The State and Tax Competition – a Normative Perspective

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Abstract

In recent decades, governments have increasingly used their fiscal policy to attract mobile capital from abroad. It can be shown that this phenomenon of tax competition puts a strain on the international fiscal system in two ways. It undermines the capacity to make autonomous fiscal choices, and it tends to exacerbate inequalities. The existing regulatory framework is not able to address these challenges. Yet, what considerations should guide our efforts for reform? This paper argues that in order to understand what is wrong with tax competition and to develop proposals for reform, we need to return to the principles that justify the state as the principal locus of fiscal control in the first place. Building on an account of the legitimacy of the state and its fiscal powers, the paper shows how tax competition is in tension with the principal objectives this account assigns to the state. It then proposes a normative response to tax competition that relies on a combination of reforming jurisdictional rules and redistribution between states.

The State and Tax Competition – a Normative Perspective

Fiscal policy is a central topic of political philosophy. Most theories of social justice turn to redistributive tax and transfer regimes in one form or another when it comes to implementing their ideal of a just society. Conversely, evaluating the justice or injustice of any particular fiscal measure in isolation does not make sense. While one can make a *pro tanto* judgement about the progressive or regressive impact of a particular fiscal measure, a judgement about its being just or not always has to be an all things considered judgement that applies to the fiscal policy of a jurisdiction as a whole.[1]

This paper focuses on an additional dimension of tax justice that has largely escaped the attention of political philosophers. Where differences exist in the tax rates and tax bases of different jurisdictions, the ensuing dynamics will raise normative questions in their own right. In recent decades, governments have started to actively compete for mobile capital through low rates and favourable regulation. Tax competition, that is, the interactive tax setting by independent governments in a non-cooperative, strategic way, has become one of the principal policy variables employed by governments to shore up the "competitiveness" of their economy – to attract capital and the jobs as well as the economic growth this capital brings in its wake.

Tax competition raises normative questions of two kinds. First, following the rationale set out in the first paragraph, one may ask how to evaluate the distributive consequences of tax competition from the perspective of one's overall theory of distributive justice. Second, one can inquire whether the current institutional structure governing fiscal interdependence between states, which is one that tolerates and even encourages tax competition, is conducive to promoting the wider goals of fiscal policy. The principal objective of this paper is twofold. It aims, first, to spell out these two normative dimensions of tax competition between states and, second, to put forward a conceptual framework designed to address them.

A project of this sort risks having the carpet pulled from under its feet if it does not provide a satisfactory account of the legitimacy of the state as the locus of substantial fiscal control. In other words, any normative judgement on tax competition between states needs to be grounded in a convincing story about why states should form part of our institutional landscape in the first place. Unsurprisingly, this is a question that political philosophers disagree about. My goal here is not to overcome this disagreement. It is rather to posit what I consider a pluralist account of the grounding of the state that rests of relatively weak normative premises, to then analyse the implications of this view for our perspective on, and our response to, tax competition.

Laying out the conceptual groundwork for justifications of the state will be the task of section 2. In section 3, I will provide a summary account of how tax competition works. Building on the role of the state set out in section 2, I will then describe in more detail the two normative challenges tax competition presents. Whereas sections 2 and 3 largely consists in weaving together existing contributions to the literature on the foundations of the state on the one hand and on tax competition on the other, section 4 aims to break new ground. Here, I will present a normative framework designed to address the problems tax competition raises.

[1] This argument is convincingly made by Liam Murphy and Thomas Nagel in *The Myth of Ownership*, Oxford: Oxford University Press, 2002. Their book is one of the rare contributions to the literature in political philosophy in recent years that goes beyond taking fiscal policy for granted as a tool of distributive justice, and provides an analysis of various economic concepts of tax equity.

1 The foundations of the state

We mostly take it for granted that states are the institutional centrepiece of our political world. Even though the modern state is a relatively recent invention, we have trouble even imagining a world without states. And yet, a plausible case can be made that states not only conserve but sometimes even promote some of the most egregious injustices. As an example, think of the way in which state borders limit mobility between countries.[2]

Before engaging in a normative evaluation of tax competition between states, it is therefore useful to ask if and how states would form part of an ideal global institutional structure in the first place. The response can then serve as normative benchmark against which to evaluate current (fiscal) practices and institutions.

Let me emphasize that I do not intend to discuss a comprehensive list of potential justifications of the state here. Instead, I will consider a mixed justification of the state that rests on what I believe to be a relatively weak normative assumption.[3] Of course, there will be people who do not share this normative assumption, and I will come back to the question of who might fall into this category further down. The normative assumption I have in mind is what Thomas Pogge calls moral cosmopolitanism. "Moral cosmopolitanism holds that all persons stand in certain moral relations to one another: we are required to respect one another's status as ultimate units of moral concern – a requirement that imposes limits upon our conduct and, in particular, upon our efforts to construct institutional schemes."[4] Pogge stresses that moral cosmopolitanism does not imply legal cosmopolitanism, that is, a global order in which people have "equivalent rights and duties."[5]

It is obvious from the above definition of moral cosmopolitanism that the role this theoretical position assigns to the state is an instrumental one. States and other institutional schemes are to be designed such that they respect the status of individuals as ultimate units of moral concern. So what is it that guarantees such respect? What are the more specific objectives that such respect translates into? In short, they are distributive justice and democratic participation. Some moral cosmopolitans appeal exclusively to the former, some concentrate on the latter. The most plausible position is a mixed view.[6] Let me explain.

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[2] For a normative assessment of international borders, see Joseph Carens, "Aliens and Citizens: The Case for Open Borders", *The Review of Politics* 49/2 (1987), 251-73.

[3] It is worth pointing out that there are also pragmatic reasons for accepting states as part of the given. Views of this kind emphasize that normative arguments with practical ambitions have to hold constant some variables to satisfy conditions of feasibility. An example for such a pragmatic perspective on the state is Jacob T. Levy, "National and statist responsibility", *Critical Review of International Social and Political Philosophy* 11/4 (2008), 485-99. Pragmatic reasons for accepting states are compatible with a variety of normative commitments, including for instance the libertarian position held by Levy.

