

Tax Competition and Global Background Justice

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Abstract

In a globalized economy states compete for mobile tax bases. This tax competition undermines the fiscal self-determination of states and exacerbates inequalities of income and wealth both within countries and across borders. The paper provides a normative evaluation of the rules governing international tax competition. We put forward two principles of international taxation designed to both protect and circumscribe the fiscal self-determination of states. First, a membership principle which holds that deriving the benefits of membership in any given country grounds an obligation to pay one's taxes there. Second, an intentionality principle which states that any tax policy change is legitimate only if it would still be pursued in the counterfactual situation where the benefits of this move in terms of inflowing capital were absent. We then consider how the two principles can be implemented and propose to establish an International Tax Organization (ITO). This organization would have to be assigned institutional capacities very similar to those of the WTO in governing international trade. Finally, we show that our principles, despite being anchored in the fiscal self-determination of states, are compatible with a cosmopolitan position on global justice. They are principles of background justice in the sense that they define the rules of the game required for an international tax regime free of unjust bias.

Keywords: Tax Competition, Global Justice, Background Justice, Self-determination, Institutional Design, Multi-level Governance.

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A globalized economy raises intricate questions of distributive justice. Some of these have come under scrutiny in the literature. Under what conditions can international trade be regarded as respecting norms of fairness? Are wages at the subsistence level a necessary step on the path to growth or a form of exploitation? Who does and who should benefit from the profits generated by the exploitation of natural resources?¹ Yet, one important determinant of global justice, namely questions of international taxation, has received little attention in the philosophical debate.² While the importance of taxation as a means to implement *domestic* public policy and conceptions of justice is widely acknowledged – and indeed often taken for granted – issues of *international* tax justice are mostly neglected. Tax competition between states puts pressure on domestic fiscal regimes. Mobile factors of production have the opportunity to “shop around” to minimize their tax burden. This interdependence of national tax regimes generates external effects that undermine the *de facto* sovereignty of states. As a consequence, tax competition tends to exacerbate inequalities of income and wealth both within countries and across borders.

One way to address these issues is to condemn the distributive outcomes and to propose redistributive policies to correct what are perceived to be unjust inequalities. This approach is largely remedial. A second possibility is to examine the rules of the game of international taxation themselves, and make sure they do not contain any unjust bias. This approach, which is geared towards the prevention of distributive injustice in the first place, is the approach favored here. To

¹ See e.g. {Kurjanska, 2008 #3925;Risse, 2007 #3922}{Wenar, 2008 #3924}{Pogge, 2005 #3926}

² There are, however, contributions from lawyers and economists discussing normative principles of international taxation, see e.g. {Musgrave, 1972 #690;Vogel, 1990 #109;Avi-Yonah, 2006 #931}. One exception in the philosophical literature is {Cappelen, 2001 #3793}.

what extent does the fiscal interdependence between countries call for a normative interdependence in the form of obligations towards other countries that governments have to respect in their fiscal policy? How can we delineate legitimate fiscal interdependence from illegitimate tax competition? These are the questions that motivate this paper. They target the conditions of *international background justice* that need to be met to guarantee rules of international taxation that are free from any unjust bias.³

The core of the paper consists of two principles of international taxation designed to both protect and circumscribe the fiscal prerogatives of the state.⁴ First, a membership principle which holds that deriving the benefits of membership in any given country grounds an obligation to pay one's taxes there. Second, an intentionality principle which states that any lowering of national tax rates is legitimate only if it would still be pursued in the counterfactual situation where the external benefits of this move in terms of inflowing capital were absent.

The paper is structured as follows. In a first step, we sketch the impact of tax competition on the *de facto* sovereignty of states as well as on social inequalities in order to explain why tax competition in its current form is a case of background injustice and should thus be on the radar of theories of justice (section 1). The central part of the paper then lays out the membership and intentionality principles (section 2). In section 3 we address the question of how these principles

³ See {Ronzoni, 2009 #3958}. The idea of background justice is discussed in detail in section 4 of the present paper.

⁴ Note that we only consider income taxes, so-called direct taxation. This is the area where tax competition is fiercest. We do however also consider the effect of income tax competition on the structure of tax systems, e.g. the mix of direct and indirect taxes. Given that direct taxes are most sensitive to tax competition, one may think that the easiest way to solve these issues is to rely more or solely on indirect taxes. This would however have adverse distributive consequences. See section 2.

could be implemented. We propose the establishment of an International Tax Organization (ITO) after the model of the World Trade Organization (WTO). We also endorse unitary taxation with formulary apportionment (UT+FA) as a reform of corporate taxation. Section 4 considers and rejects the potential objection that our account is incompatible with defending a cosmopolitan theory of global justice. Furthermore, it elaborates on the normative status of our account as one of international background justice. Section 5 concludes.

1. How Tax Competition Undermines Fiscal Self-Determination

In this section we show that tax competition leads to policy changes that have not been legitimately chosen by the states involved, but were forced upon them by external competitive pressures. In other words, tax competition undermines the self-determination of states. We first explain what fiscal self-determination entails and then how tax competition undermines it.

The Content of Fiscal Self-Determination

In order to establish the fiscal prerogatives of the state, it is useful to step back and consider what the purpose of taxation is. Among other things, it is needed in order to finance public goods.⁵ Due to collective action problems their provision generally requires a central enforcement institution, the state. Therefore the prior public good paid for by taxes is the state itself. The state can be viewed as a complex exchange between individuals in order to supply themselves with the public goods necessary to pursue their individual life plans. Under pluralism of conceptions of the good life, the legitimacy of the state is generally grounded in a democratic form of government, where those subject to the coercively enforced rules of the state are also the authors of these rules.

⁵ Other objectives of taxation include the redistribution of income and wealth as well as the setting of incentives or disincentives for certain kinds of economic behaviour.

Importantly, for the purposes of the present section, we take it for granted that polities should be granted considerable autonomy in designing their state institutions.⁶ In the fiscal context, a stylized definition of collective self-determination entails two basic choices concerning the size of the public budget (level of revenues and expenditures) and the question of relative benefits and burdens (extent of redistribution). While there are certainly many different views on how these two evidently interdependent choices ought to be made, there is widespread agreement that they constitute the fiscal prerogatives of the state.⁷ This is the substantive content of fiscal self-determination or tax sovereignty.

Three points are worth mentioning. First, we make the simplifying assumption that governments perfectly track their citizens' preferences.⁸ We acknowledge that this is an unrealistic assumption, since government preferences often are the result of rather messy and conflictual political processes, in which different groups of citizens pursue different interests. It is, in reality, not necessarily true that differences in political preferences *within* the polity of a state are less important than differences *between* polities.⁹ Second, a distinction needs to be made between *de jure* and *de facto* tax sovereignty. As will become clear in the next subsection, effective self-determination in fiscal matters requires the latter. Third, self-determination is not to be under-

⁶ We discuss the normative foundations of the (fiscal) self-determination of states in section 4. This organisation of the paper reflects our emphasis on the *content* of the fiscal prerogatives of the state in an economically interdependent world. While the normative foundation of the state itself has to be addressed in this context, it is not at the heart of this paper.

⁷ {Cf. e.g. \Avi-Yonah, 2000 #516;Dietsch, 2008 #3637}

⁸ For a discussion of the problems associated with this assumption see {Cappelen, 2005 #3927@ 220-22}.

⁹ Such situations raise questions about a possible reorganisation of the boundaries of states or of secession. See for instance {Buchanan, 2004 #3639}

stood in absolute terms. Instead, effective protection from illegitimate interference by other states requires limits on self-determination. Spelling out these limits lies at the heart of this paper.

