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Paper Proposal for the Workshop on
TAX COMPETITION: HOW TO MEET THE NORMATIVE AND POLITICAL CHALLENGE
Université de Montreal, 28-29 August 2008

Tax Competition and Inequality

The paper shows that international tax competition leads to inequality in two dimensions – among individual taxpayers and between developing and developed countries, proposes an institutional solution that can address both problems and assesses its political feasibility.

First, I show that tax competition is largely driven by the ability of multinational companies and wealthy taxpayers to engage in “paper profit” shifting – they can benefit from foreign low-tax regimes without relocating real economic activity. This type of tax competition causes inequality in two dimensions. For one, there is a change in the structure of national tax systems resulting in inequality between different groups of taxpayers; transnational businesses are favored over small and medium sized national companies and capital owners over labor. In addition, tax competition leads to inequality between different nation states. While in industrialized countries there are hardly any adverse effects on overall government revenue, developing countries, in addition to the effects on their tax structures, experience severe revenue losses.

Second, I argue that an adequate institutional solution can be a system of unitary taxation with formula apportionment. Since the creation of a “World Tax Organization” that could centralize tax policy is highly unrealistic, unitary taxation is legitimized as a workable middle ground between cosmopolitan ideals of enfranchising all affected interests and traditional conceptions of national and international justice. The consolidation of the tax base across borders would make unfair paper profit shifting much more difficult and would thus address the inequality between individual taxpayers. Further, such a system would link taxation closer to real economic activity so that developing countries would have a better chance of realizing some tax revenue from foreign investment. At the same time, since unitary taxation with formula apportionment would leave member states the possibility to set their tax rates independently, it would not curb tax competition entirely. Thus, it would satisfy developing countries' legitimate interest to use tax policy as an instrument for attracting foreign investment.

In the third part, I analyze the feasibility of the proposed solution. In the past, governments have jealously guarded their national tax sovereignty. They have insisted on their right to set tax rates, tax bases and tax systems independently. Introducing unitary taxation with formula apportionment, even though it would not fully take away governments' tax sovereignty would thus be a major departure from the traditional principles of international tax cooperation, conceived in the 1920s. Tracking the development of international tax cooperation I identify several mechanisms of positive feedback and show that the international tax institutions are subject to path dependence. Accordingly, all attempts to deal with the problem of harmful tax competition have focused on solutions that are compatible with the traditional "sovereignty-preserving" trajectory, such as improving transparency and exchange of information. A fundamental change in the form of unitary taxation is thus unlikely in the near future.

Finally, focusing on the interest constellations within and among the three relevant actor groups – transnational business (and capital owners), civil society, and national governments – I argue that more effective regulation of tax competition can only be expected if transnational, rather than nationally organized, civil society can successfully politicize the issue and make their demands heard by governments and International Organizations.