[4] Thomas W. Pogge, "Cosmopolitanism and Sovereignty", *Ethics* 103/1 (1992), 49.

[5] *Ibid*.

[6] The distinction between distributive justice and democratic participation is inspired by what Simon Caney calls instrumental *versus* democratic principles of institutional design for cosmopolitan justice. See Simon Caney, "Cosmopolitan Justice and Institutional Design: An Egalitarian Liberal Conception of Global Governance", *Social Theory and Practice* 32/4 (2006), 725-56. Caney, too, is sympathetic to a mixed view.

a) Justice-based justifications of the state

For justice-based views, "the *sole* consideration when determining what kind of political structure is best is: 'Which best realizes the best view of justice?'"[7] *Prima facie*, it may seem counterintuitive for someone who is concerned with a distribution that respects individuals globally as ultimate units of moral concern to rely on states to attain this distribution. Actual states today are doing a lousy job at this task. However, the relevant question is a comparative one. Is there an alternative institutional structure that will do better?

Robert Goodin provides a classic formulation of the view that the best way of discharging "the general duties that everyone has towards everyone else worldwide"[8] is to partition them into special duties that states have towards their citizens.

Two kinds of objections can be raised against such a view. The first is an empirical one. Even given ideal states, rather than today's imperfect instantiations, assigning special responsibilities may not in fact be the best way to discharge global duties.[9] The second objection, by contrast, is theoretical. Purely justice-based views cannot adequately deal with pluralism. In the absence of an Archimedean point to arbitrate between different accounts of global justice, imposing one substantive view of the content and scope of global duties "can be accused of failing to show respect to other reasonable persons."[10] This latter weakness of pure justice-based views is one that democracy-based views are able to address.

b) Democracy-based justifications of the state

"[I]ndividuals must be acknowledged to have an interest in procedural control over the social institutions which shape values, goals, options and expectations."[11] Whereas justice-based approaches focus on whether individuals receive a fair share of social goods, democracy-based approaches emphasize the importance of controlling the rules that determine the distribution of social goods.

Democracy-based justifications of the state come in negative as well as positive formulations. The former see the decentralisation of power to states as a safeguard against the potential abuses of power by a world government as well as against decisions made by outsiders that are either irresponsible or insensitive to local particularities or both.[12] The focus of the latter

[7] *Ibid*., 726.

[8] Robert Goodin, "What is So Special about Our Fellow Countrymen?", *Ethics* 98/4 (1988), 681.

[9] Goodin himself makes this point against his earlier position by arguing that alternative forms of international cooperation like international organisations or NGOs provide channels to discharge global duties at a distance, and more effectively so. See Robert Goodin, "Justice in One Jurisdiction, No More", *Philosophical Topics* 30/2 (2002), 29-48.

[10] Caney, "Cosmopolitan Justice", 731.

[11] Andreas Follesdal, "Survey Article: Subsidiarity", *The Journal of Political Philosophy* 6/2 (1998), 210. Follesdal attributes the cited passage to Thomas Scanlon, "Rights, goals, and freedoms", in Stuart Hampshire (ed.), *Public and Private Morality*, Cambridge: Cambridge University Press, 1978, 102. Cf. also Caney, "Cosmopolitan Justice", 727, who notes that what he calls "the democratic approach is one example of a more general approach to institutional design, what might be termed 'procedural approaches'." He attributes the most nuanced formulation of a democracy-based view to Pogge, who he cites as stating that "persons have a right to an institutional order under which those significantly and legitimately affected by a political decision have a roughly equal opportunity to influence the making of this decision – directly or through elected delegates or representatives." (Thomas Pogge, *World Poverty and Human Rights*, Cambridge: Polity, 2008, 184, *footnotes omitted*)

[12] Cf. Andreas Follesdal, "Federal Inequality among equals: a contractualist defense", in Thomas Pogge (ed.), *Global Justice*, Oxford: Blackwell, 2001, 252 as well as Pogge, "Cosmopolitanism", 65.

explicitly lies on the value of letting people decide for themselves. The tighter the connection between those whose interests are concerned and the polity making the collective decision, the better. A tight connection of this sort is not only a value in its own right, but it will also create incentives for people to invest themselves in their political community.[13] In addition, as already highlighted by John Stuart Mill, there is a positive value in the diversity and institutional experimentation encouraged by decentralised decision making.[14]

A closer look at the arguments reviewed in the preceding paragraph reveals that they are not necessarily arguments in favour of the state, but rather for a multi-layered global governance structure that states may or may not be a part of. Political decision-making should be as centralised as *necessary* to guarantee that those whose interests are concerned have a democratic input, but beyond this constraint political decision-making should be as decentralised as *possible*.[15] Note that the need to centralise is positively correlated with the socio-economic interdependence between the respective subunits. The maxim just set out is a close relative of the principle of subsidiarity, which is frequently invoked in debates on how to organise the European Union.[16] It is also intimately connected with the federalism literature. The latter can be read as aiming specifically at balancing out the benefits and costs of autonomous sub-unit decision-making against the benefits and costs of moving them to a higher, more centralised level.[17] For lack of space, I will not discuss the literature on subsidiarity or on federalism in any detail here.

Even though democracy-based views do not specifically call for states, a plausible case can be made that the multi-layered governance structure they call for will involve entities like states. We can interpret the state as a *placeholder* for one salient level of governance that strikes a balance between addressing certain issues at as centralised a level as necessary and as local a level as possible.

Despite its obvious appeal, it is hard to think of anyone who defends a pure democracy-based view. Why? Simon Caney believes the answer lies in what he calls the "wrong priorities objection."[18] In a world in which people are starving, it would seem misplaced to establish democratic participation as the only relevant criterion to evaluate governance structures. This objection suggests that a democracy-based justification has to be complemented with some component of a justice-based justification to pass muster.

c) A mixed view and its implications for the fiscal context

Given the pros and cons of justice-based and democracy-based views respectively, several moral cosmopolitans opt for a mixed view of some sort.[19] The precise formulations of such a view vary. For the purposes of this paper, I will take a mixed view to be defined as follows. The most robust

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[13] See e.g. Jean L. Cohen, "Rethinking Human Rights, Democracy, and Sovereignty in the Age of Globalization", *Political Theory* 36/4 (2008), 589.