The Consequences of Tax Competition

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 is met if tax bases are sensitive with respect to tax law differences, so that there is an effect of governmental actions on the allocation of mobile tax bases among jurisdictions. Tax base mobility must be legally possible and it must actually occur.¹⁰ Favorable tax conditions to attract foreign capital can be brought about in various ways, such as a reduction in tax burdens (be it by reducing tax rates or defining tax bases in favorable ways), fashioning preferential tax regimes for foreigners, or creating (or not closing) tax loopholes, e.g. through implementing bank secrecy rules or a lax enforcement of existing rules.

Tax competition primarily targets capital, which is mobile internationally.¹¹ Governments use different strategies and tax instruments depending on the kind of capital targeted. Three kinds of capital can be distinguished. First, in the area of portfolio capital of individuals and firms, so-called tax havens often have low or zero tax rates. More importantly, they offer strict bank secrecy rules as well as certain legal constructs such as trusts that enable individuals to hide their ownership vis-à-vis tax administrations in their state of residence. While it is hard to come up with reliable figures since tax evasion is illegal, the available evidence suggests that there is a real

¹⁰ {Wilson, 2004 #571@ 1065-6}

¹¹ In general, labor is quite insensitive to tax differentials and thus the fundamental requirement of fiscal interdependence is hardly met. However, this is not true for certain high-skilled segments of the labor market. We bracket tax competition for labor here.

effect of these policies. Estimates of the worldwide yearly revenue losses to government coffers range from 155 to 255 Billion USD.¹²

Second, governments compete for foreign direct investment (FDI) in the form of real business activity, e.g. location decisions of multinational enterprises (MNEs). These business decisions depend on various factors such as the level of education, the costs of labor, and the quality of the infrastructure. But the effective tax burden also plays a role. Empirical studies come to the conclusion that raising taxes decreases the inflow of foreign direct investment. However, the direction and strength of the correlation is strongly affected by the method of measurement and the kinds of tax rates investigated.¹³ In their quest to attract foreign direct investment, governments may either lower the general business tax rate or they can engage in designing so-called preferential tax regimes, which grant tax advantages to foreigners only (ring fencing).

Third, there is competition for so-called paper profits. Through various techniques, such as transfer pricing (especially of intangible assets) and thin capitalization, MNEs can assign profits made in high-tax countries to their subsidiaries in low-tax countries without relocating real business activity.¹⁴ Despite different approaches, all empirical investigations into this issue come to the same conclusion: the transfer of taxable profits is very sensitive to taxation, and companies make ample use of these possibilities. The decisive factor to attract mobile profits is the nominal tax rate, because companies shift only those profits that cannot be offset against depreciation and

¹² {Owens, 2007 #2749; Tax Justice Network (TJN), 2005 #1831}

¹³ {de Mooij, 2008 #3635}

¹⁴ For a description of these and other techniques of shifting paper profits, see e.g. {}, 1995 #330@ 8-17} The fact that 60% of world trade is intra-firm indicates that the tax base at stake is significant.

other tax benefits.¹⁵ Again, governments may also decide to compete via specially designed regimes to attract paper profits. For example, the regime of Special Financial Institutions (SFI) in the Netherlands allows foreign companies to channel capital through them in order to realize tax benefits.

Standard theory predicts a “race to the bottom” in capital taxation and the under-provision of public goods in all jurisdictions.¹⁶ While this extreme outcome cannot be observed empirically, it can be shown that tax competition undermines the fiscal self-determination of states, i.e. their ability to effectively set the size of the budget and the extent of redistribution. 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 personal income tax rates have fallen from around 70% to well below 50%. These rate cuts were refinanced by broadening the bases on which taxes are applied (‘tax cut cum base broadening’). In this way, corporate tax revenue remained stable at an average of about 2.5% of GDP, whereas income tax revenue as a percentage of GDP rose from 11.2% to 12.8% of GDP.¹⁷ The trend towards low nominal tax rates and broad tax bases is an attempt to defend against the outflow of mobile profits and at the same time prevent an adverse revenue effect.¹⁸

¹⁵ {Devereux, 2006 #1951; de Mooij, 2008 #3635} The fact that profit shifting is possible may explain the weaker effect of tax policies on FDI. As long as MNEs can realize tax savings without business relocations, the competition for FDI and mobile profit is in a substitutive relationship. We return to this issue in part 2.

¹⁶ {See e.g. \Wilson, 2004 #571@ 1069-70}

¹⁷ {OECD, 2008 #3170}

¹⁸ {See e.g. \Haufler, 2000 #1436}

While revenue losses did not occur, the ‘tax cut cum base broadening’ policy affects the distribution of the tax burden among different kinds of taxpayers. For one, there is an effect within the business sector: highly profitable MNEs benefit, while nationally organized small and medium-sized enterprises are more heavily burdened. Second, the tax burden is shifted from capital to labor. This is also visible in the general trend to increase indirect taxes, such as consumption taxes.¹⁹ Last but not least, competitive downward pressure on corporate tax rates affects the distributional characteristics of the personal income tax. If the nominal corporation tax rate is lowered, then it is worthwhile for private individuals to re-label their income by incorporating. In order to prevent such arbitrage, policy makers often align the corporate tax rate and the top rate on personal income, thus flattening the personal income tax schedule.²⁰

As to developing countries, the dynamics of a race-to-the-bottom have a more visible impact. The pressure from tax competition on public finances is comparable to OECD countries, but developing countries usually do not have the administrative resources to stabilize their revenues by broadening their tax base. On the contrary, in many countries the base has been narrowed.²¹ A significant part of the revenue loss is directly due to the shifting of paper profits. One study estimates the annual revenue loss of developing countries from transfer pricing to be US \$ 160 billion.²²

¹⁹ {Loretz, 2008 #3668;Schwarz, 2007 #1953;Genschel, 2002 #190}

²⁰ {Ganghof, 2006 #1435}

²¹ {Keen, 2004 #1872}

²² {Christian Aid, 2008 #2701}

Overall, the empirical evidence shows that tax competition undermines fiscal self-determination.²³ While states still possess the formal right to set tax policies (*de jure* sovereignty), they cannot effectively pursue their desired policy goals (*de facto* sovereignty). Developed countries are able to maintain the size of the budget (first component of self-determination), but this can only be achieved by compromising the desired extent of redistribution and making the tax system more regressive (second component of self-determination). By contrast, developing countries are not able to prevent revenue losses and thus lose both components of fiscal self-determination. In this respect, tax competition increases existing inequalities between countries of the global North and South. For these reasons, we consider international tax competition in its present form to be a case of background injustice. In the absence of an institutional framework to regulate it, it introduces multiple kinds of bias into the international fiscal regime that lack justification.

2. Two Principles of International Background Tax Justice: Membership and Intentionality

The last section has specified the content of fiscal self-determination and demonstrated how it is endangered by tax competition. Just like in the case of individual liberty, to be effective, the lib-

²³ Some observers argue that the policy choices described above – tax cuts cum base broadening, increasing reliance on indirect taxes and low tax burdens on capital – are not caused by tax competition. They argue that these policies reflect a general shift towards market-conforming taxation that governments implemented irrespective of competitive pressures. {cf. e.g. \Steinmo, 2003 #1432} While it is true that there are also domestic efficiency reasons for implementing these policies, our foregoing sketch of the mechanisms shows – in line with most of the public finance literature – that these changes are to a significant part driven by the pressures of tax competition. For more on this debate, see {Rixen, 2007 #1312}. If, however, as we will discuss in section 2, such policies are indeed chosen for domestic reasons only, they would not indicate a violation of self-determination but an instance of it.

erty to make these collective choices is restricted by the same liberty for the citizens of other countries. The two principles we will advance in this section spell out these restrictions and are meant to ensure that countries have an effective right to tax that reflects their polities' choices about the size of the state budget and the desired extent of redistribution. The membership principle is based on the intuition that capital mobility renders this liberty fragile and that it therefore needs to be protected. The intentionality principle argues that this liberty can be abused and therefore calls for it to be circumscribed.

