] He envisioned a state of affairs in which a large number of local communities would offer varying packages of public services and individuals would "vote with their feet"[94] by choosing to live in the community whose local government best satisfied their set of preferences.[95]

> an affectation, indeed, not very common among merchants, and very few words need be employed in dissuading them from it.

ADAM SMITH, WEALTH OF NATIONS 351–52 (Charles J. Bullock ed., Cosimo Classics 2007) (1776).

91. Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416 (1956).

92. Richard Abel Musgrave, *The Voluntary Exchange Theory of Public Economy*, 53 Q.J. ECON. 213, 219–20 (1939); Paul A. Samuelson, *Diagrammatic Exposition of a Theory of Public Expenditure*, 37 REV. ECON. & STAT. 350, 355 (1955); Paul A. Samuelson, *The Pure Theory of Public Expenditure*, 36 REV. ECON. & STAT. 387, 388 (1954).

93. *See* Tiebout, *supra* note 91, at 418 (stating that federal spending exclusive of defense amounted to $15 billion, while local expenditures amounted to $17 billion). Tiebout did not state explicitly whether "local expenditures" includes expenditures by states. The rationale of his article would seem to require their inclusion, as states as well as municipalities can compete for residents. According to U.S. government figures, the numbers for 2015 are $2.9 trillion for non-defense federal expenditures, $1.6 trillion for state expenditures, and $1.8 trillion for local expenditures. *Federal 2015 Government Spending*, USGOVERNMENTSPENDING.COM, http://www.usgovernmentspending.com/fed_spending_2015USrn [https://perma.cc/BXN7-Z7UX]; *State Guesstimated 2015 Government Spending*, USGOVERNMENTSPENDING.COM, http://www.usgovernmentspending.com/state_spending_2015USrn [https://perma.cc/DD5M-3WHC]; *Local Guesstimated 2015 Government Spending*, USGOVERNMENTSPENDING.COM, http://www.usgovernmentspending.com/local_spending_2015USrn [https://perma.cc/2SRY-9MV9] (the latter two being "guesstimated").

94. CLAYTON P. GILLETTE, LOCAL REDISTRIBUTION AND LOCAL DEMOCRACY 43 (2011).

95. In producing his model, Tiebout made a number of explicit assumptions: (1) consumer-voters are fully mobile, (2) consumer voters have full knowledge of different revenue and expenditure patterns and respond to those differences, (3) there are a large number of communities, (4) there are no restrictions due to employment, (5) there are no externalities between communities, (6) there exists an optimal city size, and (7) that communities seek to attain that optimal size. Tiebout, *supra* note 91, at 419. Tiebout's proposal has generated a large literature that is beyond the scope of this Article to discuss. However, I will note that one

The Tiebout model and this Article share a number of common features. Each proceeds from the proposition that an efficient allocation of resources requires knowledge of preferences regarding the use of those resources and that the market is an indispensable tool in disclosing those preferences. Each then uses tax competition as a means of revealing preferences and inducing behavior that advances allocative efficiency. However, despite these common features, the models are fundamentally distinct, and it would be inaccurate to describe this Article's proposals as an application of the Tiebout model in the international arena.

A strict application of the Tiebout model internationally would have national governments offering prospective residents varying levels and types of services at varying rates of tax and would have individuals choosing their ideal mix of services and tax. Such an application of the model is unrealistic. Tiebout explicitly assumed that individuals are easily able to move from one jurisdiction to another in response to the package of taxes and public goods offered in each jurisdiction.[96] This assumption, of doubtful validity even on the domestic front, is in almost all cases inapplicable to the international arena.[97] Consequently, the strict application of the Tiebout model internationally is unlikely to prove effective as a means of producing an optimal level of public services. An international application of the Tiebout model that is both more reasonable and more relevant to our purposes would have national governments offering prospective investors varying levels and types of services at varying rates of tax and would have MNEs choosing their ideal mix of services and tax. Countries whose packages of tax and services would not attract a sufficient level of investment would be forced to modify the packages that they offer. As individuals in the classic Tiebout model reveal their preferences for public goods by where they choose to live, MNEs in the international Tiebout model would reveal their preferences with regard to public goods via their choice of where to invest. In both instances, the goal of the competitive structure is to induce the taxing authority to provide an optimal level of public services.

However, the analogy between competition for residents and competition for investments is problematic. The Tiebout model relies upon the hypothesis that all those who consume and pay for public goods provided by a particular jurisdiction have expressed and continue to express their preference for the package offered by that jurisdiction.[98] For the analogy between competition for residents and competition for investments to hold, investors would need to be the only consumers

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of the primary questions that arises under the Tiebout model is whether it allows for redistribution via the local tax system. *See, e.g.*, GILLETTE, *supra* note 94, at 43–44 (arguing that redistributive programs may promote efficiency-enhancing benefits associated with the Tiebout model); David Schleicher, *City Unplanning*, 122 YALE L.J. 1670, 1684 n.37 (2013) ("[I]n a Tiebout world . . . redistribution is, by assumption, impossible.").

96. Tiebout, *supra* note 91, at 419.

97. *But see* Avi-Yonah, *supra* note 19 (arguing that for upper-middle and high income taxpayers, expatriation is not significantly more difficult than moving capital abroad).

98. Tiebout, *supra* note 91, at 420 ("The act of moving or failing to move is crucial. Moving or failing to move replaces the usual market test of willingness to buy a good and reveals the consumer-voter's demand for public goods. Thus each locality has a revenue and expenditure pattern that reflects the desires of its residents.").

of services provided by the host government. Rarely, if ever, is this the case.[99] The consumers of public goods include both local residents and foreign investors.[100] The fact that investors prefer a particular package of public goods does not necessarily mean that that package is optimal after taking into consideration the preferences of local residents, who likely constitute the largest number of consumers of those services.

As opposed to the Tiebout model, this Article is not concerned with determining the optimal level of expenditure on public goods. Rather, it is concerned with the means of drawing investments to their most efficient venues. Indicative of this distinction is the fact that while both models rely on the signaling of preferences to achieve economic efficiency, the identity of the preference signaler is different. Under the Tiebout model, taxpayers signal their preferences by their choice of residence, and the taxing authorities respond to those signals by providing differing packages of public goods.[101] The sole interest of the taxing authority is to attract and retain an ideal number of residents.[102] If preferences change and individuals desire more public services, community governments will respond by raising taxes and providing more services.[103] If preferences change and individuals desire fewer public services, community governments will lower taxes and provide fewer services.[104] The community government's inherent indifference to the tax burden that it imposes and the services it provides is a function of the underlying goal of the Tiebout model: establishing a market mechanism by which to optimize the provision of public goods.[105]

Under the model proposed in this Article, the taxing authority is far from indifferent to the tax burden that it imposes on MNEs. From its perspective, the higher the tax burden that it can successfully impose, the better; the only restraint is its legitimate concern that too high a tax burden will drive investors to alternative venues. As opposed to the Tiebout model, in which taxpayers signal their preferences and the taxing authority simply responds to those signals,[106] here the (positive or negative) tax burden that the taxing authority imposes on MNEs signals its desire or its reticence to host certain types of investments and the extent of that desire or

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99. One example in which this condition might hold would be a special economic zone isolated from the rest of the country so that public goods provided in the zone would not affect the rest of the country and public goods provided in the rest of the country would not affect those operating in the zone.

100. Even in the case of special economic zones, one may assume a certain degree of leakage of public goods from one sector to the other. For example, defense expenditures will benefit those on both sides of the line demarcating the border of the special economic zone, social expenditures will likely benefit investors in the zone who hire employees living outside the zone, and services provided to investors in the zone will likely benefit their employees who live outside the zone.

101. *See* Tiebout, *supra* note 91, at 419–20.

102. *Id.* at 419 ("[C]ommunities below the optimum size seek to attract new residents to lower average costs. Those above optimum size do just the opposite. Those at an optimum try to keep their populations constant.").

103. *See id.* at 422.

104. *See id.* at 422.

105. *Id.* at 419–20.

106. *Id.*

reticence. The goal of the competitive regime is to induce MNEs to factor into their decision-making processes the benefits and costs of alternative investment venues from the perspective of residents of the host country and to choose the venue that maximizes global welfare.