[14] For the last two considerations, cf. also Follesdal, "Federal Inequality", 252.

[15] I borrow this useful distinction from Pogge, "Cosmopolitanism", 65.

[16] "The principle of subsidiarity holds that an allocation of authority must satisfy a condition of *comparative efficiency*. The central unit must secure the desired outcomes better than the sub-units, due to differential ability or willingness or both." (Follesdal, "Subsidiarity", 193)

[17] Follesdal, "Federal Inequality", provides an excellent overview of the normative issues at stake here. For a survey of the literature on *fiscal* federalism, which is of particular relevance to this paper, see Wallace E. Oates "An Essay on Fiscal Federalism", *Journal of Economic Literature* 37/3 (1999).

[18] Caney, "Cosmopolitan Justice", 732.

[19] See for instance *ibid*., 733 or Pogge, "Comopolitanism", 67.

defence of the state as part of a multi-layered structure of global governance appeals to two complementary arguments. First, the state has a role to play from the perspective of distributive justice where it represents the most effective way to discharge duties of global justice – in particular those that a consensus can be reached upon in the face of pluralism.[20] Second, the state can be defended on grounds of political participation as a tool to strike a balance between necessary centralisation and desirable decentralisation.

Note two kinds of trade-offs that characterise mixed views of this kind. First, intra-value trade-offs. Depending largely on empirical matters, the state may or may not turn out to be the most suitable layer of governance to realise the goals of justice and / or of political participation. Second, there are inter-value trade-offs, that is, situations where the two values of distributive justice and political participation pull in opposite directions when it comes to determining the adequate layer of governance on a given issue. For instance, consider a scenario where democracy-based considerations recommend that state polities should be able to determine the character of their health insurance independently, whereas justice-based considerations suggest this issue be moved up to a higher, e.g. regional or global, level of governance. These trade-offs will be central to my argument in sections 2 and 3 of the paper.

Two issues remain to be addressed in this section. First, having characterised the basic features of mixed views of justifying the state, I want to add three brief comments on the mixed view defended here. Second, given the focus of this paper, it is necessary to comment on the implications of a mixed view in the fiscal context.

The first of my remarks on the mixed view defended here is negative in nature, that is, it aims to show what my argument is not. The argument presented here is about *states*, not *nations*. Considerable ink has been spilled between cosmopolitans and their critics on the question whether principles of justice can be extended from the national to the global level. Critics of cosmopolitanism maintain that there are certain features of national communities that render such an extension impossible.[21] The present paper bypasses this debate. I agree with those who believe that the focus of our attention should be on states as political actors, rather than on nations.[22]

Second, the mixed view on the legitimacy of the state has implications for the concept of state sovereignty. The justice-based component of the mixed view implies that sovereignty understood as a norm governing interstate relations is necessary limited. If one of the reasons to hand the state substantial powers of governance is to promote global justice, the resulting notion

[20] Caney, "Cosmopolitan Justice", suggests that protecting the fundamental interests of individuals is a duty of this kind.

[21] A prominent formulation of this position can be found in David Miller, *National Responsibility and Global Justice*, Oxford: Oxford University Press, 2007. For surveys of this debate between cosmopolitans and their critics, see Philippe van Parijs, "International Distributive Justice", in Robert E. Goodin, Philip Pettit & Thomas Pogge (eds.), *A Companion to Contemporary Political Philosophy*, vol.2, Oxford: Blackwell, 2007, 638-52 as well as Christian Barry and Laura Valentini, "Egalitarian challenges to global egalitarianism: a critique", *Review of International Studies* 35 (2009), 485-512.

[22] For two authors who share this opinion, consider Thomas Pogge and Jacob Levy. Writing on the question at which layer of government the power to make decisions should rest, Pogge states that "… commonalities of language, religion, ethnicity, or history are strictly irrelevant. Such commonalities do not give people a claim to be part of one another's political lives, nor does the lack of such commonalities argue against restraints." (Pogge, "Cosmopolitanism", 68) Jacob Levy notes that "[e]ven if nations *value*, they do not *decide*. Even in a democratic nation-state, the decision procedure *just is* the state…" (Levy, "National and statist responsibility", 488) He goes on to propose "that we reject any moral teleology of the basic form of political organisation." (494)

of sovereignty is one that entails not only rights, but also duties.[23] As we shall see in section 3, the duties that flow from the mixed view are either duties to promote just international institutions or duties of redistribution or both. The challenge lies in formulating a well-founded theory of what these duties are.

My third and final comment aims to highlight the *conditionality* of both state legitimacy and state sovereignty that emerges if one accepts the account of the role of the state presented above. The state is granted power for the twin reasons of promoting a minimal notion of global justice and of allowing citizens to participate politically in their respective subunits. If an actual state fails to serve these objectives, its legitimacy suffers and the foundations of its sovereignty are undermined.[24] If the state system as such fails to serve these objectives, it in turn will have to be revisited. In other words, the legitimacy of the state is conditional on its playing the role(s) assigned to it.[25] For the purposes of this paper, I bracket the question of what should happen if the antecedent of this conditional is violated. Instead, I focus on spelling out what it means for the fiscal policy of a state to play its role of promoting the twin goals of justice and participation.

This last point brings us back to the fiscal context, and to the final question of this section: If the mixed view assigns the state a role to play as part of a multi-layered governance structure, what will be its prerogatives in the fiscal context? The relevant considerations to answer this question flow directly from the two components of the mixed view defended above.

1) The democracy-based justification of the state entails that states are granted autonomy with respect to certain collective choices that concern their citizens. In fiscal matters, a stylized definition of this autonomy covers two basic choices regarding the size of the public budget (the level of revenues and expenditures) and the question of relative benefits and burdens (the level of redistribution).[26] Call this the *autonomy prerogative*.