The Membership Principle

Imagine you live on a street with two fitness clubs. One high-end club with expensive equipment and all kinds of free-bees like club towels and shaving equipment, and one less fancy club that lacks the rowing machines, has only three Stepmasters instead of ten and no free-bees. Unsurprisingly, the membership fee of the high-end club is almost three times that of its no-frills competitor. You are a member of the no-frills club. One day, you discover that your membership card actually lets you pass the turnstile at the high-end club, too. You keep quiet and start working out there. As it turns out, quite a few members of the no-frills club frequent the fancy club. A month later, you bump into a friend in the washrooms of the high-end club. "What are you doing here?" he asks. With a sheepish look on your face, you tell him about your discovery. He is enraged: "You guys are free-riding on our membership fees." He informs the manager and, the next day, the high-end club starts issuing new membership cards. This reaction appears justified and serves to stop what was an unacceptable form of free-riding.

For the purposes of our argument, the analogy between countries and clubs is a useful one. There are places, e.g. the Scandinavian countries that provide more services like state-financed daycare, more generous unemployment insurance, and so on, but in turn also "charge" more in

terms of taxes.²⁴ There are others, like England, where citizens prefer to have a leaner set of services and hence pay less. Certain forms of tax planning that involve shifting one's tax base to a low-tax jurisdiction without moving the underlying activity itself are parallel to using the high-end fitness club on your no-frills card. When a company uses the services of a country – that is its infrastructure, the human capital, and so on – to produce a certain commodity, but then shifts the paper profit made with this economic activity to low-tax jurisdictions through practices like transfer pricing or thin capitalization, the citizens who finance these services have a legitimate complaint. Tax evasion by individuals, as suggested by its illegality, represents an even blunter form of abuse. This is like jumping the turnstile at the high-end fitness club when no one is watching.

Despite these parallels between the membership in a fitness club and a country, the reaction of free-riders when they are found out is rather different. Whereas it seems reasonable to expect most people to feel sheepish about free-riding at the high-end fitness club, the parallel practice at the level of countries is often pursued without shame and, in the case of corporate tax avoidance, even under the approving stamp of legality. This reaction can be explained, but not excused, by the pervasive perception of taxation as something that the state takes away from us rather than as part of a social compact between citizens.²⁵

We are now in a position to formulate our first principle of international taxation, the membership principle:

²⁴ We put “charge” in inverted commas here, because we do not mean to imply adherence to the benefit principle. See also discussion below.

²⁵ {Murphy, 2002 #2485} call this phenomenon the “myth of ownership.” They argue that citizens do not have an entitlement to their pre-tax income but can only claim legitimate ownership to their post-tax income since the tax-financed state defines property rights in the first place.

Natural and legal persons should be liable to pay tax in the state of which they are a member.

In order to apply the principle, it is necessary to define membership. Our definition is the following: Individuals and companies should be viewed as members in those countries where they benefit from the public services and infrastructure.²⁶ This conception of membership is related to, but distinct from, what is called the “benefit principle” or the principle of “fiscal equivalence” in the public finance literature.²⁷ The *benefit principle* is sometimes contrasted with the *ability to pay principle*.²⁸ Whereas the latter justifies redistribution, the former does not and makes taxes strictly proportional to the individual benefits taxpayers receive in return. Our conception of membership is more general and comprises both of these principles. It is compatible with what has been called “group fiscal equivalence”²⁹, which demands that the *collective* benefits of the

²⁶ While, as we will briefly discuss below, this definition of membership is not detailed enough to resolve all cases of ambiguous membership assignments, it does nonetheless exclude certain conceptual possibilities. It should be emphasized, for example, that our definition of membership is distinct from citizenship. Permanently non-resident citizens should not be liable to tax in their country of citizenship. Conversely, temporary resident aliens, even though they generally do not have a democratic voice in state decisions, should be. Moreover, companies should not be given voting rights.

In the case of individuals, consider a person living and working in a country for one or two years. It seems justified to tax her, but also permissible not to give her a say in democratic decisions. In fact, one could sensibly distinguish between different thresholds of permanence. Whereas a tourist should not be liable to income tax in the country he visits, a “guest worker” staying for longer than, say, 6 months should be. For a resident alien taxpayer to acquire voting rights, the level of permanence can be significantly higher – even though it seems to us that many countries are too restrictive in granting citizenship to permanently resident foreigners. We bracket these debates here.

²⁷ {Olson, 1969 #268}

²⁸ See e.g. {Slemrod, 2004 #1630@ 61-6}

²⁹ {Thielemann, 2002 #3525}

group of citizens should be proportional to the amount of taxes paid. It thus allows for redistribution among individuals. As implicit in our notion of fiscal self-determination, the citizens of a state may well decide that it is appropriate to tax people with higher incomes at higher rates. On this issue, the above analogy between the fitness clubs and countries breaks down. True to its objective to re-establish the *de facto* sovereignty of states, the membership principle is silent on the actual tax system chosen by polities. It merely stipulates that polities should have an *effective* right to tax individuals and companies benefiting from public services and infrastructure as they see fit.

Our definition of membership is broad enough to encompass the major intuitions of diverse theories of international taxation. In the international tax literature, there is agreement that a nexus between the taxpayer and the country is required for tax membership. Yet, there is disagreement about the proper nature of the nexus – should it be economic, social, political or territorial allegation, or a combination of these? The disagreement has never been fully resolved at the level of principles.³⁰ This is unsurprising, given that each pure solution has distributive consequences which favor the material revenue interests of certain groups of countries over others. Most importantly, developing countries, as capital importers, favor taxation at source, i.e. in those countries where capital is invested. In contrast, capital exporting countries favor residence taxation, i.e. in those countries where investors reside. This conflict has shaped the history of international taxation and continues to do so.³¹

³⁰ See e.g. {Musgrave, 1991 #144} {Biehl, 1982 #1406} {Cappelen, 2001 #3793}

³¹ See e.g. {Musgrave, 1972 #690} {Vogel, 1990 #109} {Rixen, 2008 #2123@ 57-116}

Nevertheless, a working compromise has been found. According to the so-called “international tax principles”³² *individuals* are assessed on a residence basis, because residence determines where they benefit from public services and where they should therefore be counted as a member. *Companies* benefit from public services and infrastructure in the country where their substantive activities take place. Beyond a certain threshold of economic activity, they are therefore liable to tax in source countries, i.e. those countries in which the income was generated. For MNEs whose activities spread across borders, membership comes in degrees and should correspond to the distribution of its economic activities among countries. This justification for the combination of the residence and source principle of international taxation is commonly accepted. While the detailed definition of membership for particular cases remains a thorny and often controversial issue, which keeps many tax experts busy, the distribution of taxing rights broadly follows this pattern, which is in line with our membership principle.

However, there are two problems. First, even though their underlying rationale is in line with our membership principle, the actual international tax rules, which are made up of domestic tax laws, bilateral double tax agreements (DTAs) and non-binding model conventions of international organizations, create certain overlaps (so-called double taxation) and gaps (double non-taxation) in countries’ taxing rights³³. As described in section 1, these grey zones can be ex-

³² {Avi-Yonah, 2006 #931} Avi-Yonah argues that the existing rules of international taxation make up a coherent “international tax regime”.

³³ For example, a few countries, most importantly the US, tax not only their residents but also their non-resident citizens. Some countries apply different rules if an individual has multiple residences (typically, an individual counts as a resident for tax purposes if she spends 183 days or more in the country). In some instances, countries disagree over what counts as a sufficient economic activity to warrant taxation at source. For a discussion of the gaps and overlaps in the international tax regime with references to the vast legal and economic literature on the topic, see {Rixen, 2008 #2123@ 66-85}

exploited by sophisticated taxpayers to minimize their tax bill, and thus violate the membership principle. Second, even if there were no scope for manipulation, the current rules are badly enforced. There is no international authority guarding countries' adherence to the rules, and administrative assistance and information exchange among national tax authorities is underdeveloped. This makes it possible for taxpayers to escape the taxman and is a violation of the membership principle.