Another expression of the difference between the two models is their underlying assumptions regarding similarities and differences among competing jurisdictions. Tiebout did not explicitly state whether he assumed that local communities are equal in all respects except for the level and type of public goods that they offered, and indeed his model works well either way.[107] In fact, the simplest case in which to apply his theory would be one in which local communities compete for residents under conditions of equality and craft their public expenditure budget purely in response to individuals' preferences. This Article, by contrast, necessarily assumes that countries are dissimilar and that the (positive or negative) taxes that they impose on MNEs quantify and signal the relevant aspects of local circumstances. Were all countries equal with regard to the cost and benefits of hosting MNE investment, tax competition would have no role to play in achieving allocative efficiency: investments would simply flow to those venues in which the pretax return was the highest. It is only because of the differences in local circumstances that the most efficient investment may be in a venue other than the one that offers the highest pretax return.

G. Objections

The case for tax competition as a means of maximizing global welfare is open to several possible objections. One is that the analysis presented above is of an idealized picture of free competition that does not necessarily correspond to reality, in which market failure is prevalent. Prominent categories of market failure could include an insufficient number of international actors,[108] externalities such as the environmental consequences of economic activity, and the agency issues that arise when governments prefer their own interests to those of the people they ostensibly serve.[109]

It is undeniable that tax competition would be more successful in promoting global welfare in the absence of market failure. However, the choice is not between an ideal world and a nonideal world, but rather among the options available in the nonideal world in which we live. The environment in which international tax competition operates is analogous to the environment in which domestic commercial

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107. One of his examples involves a community with a 600-yard beach, presumably a competitive advantage over other communities without such a facility; however, he only discusses this asset of the community with reference to the optimal size of the population. *Id.* at 419, 421.

108. It is interesting to note that although there are a limited number of actors, the forces seem to be fairly evenly balanced. According to UNESCO, fifty-one of the largest one hundred economies are MNEs and forty-nine are countries. *Corporate Power Facts and Stats*, UNESCO, http://www.unesco.org/education/tlsf/mods/theme_c/popups/mod18t04s01.html [https://perma.cc/6AYB-TPQH] (citing MANFRED STEGER, GLOBALISATION: A VERY SHORT INTRODUCTION 51 (2d ed. 2008)).

109. Avi-Yonah, *supra* note 16, at 1613–16; Margalioth, *supra* note 5, at 188; Roin, *Taxation Without Coordination*, *supra* note 1, at S79–S86.

competition operates. Monopolies, oligopolies, and cartels inhibit free competition; the noninternalization of externalities can induce socially inefficient behavior; the interests of corporate management do not necessarily align with those of shareholders and other corporate stakeholders; and, due to fraud, ignorance, or cognitive imperfection, market actors, whether individuals or corporations, often act in ways that are detrimental to their own welfare. On the domestic front, both theory and practice have shown that the proper regulatory function of the government is to promote free and fair competition and, where the market cannot operate successfully, to attempt via its own efforts to replicate the results of an ideal market.[110] Examples of regulations that promote free and fair competition include antitrust law, carbon taxes, subsidies for education, civil and criminal sanctions for breach of fiduciary duties, and consumer protection. Examples of replicating the results of an ideal market include public services and social insurance.

Combating market failure in the field of tax competition is more difficult than in the field of domestic commercial competition. Perhaps the most important reason is that, whereas on the domestic front the government can act as a neutral observer and regulator of the market, on the international front the entities that must make and enforce the regulations are themselves competitors.[111] Nevertheless, transnational efforts to combat market failure have been, and others could be, undertaken. An example of efforts that have been undertaken is the attempt to reach international agreement on the emission of greenhouse gases. Although disagreement regarding distributional issues, particularly among countries with economies at differing stages of development, has hitherto dominated the discourse,[112] from an economic

110. *See generally* David Elkins, *Taxation and the Terms of Justice*, 41 U. TOL. L. REV. 73, 78–82 (2009) (explaining that the function of commutative taxation is to overcome market failure by providing funding for public services, internalizing externalities, and overcoming cognitive imperfection).

111. *See* Diane Ring, *Democracy, Sovereignty and Tax Competition: The Role of Tax Sovereignty in Shaping Tax Cooperation*, 9 FLA. TAX REV. 555, 573–75 (2009).

112. *See*, ERIC A. POSNER & DAVID WEISBACH, CLIMATE CHANGE JUSTICE (2010); Brooke Ackerly & Michael P. Vandenbergh, *Climate Change Justice: The Challenge for Global Governance*, 20 GEO. INT'L ENVTL. L. REV. 553 (2008); Paul Baer, *Who Should Pay for Climate Change? "Not Me,"* 13 CHI. J. INT'L L. 507 (2013); Daniel A. Farber, *The Case for Climate Compensation: Justice for Climate Change Victims in a Complex World*, 2008 UTAH L. REV. 377; Yoram Margalioth, *Analysis of the US Case in Climate Change Negotiations*, 13 CHI. J. INT'L L. 489 (2013); Yoram Margalioth, *Assessing Moral Claims in International Climate Change Negotiations*, 3 WASH. & LEE J. ENERGY CLIMATE & ENV'T 43 (2012); Yoram Margalioth & Yinon Rudich, *Close Examination of the Principle of Global Per-Capita Allocation of the Earth's Ability to Absorb Greenhouse Gas*, 14 THEORETICAL INQUIRIES L. 191 (2013); Martha C. Nussbaum, *Climate Change: Why Theories of Justice Matter*, 13 CHI. J. INT'L L. 469 (2013); R.T. Pierrehumbert, *Cumulative Carbon and Just Allocation of the Global Carbon Commons*, 13 CHI. J. INT'L L. 527 (2013); Eric A. Posner & Cass R. Sunstein, *Climate Change Justice*, 96 GEO. L.J. 1565 (2008); Eric A. Posner & Cass R. Sunstein, *Should Greenhouse Gas Permits Be Allocated on a Per Capita Basis?*, 97 CAL. L. REV. 51 (2009); Noah M. Sachs, *Climate Change Triage*, 44 ENVTL. L. 993 (2014); Amy Sinden, *Allocating the Costs of the Climate Crisis: Efficiency Versus Justice*, 85 WASH. L. REV. 293 (2010); Tom E.R.B. West, *Environmental Justice and International Climate Change Legislation: A Cosmopolitan Perspective*, 25 GEO. INT'L ENVTL. L. REV. 129 (2012); Daniel A Farber,

perspective a successful agreement would be one that compels countries to internalize the environmental cost of activity occurring within their territory.[113] Countries would then need to consider those costs when constructing the package of taxes and incentives that they offer to potential investors. As an example of efforts that could be undertaken, consider the field of antitrust laws. Recent years have seen an increase in international cooperation in this field.[114] It is worth investigating whether the goals of antitrust regulation could include effective tax competition, in addition to traditional goals such as lowering consumer prices, expanding consumer choice, and protecting small businesses.[115] For instance, a determination that a proposed merger would make it more difficult for potential host countries to capture a reasonable share of the efficiency bonus could weigh against approval of the merger. In a similar vein, perhaps regulatory authorities could sanction MNEs where evidence exists that they explicitly or implicitly agreed not to compete for investment opportunities.

Analysis of these issues is well beyond the scope of our current discussion. What this Article does suggest is that instead of curbing tax competition, transnational organization and structures should focus on reducing instances of market failure and thereby promoting effective tax competition.

Some commentators claim that tax incentives are unnecessary to attract beneficial investment. Their argument is that MNEs ordinarily weigh nontax factors more heavily than they do tax factors,[116] and in those relatively rare instances in which tax breaks do tip the balance, the investment will be at best marginally beneficial from the perspective of the host country.[117] Whether or not this claim is empirically

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Climate Justice, 110 MICH. L. REV. 985 (2012) (reviewing ERIC A. POSNER & DAVID WEISBACH, CLIMATE CHANGE JUSTICE (2010)); Rachel Ward Saltzman, Note, *Distributing Emissions Rights in the Global Order: The Case for Equal Per Capita Allocation*, 13 YALE HUM. RTS. & DEV. L.J. 281 (2010); Matthew Schuman, Note, *Can Global Warming Laws Redistribute Wealth?*, 18 S. CAL. REV. L. & SOC. JUST. 463 (2009).

113. *See, e.g.*, Reuven S. Avi-Yonah & David M. Uhlmann, *Combating Global Climate Change: Why a Carbon Tax Is a Better Response to Global Warming than Cap and Trade*, 28 STAN. ENVTL, L.J. 3, 44–45 (2009) (arguing that a carbon tax forces polluters to internalize the negative externality they impose on others); Gilbert E. Metcalf & David Weisbach, *The Design of a Carbon Tax*, 33 HARV. ENVTL. L. REV. 499, 500–01 (2009) (asserting that a carbon tax internalizes externalities associated with anthropogenic climate change); Nicholas Stern, *The Economics of Climate Change*, 98 AM. ECON. REV. (PAPERS & PROC.) 1, 24–26 (2008), *available at* pubs.aeaweb.org/doi/pdfplus/10.1257/aer.98.2.1 [https://perma.cc/7SEF-L6N8].