2) The justice-based justification of the state imposes a constraint on this prerogative. While, as we have seen, a thick or substantial notion of global justice fails the test of pluralism, it is reasonably to assume that there are *some* global institutions and *some* level of deprivation that any plausible theory of global justice views as unjust.[27] This thin or minimal notion of global justice creates obligations for the state and its citizens that trump its fiscal prerogatives outlined

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[23] See Peter Dietsch, "Rethinking Sovereignty in International Fiscal Policy", *Review of International Studies*, forthcoming. Note that the limited character of sovereignty as a norm governing interstate relations is not contingent on the view of the state defended here. See Henry Shue, "Limiting Sovereignty", in J.M. Welsh (ed.), *Humanitarian Intervention and International Relations*, Oxford: Oxford University Press, 2004, 15 on this point: "Without a partially rule-governed society, there are no duties; and with no duties, there are no effective rights. This is nothing specifically to do with sovereignty but is a matter of what a right is. Thus, if sovereignty is a right, sovereignty is limited."

For another account that considers placing "restrictions on the type of effects that we allow changes in policies in one country to have on other countries", see Alexander Cappelen, "Responsibility and International Distributive Justice", in Andreas Follesdal and Thomas Pogge (eds.), *Real World Justice*, Dordrecht: Springer, 2005, 226.

[24] Such an undermining of sovereignty has to be distinguished from the earlier point about the limited character of sovereignty. Sovereignty is necessarily limited, but it is only contingently undermined.

[25] The idea of a conditional conception of sovereignty akin to the one outlined here is gaining ground notably in the literature on human rights. See for instance Allen Buchanan, *Justice, Legitimacy, and Self-Determination*, Oxford: Oxford University Press, 2004, 56.

[26] See for instance Reuven Avi-Yonah, "Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State", *Harvard Law Review* 113/7 (2000), 1573-1676.

[27] This paper explicitly brackets the question of what the threshold for these injustices should be.

under point 1.[28] In other words, this minimal notion of global justice takes priority over both the value of local (e.g. state) political participation and over the more substantial theory of justice that prevails at the local (e.g. state) level. Call this the *global justice constraint*.

In the introduction, I emphasized the importance of distinguishing two facets of fiscal policy. Fiscal policy as a means to realise local (e.g. state) autonomous political choices on the one hand, and fiscal policy as a means to promote distributive justice globally on the other. As the discussion of the mixed view illustrates, both of these facets fit under the ideal of moral cosmopolitanism. The two points just made show how the two relate to one another: Citizens enjoy the twin fiscal prerogative of choosing the size of their state budget and the level of redistribution, subject however to a global justice constraint.

The next section will show why such a detailed discussion of the foundations of the state is essential to an adequate understanding of the phenomenon of tax competition.

2 The double impact of tax competition

In order to assess its impact, it is useful to briefly review how tax competition works.[29] As already mentioned, tax competition is defined as interactive tax setting by independent governments in a non-cooperative, strategic way. For tax competition to exist there must be *fiscal interdependence*. This condition holds when the fiscal policy of one country creates externalities for other countries in the sense that it affects their tax base. Tax competition takes a variety of forms. It operates not only through lower rates, but also through the definition of the tax base, preferential tax regimes for foreigners, loopholes, or other regulative measures like bank secrecy. Due to its mobility, capital is the prime target of tax competition. Three types of capital can be distinguished to illustrate different aspects of tax competition.

First, classical tax havens target individual or corporate portfolio capital through a combination of low or even zero rates with legal provisions like bank secrecy or trusts. The latter make it impossible for the revenue agencies entitled to tax the capital in question to trace it. Tax evasion of this kind is obviously illegal, which makes it hard to come up with reliable estimates of the magnitude of these activities. However, the figures that do exist suggest that it is significant.[30]

Second, governments use their fiscal policy to attract real investment from multinationals. This can be done either through a low corporate tax rate or by creating so-called preferential regimes for foreign corporations (‘ring-fencing’), which has the advantage of protecting the revenue stream from domestic firms. Ireland is a classic example for a country that had a preferential tax regime for a long time, and as a result benefited from a large inflow of foreign

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[28] See the discussion of the wrong priorities objection by Caney in footnote 18.

[29] Given the objectives of this paper, this review will be brief. For a comprehensive discussion, see Avi-Yonah, “Globalization” as well as Thomas Rixen, *The Political Economy of International Tax Governance*, Basingstoke: Palgrave MacMillan, 2008. My discussion of tax competition in the next four paragraphs is closely modelled on Peter Dietsch and Thomas Rixen, “Justice and International Tax Competition”, 3rd draft.

[30] Estimates for the annual revenue loss to governments from this kind of tax competition range between 155 and 255 billion USD. See Jeffrey Owens, “Written Testimony of Jeffrey Owens, Director, OECD Center for Tax Policy and Administration before Senate Finance Committee on Offshore Tax Evasion, 3 May 2007,” http://finance.senate.gov/imo/media/doc/050307testjo1.pdf, accessed 7 January 2011; Tax Justice Network, *Tax Us If You Can. The True Story of a Global Failure* (2005), http://www.taxjustice.net/cms/upload/pdf/tuiyc_-_eng_-_web_file.pdf, accessed 7 January 2011.

direct investment.[31] Foreign direct investment obviously depends on a number of other factors, too, like the quality of infrastructure and of human capital. Yet, empirical studies confirm that fiscal policy plays an important role. In practice, multinationals frequently "shop around" for a favorable tax arrangement among a number of potential locations that satisfy their business needs.[32]

Third and finally, there is competition for so-called paper profits. Multinationals are able to shift profits from high-tax jurisdictions to low-tax jurisdictions by using a number of techniques.[33] Since these possibilities allow multinationals to reduce their tax bill without actually relocating business activities, they are thought to reduce the competition for real investment discussed under the previous point. Estimates for the magnitude of this type of tax competition are hard to come by, but the fact that 60% of international trade is intra-firm suggests that it is significant.