How would respecting the membership principle change the international tax landscape? While the detailed answer depends on the way it is institutionalized, a general answer can be given. The membership principle ensures that tax competition is actually in line with Tiebout's notion of "voting with your feet."³⁴ Tiebout's model is generally presented as a *justification for* tax competition. It is argued that competition among jurisdictions leads to an efficient allocation of public funds as individuals self-select into different jurisdictions offering certain tax-expenditure packages according to the extent to which these match their fiscal preferences. A crucial assumption of the model is that there are neither positive nor negative externalities on other countries stemming from the provision of "local" public goods. This assumption will generally not hold in reality.³⁵ While the costs and benefits of government action will never align perfectly in an economically interdependent world, the membership principle works to minimize the gap between them. It prohibits the hiding or shifting of part of the tax base from one's residence in the case of individuals and from the source of the economic activity in the case of multinationals. In order to realize tax advantages, companies and individuals would actually have to

³⁴ {Tiebout, 1956 #277}

³⁵ Most defences of the status quo of tax competition assume Tieboutian sorting to work efficiently {see e.g. \Mueller, 1998 #262}. Given the reality of externalities and capital shifting, it is easily apparent that such arguments cannot hold {Sinn, 1997 #274}.

relocate, rather than merely shifting their funds. Free-riding would no longer be possible. In other words, two of the three kinds of competition, shifting of mobile profits and competition for portfolio capital would be curtailed.

The crucial question in assessing the potential impact of the membership principle is how individuals and companies would react if these possibilities were no longer available. To what extent would individuals and companies make use of their exit option, and move or relocate their residence or real economic activity from high-tax to low-tax jurisdictions? For an assessment of this issue, it is useful to consider individuals and MNEs separately.

Individuals form a certain attachment to the place they live in. This attachment often includes the internalization of the solidarity that is reflected in their polity's choices about the size of the state and the extent of redistribution. Having said that, it is evident that in people who evade taxes in their home country, this internalization has not happened. If their affective ties to the country are not strong enough to compensate the losses that respecting the membership principle imposes on them relative to the *status quo*, then some individuals may indeed choose to leave. Note, however, that this decision will also incur a cost. Whereas under the *status quo* they are able to free-ride by evading taxes, under the membership principle leaving a high-tax country for a low-tax one implies receiving fewer government services.

A company, by contrast, cannot form affective ties to a particular location. Its managers make the decision of where to locate its different economic activities according to what maximizes profit rather than according to the affective ties of employees. This means we can expect the reaction of companies to enforcing the membership principle to be more significant than that of individuals. Under the *status quo*, the pressure on an MNE to leave a high-tax jurisdiction is low, since the loopholes in the current system enable it to shift some of its profit instead and thereby

lower its effective tax burden. A shift from the *status quo* to a world where the membership principle is respected would be a shift from a world of (merely) *virtual* tax competition for paper profits to a world of *real* tax competition for FDI: companies would have to relocate real investment in order to realize tax savings. It has been argued that such real tax competition may be more harmful to high-tax states than virtual tax competition. Instead of losing only tax revenue, high-tax states stand to lose real capital and jobs as well.³⁶

Apparently, some politicians in high-tax countries have resigned to the fact that, in the absence of fundamental international tax reform, tolerating profit shifting is their best strategy.³⁷ Unsurprisingly, this acceptance is not reflected in the official political discourse since it would mean admitting to voters that one is letting some people free-ride. What we observe today in the practice of corporate taxation, in other words, is a system of nominal tax competition with price differentiation. It is as if a high-end fitness club nominally charges a high membership fee to cover its costs, but then secretly gives rebates to certain customers it does not want to lose. Since it is an empirical question how the world of real tax competition would play out, it remains unclear whether the above stance of policymakers is warranted. It may well be that companies requiring state-of-the-art infrastructure or access to high-skilled labor will choose high-tax countries, whereas companies in labor-intensive, low-skill sectors will move to low-tax jurisdictions.

In any case, from the perspective of the membership principle any relocation of real investment in the case of companies and of residence in the case of individuals would be unproblematic. The membership principle ensures that taxes are paid where the benefits from public services and infrastructure are obtained and thus effectively addresses two of the three types of tax

³⁶ {Keen, 2001 #3847; Dharmapala, 2008 #3283@ 671-6}

³⁷ Cf. {Rixen, 2011 #3907}

competition – the targeting of portfolio investments as well as of paper profits. In the next section we explain why this is not enough to preserve fiscal self-determination, and why there is also a need to constrain competition for ‘real’ FDI.

The Intentionality Principle

Independently of how distribution plays out in a world that respects the membership principle, the question arises whether this principle suffices as a condition of justice in international taxation. To demonstrate why we think that the membership principle on its own would be insufficient to adequately protect fiscal self-determination, let us return to a more sophisticated version of our story about fitness clubs.

Suppose the fitness clubs, though on the same street, fall on two sides of a municipal boundary. Suppose also that you can only become a member of a fitness club if you are resident in the respective municipality – this assumption guarantees that the membership principle is respected. About 20% of the population is a member in a fitness club. Since they are in better shape, fitness club members find it much easier to move house from one municipality to another. The financing structure of both clubs is 80% through membership fees and 20% through subsidies from the municipality, i.e. through municipal taxes. One day, the manager of the low-end fitness club has an idea. He lobbies the mayor to increase the municipality’s subsidy to cover 40% of the costs of running the club. This allows the club to lower membership fees and the municipality to attract new residents. Since the services offered by the club remain the same, the lower price will convince some of the members of the high-end club that the difference in price is now too big to justify the service premium their club offers. They move to the municipality of the no-frills club

(MN-F) and become members there.³⁸ Subsequently, in order to compensate the decline in revenues from membership fees, the high-end club will have to either also obtain a larger share of its financing from its municipality (MH-E) or reduce the quality of its service.

Is there anything wrong with this from the perspective of justice? The short answer is: It depends. We will argue that the legitimacy of this move depends on the motives behind the change of policy in MN-F. Against the background of section 1, the parallel between the fitness club case and tax competition between countries is straightforward to see. In the above story, for fitness club users, read mobile factors; for non-club members, read immobile factors; for mayor, read government. The altering of the financing structure at the no-frills club corresponds to a broadening of the tax base and a shift of the tax burden to relatively immobile factors.

To see why it will be necessary to appeal to the *intention* of the mayor of MN-F to decide whether the new policy poses a problem, consider the following two scenarios. In scenario A, the majority of residents see the new financing structure as the just way to fund the club, and consequently the mayor pushes for the policy change. Given the right of a polity to choose the size of their state and the extent of redistribution established in section 1, it is only consistent to consider the policy as legitimate in this case. In scenario B, the new policy is adopted, *because* it will allow the municipality to attract new residents and the corresponding tax base. The two scenarios are observationally equivalent. Hence, if one wanted to make a case that scenario B poses a normative problem, one would have to appeal to a non-consequentialist criterion that tracks the different motives.

³⁸ To make this plausible, let us assume that club membership fees represent a significant part of people's budget.

So why should we think anything wrong with scenario B in the first place? Reconsider the last sentence of the fitness club story: “Subsequently, in order to compensate the decline in revenues from membership fees, the high-end club will have to either also obtain a larger share of its financing from its municipality or reduce the quality of its service.” The external effect of the policy change in MN-F represents a violation of the liberty of the residents in MH-E to choose *their* preferred size of the budget and extent of redistribution. Under scenario A, we have to choose between restricting the right of residents in MN-F to exercise their liberty *versus* restricting the right of residents in MH-E to exercise theirs. By contrast, under scenario B, the right of residents in MH-E to exercise their liberty trumps the purely strategic considerations of MN-F. This is the basis for condemning the policy change under scenario B. To summarize in the language of countries rather than fitness clubs, if a country changes its tax system merely in order to attract tax base from abroad, this conflicts with the rights to fiscal self-determination of other countries and is therefore problematic from a normative viewpoint.