114. BARRY J. RODGER & ANGUS MACCULLOCH, COMPETITION LAW AND POLICY IN THE EC AND UK 386–88 (4th ed. 2009).

115. HERBERT HOVENKAMP, THE ANTITRUST ENTERPRISE 31–45 (2005); RENATO NAZZINI, THE FOUNDATIONS OF EUROPEAN UNION COMPETITION LAW 11–50 (2011).

116. *See* Owens, *supra* note 46, at 189.

117. *See* William B. Barker, *An International Tax System for Emerging Economies, Tax Sparing, and Development: It Is All About Source!*, 29 U. PA. J. INT'L L. 349, 363–65 (2007); Yoseph M. Edrey, *Taxation and the Encouragement of Financial, Social, and Human Capital Investments*, 40 HEB. U. L. REV. 437, 488–89 (2011); Avi Nov, *Tax Incentives to Entice Foreign Direct Investment: Should There Be a Distinction Between Developed Countries and Developing Countries?*, 23 VA. TAX REV. 685, 691 (2004); Andrew P. Kummer, Note, *Pro-Business but Anti-Economy?: Why Ireland's Staunch Protection of its Tax Regime Is*

accurate,[118] it does not constitute an objection to the arguments raised in this Part. If, due to nontax factors, a country can successfully compete for investment while imposing a high corporate tax, it will not need to offer tax incentives to potential investors, even without international cooperation to curtail tax competition. To the contrary, improving the competitive climate by addressing sources of market failure would likely improve that country's competitive position. This is not to say that countries necessarily gauge accurately either the cost and benefits of foreign investments or the tax and incentive program necessary to attract them. Empirical studies are invaluable, both from the perspective of the individual country attempting to maximize its own welfare and from the perspective of global welfare, and efforts by international organizations and the academic community to promote welfare-maximizing tax policies are to be applauded.[119] However, despite the occasional rhetoric to the contrary, the fact that tax rates may be lower than necessary to attract beneficial investment is not an indictment, but rather an exoneration of tax competition.

Another oft-raised objection to tax competition is that unbridled competition among countries for MNE investment has reduced—or will soon reduce—effective corporate tax rates to zero. This "race to the bottom," so it is claimed, prevents the host country from receiving just compensation for the services that it provides and threatens its capacity to provide for the welfare of its residents.[120]

Preventing a Celtic Phoenix from Rising from the Ashes of the Celtic Tiger, 9 BROOK. J. CORP. FIN. & COM. L. 284 (2014).

118. For views that the claim is inaccurate, see, for example, Avi-Yonah, *supra* note 16, at 1644–46 (asserting that tax incentives are essential to attract investments, citing the cases of Ireland, Costa Rica, Israel, Malaysia, and Singapore); Roin, *Competition and Evasion*, *supra* note 1, at 552–53; and Joshua D. Moore, Comment, *The Economic Importance of Tax Competition for Foreign Direct Investment: An Analysis of International Corporate Tax Harmonization Proposals and Lessons from the Winning Corporate Tax Strategy in Ireland,* 20 PAC. MCGEORGE GLOBAL BUS. & DEV. L.J. 345 (2007). Many commentators have noted that any country attempting to tax the interest income of foreign residents would impair its own and its corporations' ability to borrow funds. *See* sources cited *supra* note 27.

119. *See, e.g.*, G.A. MACKENZIE, DAVID W.H. ORSMOND & PHILIP R. GERSON, INT'L MONETARY FUND, OCCASIONAL PAPER NO. 149, THE COMPOSITION OF FISCAL ADJUSTMENT AND GROWTH: LESSONS FROM FISCAL REFORMS IN EIGHT ECONOMIES (1997); ORG. FOR ECON. CO-OPERATION AND DEV., OECD TAX POLICY STUDIES NO. 16, FUNDAMENTAL REFORM OF CORPORATE INCOME TAX (2007); ORG. FOR ECON. CO-OPERATION AND DEV., OECD TAX POLICY STUDIES NO. 17, TAX EFFECTS ON FOREIGN DIRECT INVESTMENT: RECENT EVIDENCE AND POLICY ANALYSIS (2007); Sara Dillon, *Anglo-Saxon/Celtic/Global: The Tax-Driven Tale of Ireland in the European Union*, 36 N.C. J. INT'L L. & COMM. REG. 1 (2010); Moore, *supra* note 118.

120. Muhammod Shaheen Chowdhury, *Income Tax Compliance and Policy Issues in Developing and Emerging Economies: The Case of Bangladesh*, 20 NEW ZEALAND J. OF TAX'N L. & POL'Y 277, 294 (2014) ("The desire to attract foreign investment has caused harmful tax competition (race to the bottom) among neighbouring states by offering tax incentives and concessions."); Noam Noked, *Integrated Tax Policy Approach to Designing Research & Development Tax Benefits*, 34 VA. TAX REV. 109, 142 (2014) ("Members who offer greater tax benefits to R&D than is optimal are engaged in a sort of 'race to the bottom' that hurts their own interests.").

As a preliminary matter, the concept of "race to the bottom" is a misnomer, if only because it postulates the existence of a "bottom." We have seen that "zero" is not a singularity that one can approach but never reach or that one can reach but never pass; rather, it is an arbitrary point on a line stretching to infinite positive tax in one direction and to infinite negative tax in the other.[121] In fact, tax competition could, and often does, push effective tax burdens into negative territory as countries offer MNEs inducements in the form of direct grants or subsidies in amounts that are greater than the tax, if any, that they collect.[122]

Consequently, the phrase "race to the bottom," if taken literally, would indicate a state of affairs in which tax burdens approach negative infinity. Not only is such a state of affairs impossible, but the fact that no country has any economic incentive to reduce its tax burden below what was described earlier as its indifference point creates, in practice, a floor below which taxes will not fall (whether this floor is above zero or below zero will vary from case to case). A more reasonable understanding of the term "race to the bottom" is that tax burdens will tend to approach countries' indifference points. This reading is also not entirely accurate. We have seen that countries will be able to capture a portion of the efficiency bonus flowing from investment in their territory and that the portion they are able to capture will increase dramatically when MNEs compete among themselves for investment opportunities.[123] Nonetheless, it is true that tax burdens in an environment of free tax competition will likely be lower than they would have been in the absence of such competition.[124]

The fairness objection actually involves two distinct issues that the literature tends to confuse. The first is that the "race to the bottom" violates basic tenets of transactional justice: although host countries provide essential services upon which MNEs rely and which contribute to the creation of their profits, tax competition prevents the host country from meaningfully participating in those profits. The second is that, even though tax competition may provide for an efficient (in the classic Kaldor-Hicks sense of the term) allocation of global resources, the results are not necessarily fair from the perspective of distributive justice. Unchecked, the market tends to concentrate economic power, exacerbate economic inequality, and leave many without sufficient resources.

The next two Parts of the Article will consider these objections. Part II will discuss the transactional justice objection. Part III will discuss the distributive justice objection.

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121. *See supra* Part I.B.

122. *See* Margalioth, *supra* note 5, at 187 (arguing that "[t]argeted tax incentives are much more powerful and cost effective policy tools than low across-the-board corporate income tax rates," but noting that "[t]he disadvantage of targeting is that policymakers often cannot estimate which types of investments have the greatest positive spillover effects"); Noked, *supra* note 120, at 153–54 (discussing government subsidies to encourage investment).

123. *See supra* Part I.D.

124. This state of affairs is hardly surprising. Prices tend to be lower when suppliers compete than when one supplier has a monopoly.

II. TRANSACTIONAL JUSTICE

A. Free Rider

This Part will consider the argument that by receiving services supplied by the government of the host country, the MNE incurs a moral obligation to pay for those services via taxation. In the absence of effective corporate taxation, the MNE is a "free rider," benefiting from services paid for by others.[125]

A close examination of this claim shows that it is actually several arguments wrapped into one:

a. Host countries provide services.

b. MNEs operating in the host country use those services.

c. Tax competition prevents the host country from imposing effective corporate tax on the MNE.

d. In the absence of effective corporate taxation, the MNE does not pay for the services it receives.

e. If an MNE benefits from services supplied by the host country without paying full value for them, the result is a violation of transactional justice.

The first and second arguments are uncontroversial. In addition to services that require budgetary outlay—security, infrastructure, education, and so forth—the host country provides a service simply by permitting the MNE to operate in its sovereign territory, something it is not required to do under customary international law.[126] The third argument is also uncontroversial if it means that host countries cannot successfully impose as high a tax burden as they would have been able in the absence of competition. However, the first three arguments are insufficient to ground a claim of transactional injustice. To ground such a claim it would be necessary also to prove the fourth and fifth arguments. This Part will closely examine these two arguments.