So much for a brief overview of how tax competition works. Against this background, I will now argue that the phenomenon of tax competition interferes with the state in fulfilling *both* of the fiscal roles assigned to it at the end of section 1. First, tax competition undermines the autonomy prerogative through a downward pressure on tax rates on mobile capital, thereby reducing government revenues.[34] Moreover, this process tends to result in a more regressive fiscal regime, which is not necessarily in line with citizens' preferences concerning the level of redistribution. Second, tax competition is in conflict with the global justice constraint, since it exacerbates inequalities between individuals globally.[35] Let us look at these influences in somewhat more detail.

The impact of tax competition on the *autonomy prerogative* is both predicted by economic theory and corroborated by economic practice. Economic theory predicts a so-called "race to the bottom" in capital taxation and, as a consequence, the under-provision of public goods in all jurisdictions.[36] While both corporate tax rates and rates on the top income tax

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[31] See *The Economist*, "A survey of Ireland", 16 October 2004.

[32] See Ronen Palan, "Tax Havens and the Commercialization of State Sovereignty", *International Organization* 56/1 (2002), 151-76.

[33] Transfer pricing and thin capitalisation are two prominent examples. Under transfer pricing arrangements, the subsidiary in the high-tax country will buy goods or services from the subsidiary in the low-tax country, thereby shifting profits to the latter. Thin capitalisation occurs when the high-tax subsidiary takes out a loan from the low-tax subsidiary, in order to then deduct the interest from its tax bill. OECD and WTO regulations exist for these practices, but they are notoriously hard to enforce. For a survey, see Michael P. Devereux, "The Impact of Taxation on the Location of Capital, Firms and Profit: A Survey of Empirical Evidence (with Data Appendix by Giorgia Maffini)," Working Paper, University of Warwick (2006).

[34] As Genschel and Rixen point out, the rules of today's international double tax treaty regime – originally designed to avoid double taxation – are central in facilitating tax competition and in undermining what they call fiscal autonomy, which corresponds to the autonomy prerogative in this paper. See Philipp Genschel and Thomas Rixen, "International Tax Cooperation and National Tax Sovereignty", paper prepared for the conference 'Market Making and Market Shaping in the Global Political Economy', Open University Hagen, December 2005.

[35] For an analysis of the impact of tax competition on inequality, see Peter Dietsch, "Tax competition and its effects on domestic and global justice", in Ayelet Banai, Miriam Ronzoni, Christian Schimmel (eds.), *Social Justice, Global Dynamics: Theoretical and Empirical Perspectives*, Routledge: London, 2011 as well as Thomas Rixen, "Business Tax Competition and Inequality – The Case for Global Tax Governance", *Global Governance: A Review of Multilateralism and International Organizations* 16, in print.

[36] See e.g. John D. Wilson and David E. Wildasin, "Capital Tax Competition: Bane or Boon", *Journal of Public Economics* 88/6 (2004), 1069-70.

brackets have fallen across OECD countries over the last 30 years,[37] they have clearly not hit rock bottom. The explanation for this discrepancy from the predictions of economic theory lies in the way these countries have reacted to tax competition. They have broadened the tax base, mainly to immobile factors like consumption and labour, and have thus been able to prevent a significant loss of revenue. However, this fiscal policy response has a regressive effect. It shifts the tax burden from capital to labour, from direct taxation on revenue to indirect taxation on consumption, and from high-incomes to low-incomes. One way to assess this development, then, is to say that OECD countries have bought fiscal stability in terms of revenue at the cost of a less redistributive system. In other words, they have bought the first element of their autonomy prerogative (the size of the public budget) at the price of the second (the level of redistribution).

Note that the situation in developing countries differs slightly. While the pressures tax competition exercises on the public purse are parallel to those in developed countries, developing countries usually do not have the administrative resources to stabilize their revenues by broadening the tax base. As a result, what we observe in developing countries is closer to the economic prediction of a race to the bottom.[38] Here, tax competition undercuts both elements of the autonomy prerogative. By putting downward pressure on rates on mobile capital, it dents revenues. Meanwhile, the feeble attempt to shore up government finances usually falls on the poor through regressive taxes on consumption or labour. The public budget shrinks and the level of redistribution falls.

This brings me to the relation between tax competition and the *global justice constraint*. First, even in the absence of the asymmetry between rich and poor countries just discussed, the mere fact that tax competition encourages more regressive tax regimes means that it has adverse consequences for the poor in developing countries. Provided, which is very plausible, that the poor in developing countries fall under the threshold that triggers the global justice constraint as set out at the end of section 1, tax competition is in conflict with this constraint. Second, note that the asymmetric impact of tax competition on rich *versus* poor countries exacerbates this conflict further. Developing countries are deprived of government revenues vital to fight extreme poverty.[39]

The principal upshot of this analysis is, once again, that tax competition undermines both of the pillars of state legitimacy in fiscal matters. It makes states less responsive to the political preferences of its citizens in terms of the size of the state budget and the desired level of redistribution, which is in tension with the autonomy prerogative; and it exacerbates inequalities both within states and across borders, thereby violating the demands of the global justice constraint. The question that arises at this point is what should be done about this. What should the institutional response to tax competition be?

There are two kinds of possible responses. First, one may consider the aforementioned arguments sufficient to call for abandoning the state altogether. Advocates of such a position are likely to believe that moral cosmopolitanism in fact requires legal cosmopolitanism, that is, a

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[37] In OECD countries, nominal corporate tax rates have fallen from an average of around 50% in 1975 to an average below 30% in 2005. Over the same period, nominal top income tax rates have fallen from around 70% to well below 50%.

[38] See for instance Christian Aid, *Death and Taxes: The True Toll of Tax Dodging* (London: 2008), http://www.christianaid.org.uk/images/deathandtaxes.pdf, accessed 7 January 2011.

[39] It is another, and important, question whether the governments of developing countries *actually* use their public funds to this end. For the purposes of the present paper, I limit myself to the claim that tax competition partially deprives them of the *capacity* to do so.

world state.[40] Second, one may argue that states should instead be reformed in order to restore legitimacy. The rationale of the latter approach has been discussed in section 1. The mixed view of the legitimacy of the state based on considerations of both political participation and justice suggests that an intermediate level of governance akin to states is inevitable. If this is so, then the best we can hope for is an institutional design that fulfils the conditions of state legitimacy. More specifically, restoring state legitimacy in a world of tax competition requires institutional reform to regulate the latter such that fiscal policy respects the autonomy prerogative and the global justice constraint. The last section of this paper sketches the principal outlines of such institutional reform.