These considerations motivate our second principle of justice for international taxation, the intentionality principle:

Suppose the benefits of a tax policy change in terms of attracted tax base from abroad did not exist, would the country still pursue the policy under this hypothetical scenario? If yes, the policy is evidently not motivated by strategic considerations and therefore legitimate. If not, then the policy is illegitimate.

“Strategic” here implies that a policy is justified by the prospect of attracting mobile capital from abroad rather than by appeal to the fiscal prerogatives of the state defined in section 1. The counterfactual nature of the criterion allows us, on a conceptual level, to elicit the motivation of a

country in pursuing any given fiscal policy.³⁹ It effectively delineates (legitimate) fiscal interdependence from illegitimate tax competition.⁴⁰ Note that it also captures cases of mixed motives. Suppose a country lowers a certain tax rate *in part* because this reflects the conception of justice of its citizens, *but also* because of the strategic value of doing so for attracting foreign tax base.⁴¹ Perhaps the country would, in the absence of the inflowing tax base from abroad, still lower the rate in question, but by a lesser amount. In this case, that lesser reduction is motivated by legitimate motivations, whereas the part of the reduction that would be dropped is illegitimate.

Someone might object that such an attempt to discern different motives suffers from two important ambiguities, even on a theoretical level. First, suppose the citizens of a developing country are motivated by social justice reasons to build more hospitals and, in order to do so, decide to lower their country's taxes to attract the necessary capital from abroad. Is this part of their fiscal self-determination or should it count as a strategic consideration? In the latter case, would we not deprive poor countries of an important source of redistribution? We believe that our principle can answer these questions. First, we submit that this policy should indeed count as motivated by strategic considerations. Capital that is attracted to the developing country to build a hospital is not available to build a hospital elsewhere. Second, this does not mean that building the hospital in the developing country is not important and does not exclude the possibility that richer countries have an obligation of assistance towards this project. But this obligation should not be dis-

³⁹ The counterfactual nature of the criterion is in part inspired by {Normore, 2010 #3928} on the foundations of political obligation.

⁴⁰ Remember from the definition provided in section 1 that the strategic motivation is a necessary element of tax competition. Thus, by eliminating strategic motivations, none of the remaining fiscal interdependence qualifies as tax competition.

⁴¹ As explained in footnote 23, such mixed motives are empirically plausible.

charged in the form of a bias in the way the jurisdictional structure of international taxation is set up. It should rather be dealt with on the level of the allocation of collective revenues – for instance in the form of a unitary tax with formulary apportionment as discussed below – or via explicit redistribution. Conversely, this means that rectifying the jurisdictional structure of international taxation should be conditioned on developed countries fulfilling their redistributive obligations towards developing countries.⁴²

Second, one may ask whether our intentionality principle applies to all potential policy instruments with cross-border effects. Do we rule out strategic behavior across the board, or are there instances in which they are legitimate? Our answer is that it depends on whether the strategic interaction, i.e. competition, will lead to a race to the bottom or whether it can be seen as harmless or even as a race to the top. Take the example of strategic infrastructure investments. A country invests in high-quality and specialized infrastructure in order to attract high-tech businesses from abroad which form a highly interdependent cluster. Due to agglomeration effects this will positively impact growth in the country. As a reaction to that other countries may also begin

⁴² In fact, this issue is not simply hypothetical. There is a debate about the legitimacy of developing country (often small island) tax havens. When OECD countries began to pressure tax havens to abandon their harmful tax policies (see below), some tax havens argued that they had chosen to become tax havens because they saw no other possibility to initiate economic development. In fact they argued that the rich countries are hypocritical wanting to close down the (offshore) financial centres, the development of which they had earlier advocated. See {Sharman, 2006 #1998}. In fact, we agree that those developing countries have a right to adequate compensation by ‘high-tax’ countries if our two principles are implemented. Such a right would, however, not be awarded to rich, longstanding tax havens like Switzerland, Liechtenstein and others.

to specialize in certain infrastructures and form such clusters. The result is likely to be a race to the top – in which case there is no need to rule out strategic considerations.⁴³

Given that a large part of the literature considers tax harmonization to be the relevant alternative to tax competition, two observations should be made in this regard. First, in a world where both the membership and the intentionality principle are respected there would not be full harmonization of fiscal policies across countries. Suppose the English really do have a preference for a smaller state and less redistribution than the Swedish. Neither of our principles will stop them from designing a tax structure that reflects these preferences. In turn, nothing we have said will prevent the Swedes from making a democratic choice that the best way to finance a relatively generous welfare state is to shift a considerable portion of the tax burden onto labor and consumption and to tax capital lightly. There may indeed be good internal reasons for such a policy.⁴⁴ However, the intentionality principle prohibits the very same policies if they are based on strategic considerations.

Second, even in a world where different polities have divergent preferences about the size of the state and the extent of redistribution, our two principles will create *some* pressure towards convergence. This is so because countries with preferences for a relatively large state and/or high extent of redistribution will now have to bear the real costs of these preferences in terms of part of their tax base voting with its feet. At the other end of the spectrum, however, the danger of a race to the bottom would be eliminated by our two principles for the very same reason. Countries

⁴³ This is not to deny that some attempts of strategic infrastructure investment may turn out to be unsuccessful. However such individual failures do not contradict the fact that from the collective viewpoint the competitive dynamic is beneficial.

⁴⁴ See e.g. {Przeworski, 1988 #704}

with smaller state budgets and a lower level of redistribution would also be forced to bear the full costs of their tax structure, rather than being able to finance part of their public services by strategically attracting foreign tax base. The fiscal externalities generated in both directions under the intentionality principle are those minimally present under conditions of fiscal interdependence between states. They ensure a maximum – though less than perfect – correspondence between the convictions of members of the respective polities and fiscal structure of those polities.

The intentionality principle entails that different fiscal communities have to justify their policy choices to one another. Whether a given change in tax structure is just or not depends on how the country in question justifies this change to others. The intentionality principle complements the membership principle and fills the normative void where the membership principle on its own would fall short in adequately protecting fiscal self-determination.

Despite these attractions of the intentionality principle, it also faces two related objections. First, why try to elicit the intentions of polities and their governments in fiscal policy when the market mechanism arguably offers a shortcut to the same outcome? After all, one of the main attractions of the mechanism of competitive markets is the fact that it serves to promote the common good irrespective of the individual intentions of market participants. Should this mechanism not also be at work in the case of tax competition? The answer to this question is no. In contrast to a competitive market where private goods are traded, tax competition is about public goods. As Hans-Werner Sinn has shown, tax competition amounts to trying to provide public goods via the market mechanism.⁴⁵ As every first-year economics student knows, this is inefficient and therefore detrimental to the common good. If, at the same time, we do not want to centralize the decision for the provision of public goods at the highest level (world government), but

⁴⁵ {Sinn, 1997 #274}

want to allow for some diversity among decentralized units (states), then it is necessary to eliminate the strategic element of interactions between these units. This is what our intentionality principle does.

Yet, condemning the market alternative is not sufficient to endorse our proposed alternative. According to the second objection, the fact that intentions are unobservable stands in the way of making the principle operational. Our response to this challenge is twofold. First, we acknowledge that this is a serious problem. Second, however, we think that it is a necessary problem in the sense that any approach that aims to delineate illegitimate tax competition from mere fiscal interdependence will encounter it. Whether we are right about this or not hinges on the previously discussed question of whether the legitimacy of a given tax policy depends on the motivation that drives the policy. Recall our suggestion that it is possible to have two observationally equivalent scenarios. Under scenario A, the policy change flows from the preferences of citizens about the size of the state and the extent of redistribution. Under scenario B, the change is strategically motivated. If you agree that these should be evaluated differently from a normative perspective, then you should also agree that appealing to motivation is a *necessary* component of a normative account of international taxation. In this case, the challenge of the second objection is pushed back to the institutionalization of our principles that we will turn to now.