B. Factor Prices

The argument that tax competition violates transactional justice by enabling MNEs to benefit from services provided by the host country without paying for them ignores the fact that MNEs pay for many of those services indirectly when they purchase factors of production. In most cases, requiring them to pay directly via taxation would be double charging for the same service.[127]

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125. *See, e.g.*, Avi-Yonah, *supra* note 16, at 1627.

126. As opposed to customary international law, binational and multinational agreements often require a country to permit foreigners to compete on equal footing, for example, the General Agreement on Tariffs and Trade (GATT).

127. Even Avi-Yonah would appear to accept this argument. Avi-Yonah, *supra* note 16, at 1627 ("If a multinational invests in a country with a small public sector, it will probably have to incur more costs or earn lower profits than if the public sector were larger. For example, it may have to invest in training for its workers because the government provides inadequate

For example, assume that a country has a highly skilled workforce and that those skills are the result of superior education in publicly financed schools. By hiring those employees, the MNE is indirectly benefiting from the host country's education expenditures. However, in a competitive environment, more skilled and better-educated employees will command higher salaries. In other words, the MNE will indirectly bear the cost of its employees' education via the salaries it pays them. From the perspective of benefit theory, it would probably be accurate to describe the employees as (via their taxes) buying education from the government, using that education to improve their marketable skills, and then selling more valuable and consequently more expensive services to the MNE.

Note that from the perspective of the MNE, the source of funding for the institutions that educated their employees is irrelevant. The skills of its employees are what concern the MNE, not whether the institutions that trained them received their funding from the government, from international aid, from donations, or from tuition. Clearly, a private professional school has no claim under transactional justice to receive payment from clients of its alumni. Similarly, the host country has no claim under transactional justice to compensation for the expenses it incurred in educating the MNE's future employee.

The same reasoning applies to the rent or purchase of property. In a country with a well-developed economic infrastructure, a stable social structure, and effective civil and criminal law enforcement, the cost of renting or purchasing property will be higher than in a country with a primitive economic infrastructure, in a country facing civil unrest, or in a country where law enforcement is sporadic or capricious. In a country with a relatively wealthy population, retail property will be more valuable than in countries with a poor population. In other words, to the extent that government services create an environment conducive to profitable business operations, the MNE will indirectly pay for those services. Furthermore, and similar to what we noted with regard to employee education, whether the business environment is due to direct government spending or whether it is due to other factors such as cultural norms or the country's geopolitical situation is likely not of particular concern to the MNE. In a competitive environment, it will pay the market price for use of property. The government does not ordinarily have a claim under transactional justice against the MNE.

Empirical evidence tends to support the normative argument. Analysis of tax incidence indicates that the economic burden of taxes imposed by host countries on MNEs is largely borne, not by shareholders, but by labor and land.[128] Stated differently, the more that an MNE pays the host country, the less it will pay employees and the less it will pay landowners. The causal connection between the two is that the higher the corporate tax, the less attractive the country will be to MNEs and the less demand there will be for local labor and land. Lower demand for labor

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public education, or it may have to build its own transportation systems because the government does not supply adequate infrastructure. In that case, it would be inappropriate to penalize the multinational by taxing it at a higher rate—such as its home-country rate—to offset the lower taxes levied by the host country.").

128. *See* Avi-Yonah, *supra* note 5, at 380 (stating that the standard economic advice to small open economies is to refrain from taxing foreign investment because the tax will necessarily be shifted to labor and land).

and land will drive down wages and rents.[129] These economics are a manifestation of the idea that when the MNE does not pay the government for the services it provides, it will pay those who directly benefit from those services—workers and landowners—the full market value of the services that they, in turn, provide. Conversely, requiring the MNE to participate in the expense of training its employees and of providing a convivial atmosphere in which to conduct business via a direct tax will cause a reduction in the salaries and the rent that it pays. In other words, in a perfectly competitive environment, the MNE will pay once, and only once, for the services that it receives.

C. Use and Economic Benefit

It is possible that, in certain circumstances, factor prices will not reflect the full value of government services. In such cases, one might argue that tax competition and the "race to the bottom" precipitate transactional injustice by effectively preventing host countries from imposing taxes on MNEs operating in their territories.

The response to this argument is twofold. First, we have seen that in a competitive environment, the tax that a country is able to charge MNEs reflects the relative advantages of investment in that country.[130] The more that the host country has to offer and the lower the factor prices, the more advantageous the investment will be from the perspective of the MNE and the more tax it will be willing to pay. In other words, if a country is not able to impose taxes on MNEs, this would seem to indicate that factor prices already reflect all of the advantages of operating in that country's territory. Where they do not, the country should be able to impose a positive net corporate tax and still compete successfully for MNE investment.

Second, the fact that an MNE uses government services does not necessarily mean that it economically benefits from those services, and, without economic benefit, mere use cannot substantiate a claim under transactional justice. As a simplistic example of the difference between use and economic benefit, assume that, in an effort to reduce unemployment, the government provides all businesses with publicly financed valet parking services. Although the MNE has no independent interest in the valet services, it agrees to accept them, either because it is required to do so under law or simply as a goodwill gesture toward the local community. In other words, although the MNE uses the valet services, it does not economically benefit from them. It would be hard to justify a claim that transactional justice requires the MNE to pay for the services it admittedly uses but from which it neither benefits nor expects to benefit.

Substantiating a claim for host-country taxation of MNEs under transactional justice would require a demonstration that MNEs economically benefit from services by the host country. However, providing such a demonstration may be more difficult than appears at first glance.

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129. *See* Roin, *Competition and Evasion*, *supra* note 1, at 553 ("This decrease in wages may be just as painful (economically) to the workers in such jurisdictions as would a tax increase necessitated by a decrease in corporate income taxes.").

130. *See supra* Part I.B–D.

In general terms, we can define "benefits economically" as follows: X benefits economically from Y if and only if X is better off economically with Y than without Y. If X does benefit economically from Y, then the benefit is equal to the difference between X's economic situation with Y and X's economic situation without Y. Consequently, in determining whether and to what extent an MNE benefits economically from services provided by the host country, the baseline is what the MNE's economic situation would have been in the absence of those services.

Many commentators seem to equate an MNE receiving services from the host country to the MNE economically benefiting from the services that it receives from the host country.[131] This view is inaccurate. It implicitly assumes that in the absence of services provided by the host country, the MNE would operate in a Hobbesian state of nature. The more realistic description is that in the absence of services provided by the host country, the MNE would simply invest elsewhere.

As we have seen, the ex ante economic benefit that an MNE derives from services provided by the host country is the difference between the present value of the profit it expects to earn by investing in that country and the present value of the profit it expects to earn by investing in the best alternative venue.[132] Even though the host country provides extensive services to the MNE—including permitting the MNE to operate within its sovereign territory—the pretax economic benefit that the MNE derives from availing itself of those services might be small, zero, or even negative, depending upon the alternative investment venues available. If the economic benefit is negative, the host country will likely need to provide incentives—impose a negative tax—if it is to induce the MNE to invest in its territory. If the economic benefit is positive, it should be able to impose taxes that will capture some or all of that benefit.

The claim that tax competition produces transactional injustice by preventing host countries from imposing taxes on MNEs that benefit from those services and permitting MNEs a free ride at the expense of actual taxpayers is unsustainable. To demonstrate how the issues discussed in this Subpart play out in practice, let us again consider the issue of publicly funded education. It is widely accepted that such education provides substantial positive externalities by improving the quality of debate on public issues, reducing crime, creating economic ripple effects that allow all members of society to demand and receive higher wages, and reducing economic inequality by, to some extent, leveling the competitive playing field for the next generation. It is therefore reasonable for members of a society to agree that taxes should fund or subsidize education.[133] The question is the extent to which the externalities of publicly funded education benefit MNEs and the effect of such externalities on the factor prices and taxes an MNE will pay in a competitive tax

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131. *See, e.g.*, Walter Hellerstein, *Jurisdiction To Tax Income and Consumption in the New Economy: A Theoretical and Comparative Perspective*, 38 GEO. L. REV. 1, 7 (2003); Stephen E. Shay, J. Clifton Fleming, Jr. & Robert J. Peroni, *"What's Source Got To Do with It?" Source Rules and U.S. International Taxation*, 56 TAX L. REV. 81, 90–95 (2002); Robert A. Green, *The Future of Source-Based Taxation of the Income of Multinational Enterprises*, 79 CORNELL L. REV. 18, 29 (1993) (discussing this view).