3 A two-pronged normative response to tax competition

Recall the two facets of fiscal policy distinguished in the introduction: Fiscal policy as a means to realise local (e.g. state) autonomous political choices on the one hand, and fiscal policy as a means to promote distributive justice globally on the other. The mixed view discussed in section 1 illustrates how these two facets relate under the ideal of moral cosmopolitanism: Citizens enjoy the twin fiscal prerogative of choosing the size of their state budget and the level of redistribution, yet this prerogative is subject to a global justice constraint. Section 2 showed how tax competition undermines both the autonomy prerogative and the global justice constraint. As we shall see now, the normative response to tax competition again reflects both of these facets.

I shall argue in this section that an adequate response to tax competition will rely on both a jurisdictional component and a redistributive component.[41] This may suggest that the former serves to guarantee the autonomy prerogative, while the function of the latter is to satisfy the global justice constraint. While this does reflect the relative emphasis of the two components, I will show that this perception is simplistic and misleading.

The section is divided into two parts. First, I will define and explain the jurisdictional and redistributive components of the normative response to tax competition. In a second step, I will make a series of observations on this normative account of international taxation and on how it relates to other contributions to the literature. I should emphasize that this section has the character of a research programme rather than of a fully developed normative account of international taxation. While the distinction between the jurisdictional and the redistributive component outlines the *structure* I believe our normative response to tax competition should take, I do not elaborate here on the substantive principles that constitute these components.[42]

Let me begin by discussing the *jurisdictional component*. As shown in the last section, tax competition undermines the autonomy prerogative. By setting its taxes strategically to attract capital from abroad, a state in effect depletes the tax base of other countries. However, note the following complication. Even in the absence of strategic tax setting, the diversity of tax regimes is a sufficient condition to ensure that the fiscal policy of one country creates externalities for the citizens of other countries. Suppose the citizens of country A, say, Sweden, have a preference for

[40] See Pogge, "Cosmopolitanism", 49 as well as Follesdal, "Federal Inequality", 242 for a consideration and rejection of this view. The reasons for rejecting such a position overlap with the reasons for rejecting a pure justice-based justification of the state – see section 1.

[41] One constructive way to conceive of these components is as duties that states have to respect in their fiscal policy. See also my remarks on sovereignty at the end of section 1.

[42] This lies beyond the scope of this paper. For a substantive account on the jurisdictional component, see Peter Dietsch and Thomas Rixen, "Justice and International Tax Competition".

a larger state with a higher level of redistribution that the citizens of country B, say, the United Kingdom. Sweden accordingly taxes high-income earners as well as corporations at a higher rate than the UK does. As a consequence, there will exist an incentive for the owners of part of the Swedish tax base to shift their capital to the UK through the various mechanisms described in section 2. In an economically and fiscally interdependent world, such spill-over effects of the fiscal policies of one country to others are simply inevitable. From this perspective, it would seem wrong to condemn *all* types of migration of tax base between countries. The crucial question then becomes which portion of fiscal interdependence should be considered benign from a normative viewpoint, and which portion should be condemned as problematic. *Prima facie*, it is not clear that the latter category will necessarily be identical in scope with tax competition as defined above.

The analogy with individual liberty is instructive here. Individual liberty is protected at the maximum level compatible with guaranteeing the same liberty for everyone else. This does not imply that all actions that have an effect on others are off limits. Such a demanding criterion would make life in society rather difficult. What it requires instead is a definition of where that maximum level of liberty compatible with the same liberty for others lies.

The challenge in the fiscal context is a parallel one. What is needed are jurisdictional rules that allow us to distinguish normatively benign fiscal interdependence from normatively problematic kinds of tax setting, where the latter will presumably include at least some forms of strategic tax setting and therefore tax competition. These jurisdictional rules define the precise boundaries of the autonomy prerogative.

A particularly useful way of conceiving of the jurisdictional rules invoked here is as "standards for assessing the ground rules and practices that regulate human interactions."[43] They are not principles that apply directly to the actions of economic or fiscal agents, but ones that should govern the fiscal structure under which these agents operate. Phrased to fit the context of tax competition, they are not principles that will tell individuals or corporations which kinds of capital shifting are legitimate and which are not. Instead, they are second-order principles that inform the institutional design and constraints under which states set their fiscal policy and under which, ultimately, individuals or corporations face a certain set of incentives to shift their capital from one country to another.

I will now turn to the *redistributive* component of the normative response to tax competition. Under certain conditions, so I will argue, states have an obligation to redistribute part of their tax base to other states. To help our understanding, two scenarios can be distinguished here:

a) *The autonomy prerogative is violated by tax competition practices*.[44] In other words, the jurisdictional rules just discussed are either not well defined or defined but not respected. As we have seen in section 2, tax competition tends to exacerbate inequalities both within countries and globally between the developed world and developing countries. In the

[43] See Pogge, "Cosmopolitanism", 50. Both Pogge and, more recently, Ronzoni (2009) put forward institutional or background conceptions of justice. The ultimate inspiration for both of their accounts lies in Rawls' notion of the basic structure of society. Ronzoni explicitly discusses tax competition as an example for a context where her concept of background justice is particularly relevant. See Miriam Ronzoni, "The Global Order: A Case of Background Injustice? A Practice-Dependent Account", *Philosophy and Public Affairs* 37/3 (2009), 229-56. Note that in the present paper, the standards for assessing the ground rules have explicitly been both standards of justice and of autonomy. As mentioned before, I follow Caney, "Cosmopolitan Justice" in this respect.