3. Institutionalizing the Two Principles

It is notoriously difficult to derive concrete institutions from abstract principles. This is so even in the absence of ambiguity about what the correct interpretation of the principle is, because there will generally be more than one way to institutionalize a principle. In the face of this institutional indeterminacy, we limit ourselves here to demonstrating that there is an institutional solution that

satisfies the conditions embodied in our principles. As a further caveat, we stress that the following brief sketch cannot, due to space constraints, do full justice to the complex issues of international taxation. But it should suffice to outline the institutional implications of our proposal.

Any institutional solution must provide (1) a forum for governments to negotiate agreements on the rules of international taxation and (2) make sure that the rules are enforced. In the following we propose the establishment of an International Tax Organization (ITO) and discuss the basic institutional design features required for the two tasks.⁴⁶ We have already stated that it is necessary for governments to come to a multilateral agreement on what it means to be member of a state and that the details of such a rule will be controversial. The ITO should become a forum for negotiating and defining the rules in line with the membership and intentionality principles. To ensure a level-playing field, all states should be members and adequately represented in the ITO's decision-making procedures. The OECD as today's most important international tax forum is often criticized for falling short in these respects. We first discuss a possible institutionalization of the membership principle and then turn to the intentionality principle. Third, we propose enforcement mechanisms. Last, we provide a brief comparative analysis between current institutions and policy initiatives in international taxation on the one hand and the hypothetical world in which our two principles are respected on the other in order to gauge to what extent the latter is an improvement over the *status quo*.

⁴⁶ Calls for an International Tax Organization can be found in the literature, see {e.g. \Tanzi, 1999 #98;Horner, 2001 #822} However, so far no attempt has been made to derive the institutional design from the functional requirements of the issue to be dealt with. On institutional design, see e.g. {Koremenos, 2001 #519}

Institutionalizing the Membership Principle

On the basis of our two principles several substantive reforms become imperative. First, the membership principle requires governments to abolish all rules that make it impossible for other countries to enforce the membership principle. Thus, strict bank secrecy regulations, the supply of other deliberately nontransparent legal constructs and the refusal to exchange information with other tax administrations will be ruled out. This means that governments must internationally commit themselves to rid their national tax codes of all such secrecy rules. The requirement to exchange tax-relevant information with other countries could be implemented through a system of multilateral automatic exchange of information. Automatic information exchange would represent a significant improvement upon on-request information exchange, which is currently provided for in many bilateral tax treaties. Under the on-request system, the requesting state will generally have to present initial evidence of international tax evasion in order to receive the required information about foreign funds of its residents. Yet, precisely the kind of information required to mount an initial case is often secret. Routine and electronic (i.e. automatic) exchange of information on the funds of non-residents to their respective home countries can address this problem.⁴⁷

Second, an ITO with inclusive membership would provide an ideal forum to reconsider the membership rule in the case of MNEs. How should the rights to tax shares of the profit of an MNE be allocated among jurisdictions? This issue is a very thorny one in international tax practice that has so far been resolved through so-called separate entity accounting and arm's length

⁴⁷ For more on automatic and multilateral exchange of tax information, see {Spencer, 2005 #3749} and {Palan, 2010 #3868@ 244-45}

standard (ALS) transfer pricing.⁴⁸ However, as set out in section 1, both the indeterminacy of applying this standard and the difficulties in its enforcement can be exploited by MNEs to lower their tax bills. One possible solution would be to switch to a system of unitary taxation with formula apportionment (UT+FA). This would require governments to agree on a common and consolidated corporate tax base. MNEs would have to determine their worldwide profit in one single report, and they would be allowed to consolidate profits and losses of entities in different countries. The worldwide profit would then be apportioned to the respective countries in which the MNE operates on the basis of a predetermined formula. The formula should reflect the real economic activity in each country by referring to factors such as property, sales, and payroll. This would make it impossible for companies to engage in the shifting of paper profits and thus be a major step forward in the implementation of the membership principle.⁴⁹

Institutionalizing the Intentionality Principle

As we have already acknowledged, defining rules that respect the intentionality principle will be difficult. The fact that intentions are unobservable invites hypocrisy. It will be possible for governments to misrepresent their intentions, i.e. attribute any tax policy changes to the preferences of citizens about the size of the state and the extent of redistribution, even if in reality they pursue the strategic aim of attracting foreign tax base. In order to avoid hypocritical political discourses and long but futile attempts to distinguish honest from dishonest representations of intentions, the

⁴⁸ According to the ALS, foreign branches or subsidiaries of an MNE are to be taxed as if they were independent market participants, exchanging goods and services at arm's length (i.e. market) prices, see e.g. {Eden, 1998 #838@ 32-52}

⁴⁹ There is an extensive literature in law and public finance on UT+FA and how it compares to separate entity accounting. For an overview, see e.g. {Graetz, 2003 #816@ 400-35}. Two different proposals to implement UT+FA, are {Clausing, 2007 #2668} and {Rixen, 2007 #2001}

institutionalization of the principle has to rely on objectively observable factors. The task is to identify observable implications of the unobserved intentions.

While a detailed and legally applicable definition of objective factors that indicate a violation of the intentionality principle is a task for tax lawyers and thus beyond the scope of this paper, it is nonetheless possible to derive a number of rules that are in line with the intentionality principle. First, all forms of preferential tax regimes for foreigners (ring fencing) must be abolished. Such discriminatory arrangements show that a government implements a policy for strategic reasons only because otherwise it would grant equal treatment to residents and non-residents alike.

Note, however, that non-discrimination, while it covers part of our intentionality principle is not sufficient to constrain all forms of strategic and harmful policies. As is well known in the public finance literature, relatively small countries are in a position to overcompensate revenue losses from general (i.e. non-discriminatory) rate decreases with inflowing foreign tax base.⁵⁰ We therefore need to supplement the non-discrimination rule with additional observable criteria to further constrain purely strategic behavior.⁵¹

Enforcement

What would it take to effectively enforce our two principles? First, we argue that monitoring the adherence to the rules should be relatively straightforward since governments can be expected to launch a complaint if other governments violate either or both of the two principles.⁵² Yet, what

⁵⁰ See e.g. {Bucovetsky, 1991 #1035} {Dehejia, 1999 #193}

⁵¹ Comments on this aspect of the paper are particularly welcome.

⁵² That said, it may be in the interest of governments to assign the ITO with the task to collect and provide information on tax policy changes to all member countries. This would make the tax policies of individual countries common knowledge of all countries and would thus greatly increase transparency.

is needed is an independent authority that will process the complaint and eventually enforce the rules. Independent third party enforcement is needed to ensure compliance with the two principles, because the structure of tax competition is such that every individual country has an incentive to deviate from the collectively desirable rules. The ITO could install a dispute settlement procedure after the WTO model to satisfy this requirement.⁵³ In case a member state complains that the tax practices of another member violate the rules, they can, as a first step, try to resolve the conflict in consultations. If they are unsuccessful, the case will be transferred to the dispute settlement body (DSB), which effectively functions like an independent judiciary, because a panel report (judgment) can only be blocked if all member states unanimously agree on blocking it. If the DSB considers the policy a violation of the rules, the government will have to revoke the policy. If it does not do so, it will have to pay a fine to the ITO. Since parties know that there will be effective enforcement of decisions in the DSB, it can be expected that they will resolve many cases in consultation. This procedure has the advantage of avoiding excessive litigation in the implementation of the rules and leaves room for political negotiations and decisions.