132. *See supra* Part I.C–F.

133. Of course, reasonable minds may differ regarding the extent or manner of funding or subsidizing education.

environment. If operating in a relatively highly educated society is advantageous to an MNE, it will likely pay higher wages and higher rent. To the extent that factor prices do not capture the entire benefit, the host country should be able to impose an effective tax burden. If the host country cannot do so—in other words, if imposing tax on a MNE would cause it to invest elsewhere—this would constitute strong evidence that, although operating in a country that provides public education, the MNE is not benefiting from the externalities of that education or, more likely, that the benefits are already subsumed in factor prices.

III. DISTRIBUTIVE JUSTICE

A. Introduction

A further indictment of tax competition and the consequent "race to the bottom" is that it supposedly impedes efforts to achieve distributive justice. The literature raises this claim in two separate contexts. The first is internal: the effect of tax competition on the ability of countries to supply social services.[134] The second is external: the effect of tax competition on the distribution of wealth among nations.[135] Although the literature does not always sufficiently distinguish between these two contexts, they are conceptually distinct.

Subpart B will discuss domestic distributive justice. It will distinguish between social insurance and social assistance and will demonstrate that in neither instance is it reasonable to require foreign investors to participate in the provision of those services, beyond paying the market price for the services they receive (including the tax that it would pay the home country in a competitive tax environment). It will further argue that prohibitions against ring fencing would tend to curtail social services programs by making it difficult for countries with extensive social service programs to compete for foreign investment.

Subpart C will discuss international redistribution. While alleviating global poverty is a pressing international concern, this Subpart will argue that attempting to use the international tax regime to redistribute wealth is based on a false analogy between the role of taxation in the domestic arena and its role in the international arena. As demonstrated by Kaplow and Shavell, income tax is a more effective and a more efficient method of redistributing wealth than is regulation. However, their analysis is pertinent only to the domestic arena. In the international arena, limiting tax competition is comparable to regulation, and using regulation to redistribute is the very antithesis of their theorem.

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134. *See, e.g.*, Avi-Yonah, *supra* note 16, at 1632–39; Ruth Mason, *Made in America for European Tax: The Internal Consistency Test*, 49 B.C. L. REV. 1277, 1294 (2008).

135. Avi-Yonah, *supra* note 16, at 1639–43; Avi-Yonah, *supra* note 5, at 374 ("[T]ax competition among developing countries . . . costs them significant revenues, and benefits rich-country interests . . . ."); Barker, *supra* note 117, at 354 ("The present system . . . may be characterized as foreign aid to developed economies since the developing economies are subsidizing the activities of MNEs . . . ."); Benshalom, *How to Redistribute?*, *supra* note 1; Ilan Benshalom, *The New Poor at Our Gates: Global Justice Implications for International Trade and Tax Law*, 85 N.Y.U. L. REV. 1 (2010); OECD, ACTION PLAN, *supra* note 1, at 8.

B. Domestic Distributive Justice

In the broadest sense of the term, welfare services include what one commentator described as "social insurance and social assistance."[136] The former is a service that an ideal market would be able to provide. It is only because of market failure—moral hazard, cognitive imperfection, information imbalance, externalities, and so forth—that the state finds it necessary to provide the service.[137] Social insurance is not redistributive to the extent that the present value of future expected benefits, considering both the odds of the qualifying event occurring and the time value of money, equals the premium that the state charges.[138] Social assistance, on the other hand, involves a redistribution of wealth with the goal of providing basic goods and services to those who would not otherwise be able to afford them or, more generally, of mitigating economic inequality.[139] The difference between them is that while either might disturb the ex post market distribution, only social assistance disturbs the ex ante market distribution.

As a factual matter, it is likely true that tax competition makes it more difficult for countries to finance their welfare programs. We have already noted that competition tends to drive down prices whether the market is for widgets or for investment opportunities, and that the countries cannot effectively impose the same level of taxes on MNEs as they would have been able to impose in the absence of tax competition. Nevertheless, the appropriate questions are not factual but normative.[140]

1. Social Assistance

With regard to social assistance, the question we need to ask is whether an MNE that purchases goods and services at market prices from individuals, firms, and the government of the host country—including the right to operate within its sovereign territory—has a further moral obligation to provide for the welfare of individuals with no connection to its business activity, simply because they are residents of the country in which it operates. It is important to isolate the issue at hand. The question is not whether relatively wealthy firms and individuals—represented here by the MNE and its shareholders—have a general obligation to contribute to international redistributive efforts. Subpart C will consider this issue. Nor is the question whether the MNE has an obligation to compensate residents of the host country who are adversely affected by the activities of the MNE. Compensating such residents is not an issue of distributive but of compensatory justice. In any case, a rational host country will consider these effects when determining its indifference point and will not permit the MNE to operate in its territory unless the taxes that it expects to collect compensate it sufficiently. Simply phrased, the question is whether the simple fact

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136. Avi-Yonah, *supra* note 16, at 1636.

137. *Id.* at 1637.

138. *See* Elkins, *supra* note 110, at 83–84.

139. *See* Avi-Yonah, *supra* note 16, at 1636.

140. *See* Roin, *Competition and Evasion*, *supra* note 1, at 553 ("Advocates of tax harmonization appear to regard any departure from the level and distribution of the tax burden set in the noncompetitive world as unduly low.").

that a person resides in a country in which an MNE conducts business operations is sufficient to ground a claim under distributive justice.

Because we are at present considering the effect of tax competition not on international redistribution as such, but rather on domestic redistribution in the host country, we should, systematically, begin by examining the normative basis of domestic redistribution. This would allow us to determine who is subject to the obligations of domestic redistribution and, specifically, whether it is reasonable to include foreign investors.

The problem one confronts when attempting to address this issue is that social philosophers have not yet proposed a satisfactory line of reasoning that would justify both redistributing resources for the purpose of mitigating economic inequality and limiting that redistribution to the confines of a single country. For example, while Rawls's argument that individuals do not morally deserve their social position or their natural talents can justify redistribution,[141] his use of this argument to justify domestic redistribution is problematic. Individuals do not morally deserve their place of birth or the citizenship of their parents any more than they do their social position or their natural talents.[142] Under Rawls's own terms of reference, permitting factors that are arbitrary from a moral point of view to have such a profound impact upon one's life chances is unjust.[143]

Rawls himself relied on the idea that distributive justice is the fair distribution of the benefits of social cooperation and is therefore inapplicable outside the framework of such cooperation.[144] The question of whether it is possible normatively to justify domestic redistribution and how one might go about doing so is far beyond the scope of this Article.[145] However, I believe that we can list certain characteristics of social cooperation that could serve to justify domestic redistribution.

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141. JOHN RAWLS, A THEORY OF JUSTICE 15, 73–74, 102 (1971).

142. Loren Lomasky, *Toward a Liberal Theory of Natural Boundaries*, *in* BOUNDARIES AND JUSTICE 55, 56–60 (David Miller & Sohail H. Hashmi eds., 2001).

143. *See, e.g.*, BRIAN BARRY, THE LIBERAL THEORY OF JUSTICE: A CRITICAL EXAMINATION OF THE PRINCIPAL DOCTRINES IN *A THEORY OF JUSTICE* BY JOHN RAWLS 128–30 (1973); CHARLES R. BEITZ, POLITICAL THEORY AND INTERNATIONAL RELATIONS 139–41, 143–53 (1979); Lomasky, *supra* note 142, at 60; THOMAS W. POGGE, REALIZING RAWLS 250–51 (1989); KOK-CHOR TAN, JUSTICE WITHOUT BORDERS: COSMOPOLITANISM, NATIONALISM, AND PATRIOTISM 60 (2004) ("A Rawlsian approach to global justice . . . would apply the difference principle to the global basic structure as a whole . . . ."); *cf.* Will Kymlicka, *Territorial Boundaries*, *in* BOUNDARIES AND JUSTICE, *supra* note 142, at 249–75 (explaining that a nation has a legitimate right, within limits, to encourage its national character and may, for instance, restrict but not eliminate immigration. However, a country does not have the right to reserve the use of its resources for the exclusive use of its inhabitants.).

144. JOHN RAWLS, THE LAW OF PEOPLES 113–20 (1999); *See* John Rawls, *Distributive Justice*, *in* PHILOSOPHY, POLITICS AND SOCIETY: THIRD SERIES 58, 58 (Peter Laslett & W.G. Runciman eds., 1967).