[44] Under this scenario, whether or not the global justice constraint is respected is irrelevant.

absence of the first-best solution when faced with a violation of the autonomy prerogative – which would be multilateral or global reform and proper enforcement of jurisdictional rules – states incur an obligation to correct for the additional inequalities their tax competition practices generate.[45]

Why should redistribution play this role of a default obligation when institutional reform is not feasible? The answer is straightforward. While the reform of jurisdictional rules requires a multilateral if not global effort of cooperation, redistribution is unilaterally possible.

Someone might object that instead of an obligation to redistribute to correct for inequalities generated by tax competition, it would make more sense to simply require states to disengage from tax competition practices in the first place. Such a step is unilaterally possible, and therefore not subject to the feasibility constraint of jurisdictional reform. This is indeed an alternative, but note that it is more demanding than the present proposal. Whereas the redistributive obligation put forward here asks states to correct for their share of contributing to a collectively suboptimal practice, an obligation to unilaterally desist from tax competition in effect requires them to pick up the slack for the other states' unwillingness to reform.[46] A state that unilaterally disengages from tax competition would pay a price in terms of capital outflow that is likely to be higher than the compensation for inequalities generated by its tax competition practices required here.

b) *The autonomy prerogative is respected, but tax competition violates the global justice constraint*. In other words, despite the existence and enforcement of adequate jurisdictional rules, the inequalities created by residual tax competition practices are problematic from the viewpoint of a minimal notion of global justice.[47] Under this scenario, the countries benefiting from these inequalities have an obligation to compensate the countries that lose out due to tax competition.[48]

It is worth mentioning that a redistributive obligation that arises from a violation of the global justice constraint can of course be due to factors other than tax competition. There are other potentially unjust institutions, or levels of deprivation that no one can be held responsible for, that trigger redistributive obligations. When we say that a state has a redistributive obligation to another state due to practices of tax competition, this does not imply that this particular obligation exhausts the redistributive obligations this state might have.

Having analysed the jurisdictional and the redistributive component of a normative response to tax competition, I should point out that some instruments of fiscal policy blur the line between the two. This can happen for instance in situations where states share a given tax base. One prominent example for such an arrangement is the so-called Unitary Taxation with

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[45] The benchmark for this compensation is the hypothetical situation in which the autonomy prerogative is respected. Determining the level of compensation raises important measurement problems. I bracket these here. The same caveat applies to scenario b) below.

[46] In this sense, my proposal here can be viewed as a fair share theory. See Liam Murphy, "The Demands of Beneficence", *Philosophy and Public Affairs* 22/4 (1993), 267-292.

[47] As already mentioned, I presuppose here that there are forms of tax competition that do not violate the autonomy prerogative. For a view that disagrees with this assumption, see Peter Dietsch and Thomas Rixen, "Justice and International Tax Competition".

[48] For simplicity, I do not treat separately the special case where tax competition *exacerbates* an already existing violation of the global justice constraint.

Formulary Apportionment for taxing multinational enterprises.[49] Under this regime, the accounts of multinationals are consolidated across countries, before a formula is used to assign participating states the right to tax certain shares of the consolidated activity.[50] Potential formulae to determine these shares are based on factors like the sales, payroll, and assets of a multinational in a given country. To illustrate, suppose the formula determines that 45% of the relevant activity of Toyota takes place in Japan. Then Japan has the right to tax 45% of Toyota's consolidated profits at whichever rate it sees fit.

It is easy to see how a redistributive element can be introduced in a consolidated tax base of this kind. If one is preoccupied with inequalities between the developed *versus* developing world, for instance, it is possible to introduce a factor into determining the shares states have a right to tax that is inversely correlated with per capita income.[51] A similar mechanism could be used to spread the benefits of natural resources more evenly across the globe.[52] In both cases, the fiscal measures in question are hybrids in the sense that they combine jurisdictional and redistributive elements.

This concludes the first part of this section. The remainder of the paper is dedicated to a series of observations about the merits of the two-pronged normative response to tax competition just laid out.

1) As mentioned at the beginning of the section, it may be tempting to conceive of jurisdictional reform as the fix for violation of the autonomy prerogative, while redistribution represents the response to violation of the global justice constraint. While this is partly correct, this impression is misleadingly incomplete. The following table relates the content of the three sections of this paper to show how the normative responses to tax competition map onto the challenges this practice poses.

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[49] See e.g. Kimberly A. Clausing and Reuven Avi-Yonah, "Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment", The Hamilton Project, Brookings Institution, 2007, http://www.brookings.edu/~/media/Files/rc/papers/2007/06corporatetaxes_clausing/200706clausing_aviyonah.pdf, accessed 7 January 2011.

[50] The European Union is currently debating the introduction of a consolidated tax base for multinationals. For more information, see http://ec.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/index_en.htm, accessed 7 January 2011.

[51] Richard A. Musgrave & Peggy B. Musgrave discuss this possibility in "Inter-nation equity", in Richard M. Bird and John G. Head (eds.), *Modern Fiscal Issues – Essays in Honour of Carl S. Shoup*, Toronto: University of Toronto Press, 1972, 74.

[52] See for example Pogge and Steiner on the idea of a global resource fund. Thomas W. Pogge, "An Egalitarian Law of Peoples", *Philosophy and Public Affairs* 23/3 (1994), 195-224; Hillel Steiner, *An Essay on Rights*, Oxford: Blackwell, 1994.

Table 1

Mixed justification of the state (section 1)		Justice-based	Democracy-based
Impact of tax competition (section 2)		**Violates global justice constraint**	**Violates autonomy prerogative**
Normative response to tax competition (section 3)	Jurisdictional component	Side-effect	Principal remedy
	Redistributive component	Principal remedy	Default obligation

Two complementary insights can be read of this table in conjunction with the argument presented thus far. First, each of the components of the normative response to tax competition in fact addresses, or at least can address, the violation of *both* the autonomy prerogative *and* the global justice constraint. While jurisdictional reform represents the *principal remedy* for shoring up the autonomy prerogative, it is bound to curtail tax competition to some extent and therefore likely to have the *side-effect* of dampening global inequality. While redistribution represents the *principal remedy* to address the violation of the global justice constraint, I have argued that it should also serve as a *default obligation* where the required jurisdictional reform proves elusive.