The contrast with the status quo

How does our proposal for the future rules of international taxation compare with the status quo? As we have described in part 1, the current situation is characterized by harmful tax competition. This fact has not gone unnoticed by governments and international organizations. Accordingly, they have launched policy initiatives to address this situation. The most prominent of these initiatives is the OECD project to counteract harmful tax competition.⁵⁴ The original purpose was to

⁵³ For a description of the WTO dispute settlement process, see e.g. {Zangl, 2008 #3579}

⁵⁴ {OECD, 1998 #836}.

persuade tax havens to abolish harmful tax practices. In particular, they were encouraged to change their national tax laws so that it would no longer be possible for a tax avoider to merely ‘book’ some economic activity in the respective haven without any underlying ‘real’ economic activity. Also, they were asked to give up bank and tax secrecy legislation and to open up for information exchange with other states. In addition to the tax havens, the project also aimed at so-called preferential tax regimes in OECD countries, i.e. rules which tried to attract foreign capital by offering better treatment than was available to domestic investors. Since the OECD has no authority to issue binding rules, it pursued a “naming and shaming” approach and published a blacklist of tax havens and preferential tax regimes that should be evaluated and removed in a process of peer reviews.⁵⁵

The initiative has not been successful. The criterion of missing substantial economic activity was removed from the definition of tax havens⁵⁶, who can continue to offer tax residence to corporations and individuals even if there is no real economic activity linked to the tax base. Instead, the OECD now merely advances certain standards of transparency and information exchange between tax havens and non-haven countries.⁵⁷ Importantly, this decision took the issue of tax avoidance and planning, which make up a significant part of tax competition, off the agenda. More transparency and better information exchange merely target outright illegal tax evasion.⁵⁸ And even evasion is not effectively addressed, since the OECD relies on bilateral information exchange agreements which provide for exchange on request only, which has significant short-

⁵⁵ {OECD, 2000 #51}

⁵⁶ {OECD, 2001 #52`, 10}

⁵⁷ {OECD, 2004 #568}

⁵⁸ {Webb, 2004 #860`, 816}.

comings (see above). Even after the financial crisis, when the G 20 instructed the OECD to reinvigorate its project, there were no major improvements. The OECD continued its efforts to get countries to sign bilateral information exchange agreements.⁵⁹ This does of course nothing to ameliorate the major shortcoming, i.e. the ineffectiveness of exchange on request.

The OECD initiative's failure can be attributed to successful campaigns of low-tax countries who claimed that any restrictions on their tax policy initiatives represent undue interferences into their fiscal sovereignty⁶⁰ and successful campaigns by business lobbies who succeeded in capturing their governments with threatening to exit were they to be deprived of tax planning opportunities.⁶¹

The European Union has been somewhat more successful in its initiatives against harmful tax competition. With respect to business tax competition, the Council agreed on a soft law Code of Conduct in 1997. Like the OECD project, this Code of Conduct was also aimed at harmful tax competition. Member states entered into a non-binding commitment to remove so-called preferential tax regimes, i.e., schemes that offer more generous tax treatment to foreign corporations than to domestic businesses. Despite its being non-binding, the code developed some bite because compliance with it was made a condition of accession for the Central and Eastern European countries. Also, the Commission applied the principles contained in the code to its state aid rules,

⁵⁹ As of 1 July 2011, 477 information exchange agreements had been signed (http://www.oecd.org/document/7/0,3746,en_2649_33767_38312839_1_1_1_1,00.html).

⁶⁰ {Sharman, 2006 #1998}

⁶¹ {Webb, 2004 #860} {Rixen, 2011 #3907}

which thus increased compliance among the EU-15 states.⁶² Currently, the European Union considers adopting a system of unitary taxation with formula apportionment.⁶³

In the area of portfolio tax competition the EU has passed the Savings Tax Directive, which took effect in July 2005.⁶⁴ This directive targets tax evasion on interest income by requiring automatic information exchange among countries on the savings of foreign residents. Some tax havens, jealously guarding their bank secrecy, have opted to apply a withholding tax rather than to exchange information. While the directive has significant loopholes – notably it can be circumvented by moving funds to third countries, it applies only to interest income so that it can be circumvented by restructuring portfolios from debt to equity and it is not applicable to trusts or corporations – it is important in that it shows that automatic international information exchange can be implemented in practice.

Our proposal significantly improves upon these initiatives. In line with the normative demands of our two principles we propose an international framework that is much stronger than the current international tax institutions, which cannot make binding rules and, as the case of the OECD project shows, lack international levers of enforcement. The experience at the regional level of the European Union shows that this is indeed feasible. The EU uses one of the specific policies we recommend, namely automatic information exchange, and is seriously debating another one, UT+FA. At the same time, note that our proposal, while it does involve a redefinition of fiscal sovereignty, does not require the transfer of core fiscal prerogatives to the international level. No supra-national power to tax is established. Instead, the idea is that the international community

⁶² {Radaelli, 2008 #2553`, 327-8} {Genschel, 2011 #2688, 12-3}

⁶³ {European Commission, 2011 #4293}

⁶⁴ On this initiative see {Rixen, forthcoming #4086}

can impose certain limits on the fiscal choices of nation states *ex post*. In order to implement this, we propose the establishment of an International Tax Organization, which supervises countries' tax policies and has the capacity to effectively sanction harmful national tax policies. The existence of the WTO is testament to the fact that it is achievable.

4. Toward what Kind of Global Justice?

We have pointed out that the membership and intentionality principles serve to protect the *de facto* sovereignty of states and their capacity to implement the conception of justice of their citizens domestically through their fiscal policy. Yet, what about global justice? Arguably, the most disturbing inequalities in today's world are ones between individuals across borders rather than between citizens of the same state.

Our account owes two explanations in this context. First, we need to justify granting states fiscal self-determination in the first place – a question that we bracketed in section 1. *Prima facie*, it might seem that doing so puts our account at odds with a number of theories of global justice, notably cosmopolitan ones. We will show that this is not the case. Second, a clarification concerning the normative status of the two principles is in order. In the second part of this section, we will elaborate on what we have in mind when presenting them as principles of *international background justice*.

The Normative Grounds of Self-Determination

Consider the following formulation of the basic tenet of 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.”⁶⁵ Moral cosmopolitanism is to be distinguished from legal cosmopolitanism, which calls for a global order in which people have “equivalent rights and duties.”⁶⁶ While the latter, more radical version of cosmopolitanism is indeed incompatible with state autonomy, most cosmopolitan theorists endorse the more moderate variant of the cosmopolitan ideal.⁶⁷

It is not our goal here to endorse cosmopolitanism or any other theory of global justice. We merely aim to anticipate and counter the objection that the membership and intentionality principles and the self-determination of states they advocate conflict with moral cosmopolitanism as defined above. To this end, we will now sketch three ways in which a moral cosmopolitan may accept, or even endorse, the self-determination of states.

First, a cosmopolitan may hold that “to respect one another’s status as ultimate units of moral concern” actually *requires* a certain level of state autonomy.⁶⁸ How so? Consider a purely justice-based cosmopolitan theory, i.e. one that proposes one theory of global justice to apply to all human beings across the globe. Such a position runs into the objection of pluralism concerning conceptions of justice. Given pluralism, so the objection against this position runs, imposing *one* conception of justice on everyone in fact fails to respect those who do not share it as ultimate units of moral concern. This objection can be defused by introducing a democracy-based component into cosmopolitanism. This component requires that people have a say in the decisions that affect their interests. Note that this does not provide us with a justification for the self-

⁶⁵ {Pogge, 1992 #2834}

⁶⁶ *Ibid.*

⁶⁷ They include {Beitz, 1999 #4284}, {Caney, 2006 #3641}, {Tan, 2004 #3937}, {Moellendorf, 2002 #4285}, {Pogge, 2008 #4286}

⁶⁸ {Caney, 2006 #4287} defends an argument of this sort.

determination of states as such, but for a multi-level governance structure that states plausibly form a part of. Under this structure, political issues are dealt with at the governance level that best corresponds to the scope of the policy in question – for example, environmental issues will be dealt with at a higher level of governance than questions of educational policy. The upshot of this position is what Simon Caney calls a mixed cosmopolitan view that is sensitive both to a minimal – i.e. pluralism-defying – notion of global justice and to the importance of political participation. A position of this type accepts a certain level of state self-determination on *normative* grounds. While certain constraints based on considerations of global justice may apply to the level of self-determination in question, there is no incompatibility with the membership and intentionality principles as such.