145. For arguments defending domestic redistribution, see, for example, RONALD DWORKIN, LAW'S EMPIRE 195–215 (1986); WILL KYMLICKA, POLITICS IN THE VERNACULAR: NATIONALISM, MULTICULTURALISM AND CITIZENSHIP 225 (2001); AVISHAI MARGALIT, THE ETHICS OF MEMORY 74–76 (2002); DAVID MILLER, ON NATIONALITY 84–85 (1995); RICHARD RORTY, CONTINGENCY, IRONY, AND SOLIDARITY 191 (1989); YAEL TAMIR, LIBERAL NATIONALISM 117–21 (1993); Thomas Nagel, *The Problem of Global Justice*, 33

Residents of a country share, and presumably view themselves as sharing, a long-term common fate. Both their own and their progeny's quality of life are largely dependent upon the social, political, and cultural institutions that they create and maintain. Significantly, the economic terms of engagement among members of the society do not always reflect the costs and benefits of those institutions. Whether or not such sentiments have any normative basis, people seem to care more about misfortune befalling other members of their society than they do about misfortune befalling those they perceive as outsiders. Finally, members of a society expect that should they or those that they care for find themselves in need, other members of their society will provide them with assistance commensurate with community standards.

None of these considerations justifies the inclusion of MNEs within the community of the host country for the purpose of distributive justice. An MNE's involvement in the life of the host country is strictly economic. It invests when it finds it economically beneficial to invest, and it divests when it finds it economically beneficial to divest. From the MNE's perspective, a country's social, political, and cultural institutions are factors that help determine whether it is willing to invest in that country and how much it is willing to pay in order to do so.[146]

Adopting Rawlsian terminology, we can say that, against a background of fair institutions, the distribution resulting from economic cooperation—the terms of which satisfy the criteria of transactional justice—will necessarily be fair.[147] Within a society, distributive justice is an element of that institutional framework.[148] It allocates the costs and benefits of the social cooperation that serves as background for transactional justice.[149] For an MNE, on the other hand, the institutional framework is a bargained-for advantage. In other words, the market price that it pays for goods and services within the country along with the market price that it pays for the right to operate in the country and benefit from services provided by the host government will reflect the home country's institutional framework.[150]

Furthermore, the MNE is not a member of the body politic that decides the terms of distributive justice. It does not have a vote in determining the contours of the redistribution.[151] Perhaps more significantly, those who do participate in the decision-making process presumably do not consider the desires or the needs of the

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PHIL. & PUB. AFF. 113 (2005); Michael Sandel, *The Procedural Republic and the Unencumbered Self*, *in* COMMUNITARIANISM AND INDIVIDUALISM 12, 20–24 (Shlomo Avineri & Avner de-Shalit eds., 1992).

146. *See supra* Part I.B.

147. *See* RAWLS, *supra* note 141, at 54–60.

148. *Id.* at 274–84.

149. *Id.* at 4.

150. With regard to the costs and benefits of the international institutional framework, see *infra* part III.C.

151. ECON & FIN. COMM'N, *supra* note 10, at 4044 ("A survey of the whole field of recent taxation shows how completely the Governments are dominated by the desire to tax the foreigner."); Shay et al., *supra* note 131, at 89 (2002). One of the better-known adages of tax politics is attributed to Senator Russell B. Long: "Don't tax you. Don't tax me. Tax that fellow behind the tree." ROBERT MANN, LEGACY TO POWER: SENATOR RUSSELL LONG OF LOUISIANA 333 (1992). Foreigners are behind that proverbial tree.

MNE or its shareholders except to the extent that such desires or needs are expected to affect their own economic prospects. Note also that the criteria for receiving social assistance and the extent of that assistance vary from country to country. It is not clear why residents of countries that provide relatively generous social assistance have a greater claim under distributive justice against MNEs operating in their midst than do residents of countries that provide less generous social assistance.[152] In any case, it is reasonable to assume that the terms of redistribution are such that neither the MNE nor its shareholders are entitled to benefit from social assistance should they encounter misfortune or find themselves in need.

2. Social Insurance

With regard to social insurance, the host country's claim on MNEs to participate in the costs of such programs—beyond paying full value, as determined under competitive market conditions, for the benefits of operating in the country—is, if anything, weaker than it is with regard to social assistance. It is the wealthier countries that tend to supply their residents with social insurance.[153] By definition, social insurance does not seek to redistribute ex ante wealth but rather to overcome market failure. Under ideal market conditions, individuals would save for retirement and would purchase insurance policies from private firms, protecting themselves and their dependents against the risk of unemployment, disability, or death. However, it is likely that an actual market would produce an insufficient and inefficient level of insurance coverage and savings. People tend to underestimate the risk of misfortune (cognitive imperfection).[154] Insurance companies are incapable of verifying all of the risk factors, meaning that those who purchase insurance will tend to be those who carry greater than average risk (adverse selection).[155] Those who do purchase

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152. In certain instances, MNEs benefit from social assistance provided by the host country. For example, social services may prevent civil unrest or provide a more educated and dedicated workforce. However, in those cases, the issues that we are discussing in this Part do not arise, as either the MNE will pay for those services indirectly via increased factor prices or the host country will be able to charge the MNE a tax that reflects the benefits it receives. *See supra* Part II. Competition among countries for investments would not only permit—but indeed would require—the provision of those services. The claim in the text is that MNEs have no obligation to contribute to the social assistance programs in the countries in which they invest beyond paying, directly or indirectly, the fair market value of the services they receive. With regard to general obligations of international distributive justice, see *infra* Part III.C.

153. *See* Avi-Yonah, *supra* note 16, at 1640.

154. *See* ROBYN M. DAWES, RATIONAL CHOICE IN AN UNCERTAIN WORLD 10–14, 146–63 (1988); Melvin Aron Eisenberg, *The Limits of Cognition and the Limits of Contract*, 47 STAN. L. REV. 211, 213 (1995); Robert E. Scott, *Error and Rationality in Individual Decisionmaking: An Essay on the Relationship Between Cognitive Illusions and the Management of Choices*, 59 S. CAL. L. REV. 329, 338–42 (1986).

155. Kenneth S. Abraham, *Environmental Liability and the Limits of Insurance*, 88 COLUM. L. REV. 942, 946 (1988); Adam F. Scales, *A Nation of Policyholders: Governmental and Market Failure in Flood Insurance*, 26 MISS. C. L. REV. 3, 8–9 (2006); Peter Siegelman, *Adverse Selection in Insurance Markets: An Exaggerated Threat*, 113 YALE L.J. 1223 (2004).

insurance are less likely to avoid protected risks (moral hazard).[156] The guarantee of social assistance in case of need constitutes a disincentive to the purchase of insurance protection (externalization of costs).[157] Because of these market failures, the state will often force individuals to purchase insurance and to save for retirement.[158] While it cannot hope to emulate exactly the insurance coverage and savings rate that would prevail in an ideal market, it hopes that what it does achieve under social insurance is closer to the ideal than what would prevail under nonideal market conditions absent social insurance.

The argument for curtailing tax competition because it lowers tax revenues to the point that host countries cannot adequately finance their social insurance programs is effectively an argument that host countries should adopt more extensive social insurance programs than its residents are willing to pay for. If the cost of providing insurance benefits is more than the premiums collected, the obvious options are reducing benefits and increasing premiums.[159] It is hard to imagine that a country is entitled to demand that foreigners subsidize its social insurance program. Of course, a country may legitimately charge competitive market rates for access to investment opportunities in its sovereign territory and may then distribute the revenue among its population in the form of cash or additional services, including increased insurance benefits. What proponents of curtailing tax competition have failed to do is explain why a country has the right to demand that MNEs subsidize its social insurance program in an amount that exceeds the tax that it can successfully charge in a competitive environment.

3. Ring Fencing

Several prominent tax scholars, along with international agencies such as the OECD and the European Community, have singled out the phenomenon of ring fencing as particularly noxious.[160] The idea is that countries have the right to decide for themselves how much social assistance and how much social insurance they wish to provide. The international community should not, therefore, stipulate minimum or maximum levels of tax. However, the argument goes, once a country determines the level of tax it wishes to impose, it should not be permitted to charge foreign investors less than what it charges its own residents. Doing so constitutes harmful tax competition and justifies the adoption of countermeasures by the international community to combat such abuse.

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156. TOM BAKER & KYLE D. LOGUE, INSURANCE LAW AND POLICY 6–7 (3d ed. 2013); Abraham, *supra* note 155, at 946; Tom Baker, *Containing the Promise of Insurance: Adverse Selection and Risk Classification*, 9 CONN. INS. L.J. 371, 373 (2003) (defining moral hazard as the "change in incentives that can result from insurance protection").