Second, given that both fixes to tax competition address both of the challenges it raises, one may be forgiven to think that exclusively relying on one of them may be sufficient. This is not so, albeit for different reasons in the two cases. Consider a proposal to deal with tax competition exclusively through redistributive measures. Such an approach ignores the counterproductive effect that unsatisfactory jurisdictional rules have on the inequalities one tries to correct for. This is like swimming against the current when the calmer waters a few feet across would require much less of an effort to achieve the same goal. If jurisdictional reform were implemented, the exacerbating effect of tax competition on inequalities would be reduced, and less redistribution would be necessary.[53] There is a further potential danger in neglecting the jurisdictional component. Doing so risks obscuring the fact that all those who participate in an institutional regime that lacks legitimacy incur a negative duty to push for reform.[54]

Conversely, consider a proposal to rely on the jurisdictional component alone. As we have seen, reforms of this sort require multilateral agreement, which is usually (even) harder to come by than a unilateral decision to redistribute. For reasons of feasibility, then, it is prudent to complement efforts for jurisdictional reform with redistributive measures to pick up the slack in the short term.

2) My second observation concerns a question that is vigorously debated by global justice theorists. Which inequalities, and of what magnitude, are compatible with a just world order? Let me give some indication as to where the position defended here stands on this issue. I wish to make two points here. The first identifies a kind of inequality that is in principle compatible with

[53] Unfortunately, an exclusive focus on redistribution is more common than one may think. Consider the following statement by Angel Gurria, Secretary-General of the OECD: "Developing Countries are estimated to lose to tax havens almost three times what they get from developed countries in aid." (Angel Gurria, "The global dodgers", *The Guardian*, 27 November 2008. Cynics about development aid may take this as confirmation of the fact that the developed world does not really take an interest in economic convergence. However, one does not have to be a cynic to agree that pursing a policy of redistribution in the face of heavily biased jurisdictional rules is a Sisyphus task.

[54] This point is emphasized by Pogge, "Cosmopolitanism", 52.

my normative framework. The second adds the qualifier that our current world is far removed from the conditions necessary for this compatibility to obtain in practice.

The democracy-based component of the mixed justification of the state presented in section 1 values autonomous local decision-making and, in the fiscal context, gives rise to the autonomy prerogative of section 2. Under this prerogative, the citizens of a state may, for a variety of reasons, adopt policies that will raise their standard of living above that of individuals elsewhere. They may for instance have a higher-than-average propensity to save and invest, or they may simply come up with a particularly efficient design for their public institutions. In principle, the inequalities that flow from such collective choices are legitimate.

However, following the lead of contemporary liberal egalitarianism and its position on legitimate inequalities between individuals, while we want to hold states accountable for their choices, we do not want to hold them accountable for circumstances that lie beyond their control.[55] Two types of circumstances seem particularly relevant in the present context. First, the international fiscal regime is, by and large, beyond the control of individual states. If tax competition in combination with inadequate jurisdictional rules introduces the kinds of bias into this regime that were discussed in section 2, then, in the absence of jurisdictional reform, some people will have to be compensated for the undeserved inequalities this bias generates. Second, past injustices and their effects should equally count as circumstances that call for compensation.[56] Since both institutional bias and past injustices are very common, the resulting redistributive duties put an important constraint on the extent the choices of today's states can give rise to legitimate inequalities.

3) Distinguishing the jurisdictional and redistributive component of our response to tax competition potentially has the following advantage. Global redistributive efforts today, mainly channelled through development aid, present the relation between rich and poor countries largely as one of charity. This perspective suggests that rich countries are not directly at fault for the deprivation elsewhere. It allows them to feel good about themselves, even if they also have reason to feel bad about not giving enough. Taking seriously the jurisdictional component, by contrast, implies attributing a negative responsibility to rich countries for participating in, and perpetuating, a set of ground rules that are blatantly unjust. From this viewpoint, mere redistribution, though it may represent a default obligation in the absence of jurisdictional reform, is decidedly not enough. In order to put jurisdictional reform on the political agenda, the first task is one of communication. Those who are disadvantaged by the *status quo* need to understand how the bias against them operates in order to formulate effective arguments for reform.

4 Conclusion

The aim of this paper has been to ground our understanding and regulative response to the phenomenon of tax competition in a normative account of the state and its fiscal powers. The argument has proceeded in three steps.

[55] For an illuminating discussion on the choice-circumstance distinction applied internationally, see Cappelen, "Responsibility", 218 ff.

[56] As an example, consider the following anthropological argument. If developing countries today have difficulties in creating a functional fiscal regime, one cause lies in the arbitrary and brutal way in which colonial powers introduced the idea of taxation to many of these societies. If your first contact with taxation presents itself as the choice between paying a tribute and having your hand cut off, the resulting mistrust of the state and of taxation is very hard to undo. I thank my colleague Bob White for this example.

First, I have analysed the fiscal implications of a mixed justification of the state that appeals to the values of distributive justice and political participation. According to this view, while the polity of a state enjoys the twin fiscal prerogative of determining the size of the state budget and the level of redistribution, this *autonomy prerogative* is subject to a *global justice constraint*. The latter requires that the fiscal policy of a state – and the externalities this policy generates for individuals elsewhere – respect a minimal conception of global justice.

Second, I have demonstrated that tax competition directly undermines both facets of fiscal policy. In other words, it violates both the autonomy prerogative and the global justice constraint.

Third, I have argued that understanding this double impact of tax competition is important for formulating an adequate normative response to tax competition. On the one hand, tax competition needs to be regulated by jurisdictional rules that protect the autonomy prerogative. Such regulation is bound to also mitigate the exacerbating effect tax competition has on inequalities. On the other hand, the effects of tax competition should be compensated for by redistribution between states. If jurisdictional rules are adequate, this compensation exclusively serves to respect the global justice constraint. If jurisdictional rules are inadequate, it represents a form of redress for the unjust bias they contain. While I have emphasised the importance of combining the jurisdictional and redistributive components of our normative response to tax competition, I have not addressed in this paper the substantive principles they call for.