Second, a cosmopolitan may defend state self-determination as the most effective means to promote the interests of individuals worldwide. In particular, he may believe it to offer a more effective way of serving these interests than concentrating collective decision-making at the highest level, i.e. in the hands of a world government. As Robert Goodin puts it, the special duties that states have towards their citizens are the best way of discharging “the general duties that everyone has towards everyone else worldwide.”⁶⁹ Besides, granting autonomy to states offers protection from domination as well as immunity from the larger unit that allows it to be more responsive to local interests and to reduce the burdens of decision-making.⁷⁰ A position of this type accepts a certain level of state self-determination on *instrumental and conditional* grounds. If it turns out that there is an institutional alternative that serves the interests of individuals

⁶⁹ {Goodin, 1988 #3935@ 681}

⁷⁰ These are some of the classic reasons given for a federal structure. In addition, the existence of several smaller units allows for different experiments of life. See e.g. {Follesdal, 2001 #3938@ 251-53; Oates, 1999 #265}

worldwide in a better way, the justification of self-determination is undermined. The same qualification would apply to an endorsement of the membership and intentionality principles on these grounds.

Finally, for those cosmopolitans who remain unconvinced by the two previous arguments, there is another, pragmatic reason to grant states some autonomy nonetheless. A theory of justice with practical ambitions is well advised to take some features of the world as given, rather than attempting to reform everything at once. Arguably, the division of world politics into states is a good candidate for such a feature, given that a world without states has to be viewed as utopian from today's perspective.

Note that adopting a pragmatic stance of this kind does not imply accepting the *current* state system as just. One might argue that those states benefiting from the international structure in unjust ways incur a series of redistributive obligations towards those who get short-changed under the *status quo*.⁷¹ We agree that such redistributive duties exist today. However, this paper relegates them to the background. Our focus here has been to design fair rules of the game to govern the fiscal interdependencies between states. It is to a series of comments on the normative status of these rules that we turn in the next subsection.

In sum, the cosmopolitan has at least three potential reasons to accept the kind of state self-determination implicit in our membership and intentionality principles. While we do not defend a

⁷¹ For instance, countries can have redistributive duties towards the members of other states because they unduly benefit from economic interaction with them, see {Parijs, 2007 #2933}; or because they have inflicted harm on them in the past, see {, 2002 #3640}; or simply because the latter find themselves unable to survive without outside assistance. This list is not meant to be complete.

particular theory of global justice in this paper, accepting these two principles does not impose an undue constraint on the position one may want to defend in this regard.

An account of background justice in international taxation

The literature on global justice has been dominated by questions concerning the relation between principles of domestic justice versus principles of global justice. While cosmopolitan theorists generally defend continuity between the two,⁷² their critics hold that the global sphere is significantly distinct from the domestic level.⁷³ One of these alleged differences will preoccupy us here, namely the question of whether a *global basic structure* exists that gives rise to concerns of global distributive justice.⁷⁴

On the one hand, a number of so-called “practice-dependent” views argue, first, that the content of our conceptions of justice is dependent on the practices they regulate and, second, that no clear structures and rules of the required kind exist at the global level to give rise to concerns of distributive justice.⁷⁵ On the other hand, this position has recently been contested in two ways. First, Andreas Follesdal has argued that several of the practices of international relations are in

⁷² See for instance the following two review articles: {Caney, 2001 #3918} and {Parijs, 2007 #2933}

⁷³ To cite some of the most important positions of this kind, the global sphere is argued to be distinct due to its lack of a global people (e.g. {Miller, 2007 #4288}), its lack of a global democracy (e.g. {Nagel, 2005 #2833}), or its lack of a global state (e.g. {Blake, 2001 #3644}).

⁷⁴ John Rawls defines the basic structure of society as “the way in which the major social institutions distribute fundamental rights and duties and determine the division of advantages from social cooperation.” {Rawls, 1999 #4289@ 6}. Here, we are interested in the *global* basic structure.

⁷⁵ See for example, {Sangiovanni, 2007 #2822}, and {Meckled-Garcia, 2008 #4290} While we distance ourselves from one aspect of their position here, a lot more would have to be said to do their contribution justice.

fact *constitutive* of a global basic structure and, hence, that issues of global justice do indeed arise.⁷⁶ Second, and more importantly in our context, Miriam Ronzoni has suggested that “the most pressing issue is not whether we *have* a global basic structure, but whether we *need* one.”⁷⁷ Ronzoni makes the case that the absence of a global basic structure in the face of inequalities should not lead us to conclude that these inequalities somehow fall outside the purview of justice, but instead calls for the *creation* of such a basic structure. Internationally as well as domestically, certain rules may be required to guarantee the fairness of interactions between individuals. Ronzoni submits that “under circumstances of intense international interaction and interdependence the conditions of effective sovereignty, and hence of *international background justice*, may be eroded.”⁷⁸ Consequently, she advocates the creation of functionally differentiated supranational institutions that have the (legitimate) authority to set certain rules for appropriate conduct.

This is precisely the kind of claim we have attempted to substantiate with respect to international tax competition in section 1. The current institutional setting undermines effective sovereignty. The membership and intentionality principles are designed to restore this sovereignty and to guarantee international background justice. In fact, Ronzoni explicitly cites tax competition as one policy area where she considers international background justice to be violated and calls for interdisciplinary research on this issue. Delivering on the research program of international background justice in international taxation is the principal objective of this paper.

Let us add two comments on this categorisation of our account as one of international background justice. First, in line with Ronzoni’s account as well as with our remarks in the introduc-

⁷⁶ Cf. {Follesdal, 2011 #4291}.

⁷⁷ {Ronzoni, 2009 #3958@ 243}

⁷⁸ {Ronzoni, 2009 #3958@ 248-49}

tion to this paper, the idea of background justice emphasizes institutional reform over redistributive obligations. It favours preventative institutional reform to remedial redistribution of income. That said, note that our two principles will go *some* way towards reducing global inequalities. For those who agree that we are currently facing a situation of background *injustice*, the inequalities that would be eliminated by institutional reform of the kind proposed here in fact qualify as injustices. What is more, neglecting institutional reform at the expense of an exclusive focus on redistribution amounts to a Sisyphus task. Redistribution to correct for an institutional bias and injustice is analogous to swimming against the current – it takes a lot more energy while getting you less far.

Second, this short section cannot claim to present a comprehensive treatment of the rich literature on global justice. Our limited objective here has been to elucidate the nature of our contribution to the literature. The membership and intentionality principles represent principles of international background justice.

5. Conclusion

Portraying the tax and transfer branch of government as the major instrument of redistribution can obscure the fact that competition between different tax systems will in fact exacerbate income inequalities both domestically and globally. This paper was motivated by the intuition that the inequality-enhancing effects of tax competition can be qualified as unjust. The membership and intentionality principles defended above serve as a normative toolkit to identify what that portion is. They specify to what extent the interdependence of states in fiscal matters calls for normative interdependence. To put these principles into practice, we propose the creation of an International Tax Organization (ITO), whose job description would include the settling of dis-

putes between states about which tax policies violate the membership and intentionality principles.

To be sure, a world in which the membership and intentionality principles are respected is not yet a just world. It is merely a world that guarantees international background justice in two important ways. First, national polities would regain the capacity to make collective fiscal choices about the size of the state and the level of *domestic* redistribution. In other words, the membership and intentionality principles ensure that the costs of fiscal choices fall on those who make them, at least to the extent that this can be achieved under conditions of fiscal interdependence. Second, the two principles will have to be complemented by substantive principles of *global* tax justice. While these necessarily build on the work done in this paper, they also ask the question whether states have normative obligations to make transfer payments to other states and, if so, what they are. We hope to address this issue in future work.