157. Elkins, *supra* note 110, at 89–90.

158. *See* David Autor, Mark Duggan & Jonathan Gruber, *Moral Hazard and Claims Deterrence in Private Disability Insurance*, 6 AM. ECON. J.: APPLIED ECON. 110 (2014).

159. *See* Mitchell B. Weiss, *International Tax Competition: An Efficient or Inefficient Phenomenon?*, 16 AKRON TAX J. 99, 130 (2001) ("Rather than adapting their tax systems to this New World, [OECD countries] are attempting to adapt this New World to their tax systems.").

160. *See* sources cited *supra* note 5.

It is not clear why ring fencing is a negative phenomenon. The choice of how much social insurance and how much social assistance to provide is a domestic matter, involving at a deep level what the society in question considers to be the mutual rights and obligations inherent in, or constitutive of, a national community. A prohibition against ring fencing would effectively discriminate against countries with extensive social service programs, as they would find it difficult to compete against other countries with less extensive social service programs and lower tax rates.

Furthermore, and contrary to the intentions of those who advocate such a rule, the likely result of prohibiting ring fencing would not be higher tax rates on MNEs but rather lower tax rates across the board.[161] In other words, instead of increasing the revenue available for social programs, it would actually decrease those revenues. Ireland is a paradigmatic case in point. Prior to 1997, Ireland, in an effort to attract foreign investment, imposed a lower rate of tax on foreign corporations than it did on domestic corporations. In 1998, following the adoption of the EU Code of Conduct that prohibited measures providing for "significantly lower effective level of taxation, including zero taxation, than those levels which generally apply in the Member State in question,"[162] Ireland replaced its multi-rate structure with a single low tax rate applicable to all corporations, foreign and domestic.[163] Other countries were thus no better off than they had been when competing against Ireland for MNE investment, and Ireland's tax structure became considerably less progressive. Why this shift was a positive phenomenon from the perspective of those who advocate for redistributive tax structures is something that the opponents of ring fencing have yet to explain.

In general, countries should be free to determine the level of social services—whether insurance or assistance—that they wish to provide without fearing that too high a level will impede their ability to attract foreign investment. The argument that countries need to choose between extensive social services and foreign investment is unpersuasive.

C. International Redistribution

Opponents of tax competition have contended that limiting tax competition would result in a fairer distribution of global wealth, as it would stimulate a flow of revenue

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161. *See, e.g.*, OECD, ACTION PLAN, *supra* note 1, at 17 ("[T]he 'race to the bottom' nowadays often takes less the form of traditional ring-fencing and more the form of across the board corporate reductions on particular types of income . . . ."); Rosenzweig, *Tax Havens?*, *supra* note 1, at 966–67; *see also* Avi-Yonah, *supra* note 16, at 1646 (illustrating the distinction between legitimate and illegitimate low tax regimes by comparing Ireland offering foreign investors a preferential tax regime and Ireland lowering its generally applicable tax rates).

162. Conclusions of the Ecofin Council Meeting, *supra* note 1, at 3.

163. Avi-Yonah, *supra* note 16, at 1654; Michael J. Graetz & Rachael Doud, *Technological Innovation, International Competition, and the Challenges of International Income Taxation*, 113 COLUM. L. REV. 347, 379 (2013).

from wealthy MNEs to the governments of poor host countries.[164] The present Subpart will examine that contention.

Alleviating global poverty is one of the more pressing and under-addressed issues in the field of international affairs. However, international redistribution is an extraordinarily broad subject and involves normative and practical issues that are far beyond the scope of this Article. The present Subpart will focus upon one particular aspect of that topic and will argue that limiting tax competition would be ineffective and inefficient as a means of redistributing wealth. It will begin by describing the assumptions underlying the contention that tax competition inhibits international redistribution and will then critically examine those assumptions. The Subpart will conclude by discussing the applicability of Kaplow and Shavell's view of taxation and regulation to the international front and will argue that, far from supporting the use of the international tax regime as a means of redistributing wealth, their analysis argues strongly against it.

1. Tax Competition as an Impediment to International Redistribution

The claim that tax competition impedes efforts at international redistribution rests upon a number of tacit factual assumptions. The first is that host countries are generally poor.[165] The second is that limiting tax competition will benefit host countries by enabling them to impose greater tax burdens on MNEs operating in their territories. The third is that increasing the tax coffers of developing countries is an effective means of combating poverty.

With regard to the first assumption, while it is true that some host countries are poor, identifying host countries as poor is both overinclusive and underinclusive. It is overinclusive because host countries are often relatively wealthy, as evidenced by the well-publicized competition between Israel and Ireland for Intel investment,[166] by the establishment of Patent Box regimes by prominent European countries,[167] and by the abolishment of withholding tax on portfolio interest by the United States.[168] It is underinclusive because many poor countries are unattractive investment venues, with or without tax incentives.[169] Enabling host countries to impose a higher tax burden than a competitive market for investment would allow seems a rather haphazard means of mitigating global inequality and alleviating international poverty.

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164. *See* sources cited *supra*, note 135.

165. Benshalom, *How to Redistribute?*, *supra* note 1 at 330–36.

166. *Intel in Israel: A Fab Relationship Faces Criticism*, WHARTON SCH. U. OF PA.: KNOWLEDGE@WHARTON (Sept. 29, 2014), http://knowledge.wharton.upenn.edu/article/intel-israel-old-relationship-faces-new-criticism/ [https://perma.cc/5G47-XQV8] ("Israel has to compete with other countries every few years to be the site of the next new and upgraded plant. In 2012, Ireland won the race to host Intel's next generation 14-nanometer chip plant because the company deemed Israel's offer of 1 billion shekels in aid as insufficient.").

167. *See* sources cited *supra* note 29 and accompanying text.

168. *See* sources cited *supra* note 26.

169. Tracy A. Kaye, *Taxation and Development Incentives in the United States*, 62 AM. J. COMP. L. SUPP. 617, 626 (2014).

The problem with the second assumption is that, given the advantages inherent in conducting operations in countries with developed economies, tax incentives may be necessary to allow poor countries to compete with wealthy countries for investments. [170] Prohibiting them from engaging in tax competition would most likely result in a decrease in both their tax revenues and their share of international investment. In fact, many commentators have argued that the true purpose of limiting tax competition is to protect the tax base of wealthy countries against encroachment by poor countries (and that the term "base erosion" in the OECD's attempts to combat "base erosion and profit shifting" refers to the tax base of OECD countries).[171]

Regarding the third assumption, it is far from certain that the governments of poor host countries would use the additional funds to alleviate poverty in their midst. While there are certainly exceptions across the board, as a rule the governments of poorer countries tend to be less responsive to the needs of their populations than the governments of wealthier countries. Much of the additional revenue may find its way into offshore bank accounts or be used to suppress political opposition. In many cases, direct assistance to needy individuals—by wealthy countries, by NGOs, or by individual philanthropists—may be a more effective means of combating poverty than transferring funds into government coffers. True, some poor countries do have responsible governments that would use the additional resources wisely, and in such cases using the government as a conduit of international aid might make sense. However, proposals to limit tax competition do not make any distinction among countries based upon the expected use of the additional funds, nor is it likely that they could make such a distinction.[172] Furthermore, we already noted that the prohibition against ring fencing places countries that actively attempt to combat poverty through a redistributive tax system at a disadvantage when competing for

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170. Margalioth, *supra* note 5, at 184; Rosenzweig, *Tax Havens?*, *supra* note 1, at 932–33.

171. *See generally* Michael Littlewood, *Tax Competition: Harmful to Whom?*, 26 MICH. J. INT'L L. 411, 449 (2004); George M. Melo, Comment, *Taxation in the Global Arena: Preventing the Erosion of National Tax Bases or Impinging on Territorial Sovereignty?*, 12 PACE INT'L L. REV. 183, 205 (2000) ("This type of international coercion is perfectly logical in light of the inequality of power that exists between the OECD members, the most powerful nations in the world, and the tax havens, which are economically weaker . . . ."); Alexander Townsend, Jr., Comment, *The Global Schoolyard Bully: The Organisation For Economic Co-operation and Development's Coercive Efforts to Control Tax Competition*, 25 FORDHAM INT'L L.J. 215 (2001). Designing international tax rules that benefit wealthy countries is not a new phenomenon:

> The victors of World War I were the capital exporting nations of the world. Those countries desired to ensure that the source countries (former colonies) would only be allocated routine profits and the remainder of profits (the coveted residual profits) would be allocated to the developed nations of the world where the capital and know-how were presumed to reside. . . . The early framers knew what they were doing. They wanted residual profits to be stripped out of source countries without the need for explanation . . . .

Wells & Lowell, *supra* note 29, at 776–78.

172. Avi-Yonah, *supra* note 16, at 1641 ("While direct aid can be targeted at those countries whose governments seem able to use it best, it is doubtful that tax rules can be targeted in this way."); *see* Fleming et al., *supra* note 14, at 345–46;

foreign investment.[173] In other words, the bulk of the additional tax revenues that would result from restricting tax competition under current proposals would likely flow to those countries that do not seek to redistribute wealth internally. Far from alleviating poverty in the developing world, these proposals could end up exacerbating global poverty.

Morality and pragmatism both require the international community to devote more attention and resources than it does at present to the alleviation of poverty, and particularly extreme poverty, in the developing world. The question of how best to do so is far beyond the scope of this Article. What this Article has attempted to demonstrate is that limiting tax competition is not only ineffective as a means of alleviating poverty in the world's poorest countries, but is also most likely counterproductive.

2. The Kaplow-Shavell Model

It is possible that proposals to use the international tax regime as a means of redistributing wealth rely upon a false analogy between the roles of competition, regulation, and taxation on the domestic and the international fronts. Under the model proposed by Louis Kaplow and Steven Shavell, regulation has no role to play with regard to distributive justice.[174] Its sole function is to promote transactional justice by encouraging competition, preventing fraud, and so forth. Using regulation to attempt redistribution is both ineffective and inefficient. It is ineffective because the categories of those who gain or lose under redistributive regulation do not necessarily coincide with the categories of those from whom a rational redistributive scheme would want to take and to whom a rational redistributive scheme would want to give. For example, even if plaintiffs in personal injury cases are usually less well-off economically than are defendants, a pro-plaintiff rule would ineffectively redistribute wealth because not all plaintiffs are badly off economically and not all of those who are badly off economically are plaintiffs.[175] It is inefficient because people change their behavior in response to regulation. For example, a pro-plaintiff rule will result in individuals and firms devoting more resources to preventing injury to others than is justified economically.[176]

True, regulations that conform to the Kaplow-Shavell model may have distributional side effects, as the poorest and least educated members of society are often the most vulnerable to fraud and deception, and the wealthiest members of society are often the primary beneficiaries of curtailed competition. However, it would not be accurate to describe antifraud and antitrust legislation as redistributive. It is more accurate to start with a baseline of a world without transactional justice

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173. *See supra* Part III.B.3.

174. *See* Louis Kaplow & Steven Shavell, *Why the Legal System Is Less Efficient than the Income Tax in Redistributing Income*, 23 J. LEGAL STUD. 667, 677 (1994); *see also* David A. Weisbach, *Taxes and Torts in the Redistribution of Income* (John M. Olin Program in Law & Econ., Working Paper No. 148, 2002), *available at* http:// http://www.law.uchicago.edu /files/files/148.Weisbach-Coase_0.pdf [https://perma.cc/4APY-N2AY].

175. Kaplow & Shavell, *supra* note 174, at 674–75.

176. *See id.* at 669–70, 679–80 (explaining that potential defendants faced with a pro-plaintiff rule will tend to exercise undue caution).

and to view antifraud and antitrust legislation as attempts to prevent the unjust redistribution of wealth from the victims of injustice to its perpetrators. To demonstrate the difference between regulations that seek transactional justice and those that seek distributive justice, consider the prohibition against shoplifting on the one hand and the regulation that retailers clearly explain to customers the terms of their contract on the other. The former prevents the unjust flow of wealth from retailers to consumers. The second prevents that unjust flow of wealth from consumers to retailers. It would not be correct to say that the regulations are operating at cross-purposes (even if we assume that cancelling both provisions would leave retailers, as a class, and consumers, as a class, in the same position). The goal of each is transactional, not distributive, justice.

According to Kaplow and Shavell, the only proper means by which to redistribute wealth is taxation and, in particular, income taxation.[177] Although income taxation also creates economic inefficiency by disincentivizing productive economic behavior, they demonstrate that the inefficiencies created by income taxation are less than those that are created by redistributive regulation.[178]

At least one commentator explicitly relied upon the Kaplow-Shavell model in arguing that the international tax regime is an appropriate tool for redistributing global wealth, [179] and others may have done so implicitly. The problem with this analogy is that it fails to consider the different roles played by competition, taxes, and regulation on the domestic and international fronts. On the domestic front, tax is imposed by a sovereign force operating outside the market, while on the international front taxation is the subject of competition. To mimic in the international arena the role played by taxation in the domestic arena, we would need an international tax-imposing body, a model that almost no one proposes. Instead, the primary proposals call for countries to coordinate or harmonize their domestic tax policies in order to limit tax competition.[180] Despite their rhetoric, these proposals are the very antithesis of the Kaplow-Shavell model.

On the domestic front, because tax is imposed by a sovereign force operating outside the market, neutrality is an important factor in evaluating tax provisions. All else being equal, taxes that least affect behavior are preferable. On the international front, in contrast, taxes are among the means by which countries signal their desire for investment.[181] MNEs signal their preferences via their investment decisions, relying, inter alia, on the tax burdens imposed by the various countries, and, under Hayekian theory, the purpose of these signals is not only to convey information but also to induce behavior modification and cause resources to flow to their most

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177. Kaplow & Shavell, *supra* note 174, at 669 ("[A]ny regime with an inefficient legal rule can be replaced by a regime with an efficient legal rule and a modified income tax system designed so that every person is made better off.").

178. *Id.* at 677 ("Redistribution through legal rules causes the same inefficiency as taxes with regard to the labor-leisure choice . . . . [a]nd when redistribution involves choosing less efficient legal rules, additional costs are incurred.").

179. Benshalom, *How to Redistribute?*, *supra* note 1, at 327–29; Benshalom, *supra* note 135, at 3–4.

180. *See* sources cited *supra* notes 35–48.

181. *See supra* Part I.B–D.

efficient uses.[182] Restricting tax competition for the purpose of redistributing wealth is the conceptual equivalent of using regulation to achieve distributive justice. As demonstrated by Kaplow and Shavell with regard to regulation on the domestic front and as demonstrated by our previous discussion with regard to restricting tax competition on the international front, there is every reason to assume that they will prove both ineffective and inefficient.

CONCLUSION

The call to limit tax competition in the wake of globalization contains more than a hint of irony. Perhaps the two most important economic developments of the late twentieth century were globalization and the demise of the command economy. In fact, it would not be unreasonable to posit that the two developments were interrelated: increasing integration of the world's markets brought to a fore the difficulties faced by command economies in competing with market economies, and the collapse of centralized planning permitted increased integration of the world's markets.[183] As currency controls were lifted, as trade barriers were dismantled, and as technology improved, capital became more mobile and the competition for investment, including tax competition, intensified. As anyone who has taken Economics 101 knows, competition tends to reduce prices. Predictably, therefore, tax rates have decreased since the late 1980s, particularly with regard to those sources of income that are the most mobile. In an effort to prevent the diminution of tax revenues, transnational organizations, along with prominent members of the academic community, have proposed international cooperation to limit or prevent tax competition. In other words, while in the late twentieth century globalization went hand-in-hand with the demise of the command economy, during the early twenty-first century it has been accompanied by an attempt to introduce an international command structure into the tax arena by dictating the terms of agreement between countries and investors.

To achieve allocative efficiency, we must take into consideration the (positive and negative) effects of investments on the lives of people residing in potential host countries: a simple comparison of projected pretax returns is insufficient. Furthermore, the only practical means by which countries can convey information regarding local conditions and preferences and induce MNEs to factor them into their decision-making process is via the package of taxes and incentives that they offer potential investors. Instead of attempting to restrict tax competition, the international community should work towards creating an environment in which free and fair tax competition can flourish to the benefit of all.[184] Within the framework of a well-functioning competitive tax structure, the government and the residents of host countries would receive just compensation for the services that they provide.

With regard to issues of international distributive justice, attempts to restrict tax competition and, in particular, to prohibit ring fencing would prove not only

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182. *See supra* Part I.A

183. *See, e.g.*, Mark B. Baker, *Integration of the Americas: A Latin Renaissance or a Prescription for Disaster?*, 11 TEMP. INT'L & COMP. L.J. 309, 309 (1997); Melo, *supra* note 171, at 193.

184. *See supra* Part I.G.

ineffective but most likely counterproductive by preventing poor countries from competing effectively for investment and by inhibiting countries from adopting redistributive tax systems. Alleviating international poverty is indeed a pressing international concern. However, on the international front the tax system is both an ineffective and an inefficient means of achieving this goal.