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The Economic Importance of Tax Competition for Foreign Direct Investment: An Analysis of International Corporate Tax Harmonization Proposals and Lessons from the Winning Corporate Tax Strategy in Ireland

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I. INTRODUCTION

Two hundred and thirty years ago, Adam Smith wrote that man should be "perfectly free to pursue his own interest in his own way and to bring both his industry and capital into competition with those of any other man."[1] He further maintained that free competition should dominate the market and be left to self-regulation by "an invisible hand [that] promotes [the best interests of] society."[2] With amazing foresight regarding modern tax practice, Smith warned about the dangers of high taxes:

> "[t]he proprietor of stock is properly a citizen of the world, and is not necessarily tied to any one country. He would be apt to abandon the country in which he was exposed to a vexatious inquisition, in order to be assessed to a burdensome tax, and would remove his stock to some other country where he could either carry on his business, or enjoy his fortune more at his ease."[3]

In other words, competition is king, it will best regulate itself, and high taxes mean that money goes somewhere else.

Smith changed the world's view of economics just as surely as Sir Isaac Newton and Charles Darwin changed their respective disciplines.[4] His ideas became the basis for capitalism by demonstrating how free trade, competition, and market self-regulation would spur economic development while also reducing poverty and other social ills.[5] Today, an entire body of law has

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1. ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 300 (Encyclopedia Britannica, Inc. 1971) (1776).

2. *Id.* at 194.

3. *Id.* at 372-73.

4. Dr. Eamonn Butler, *Preface to the Online Edition* of ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS, http://www.adamsmith.org/smith/won-intro.htm, (last visited Oct. 13, 2006).

5. *See id.* (stating that Adam Smith demonstrated how "free trade, competition, and choice would spur

developed based on these economic ideas, seeking to establish market efficiency and perfect competition.[6]

Globalization continually presses toward one world economy,[7] and as this unified economy develops, so does the need for increased economic efficiency. Increased efficiency and awareness has caused many nations to learn the hard way that high tax rates are increasingly difficult to sustain,[8] because "[a]s economic integration increases, individuals and businesses gain greater freedom to take advantage of foreign economic opportunities [that] increase the sensitivity of decisions about investment and location to taxation."[9] For Multinational Enterprises (MNEs), corporations that do business in several nations, global efficiency is of special importance because of their ability to take advantage of economic opportunities in many jurisdictions.[10] As a result, recently proposed regulations to limit tax competition for foreign investment[11] have sparked intense debate and controversy. Although there are valid arguments in favor of some limitation,[12] this comment will demonstrate why international tax competition would be best left to self-regulation by Smith's invisible hand. Ultimately, if market forces control and tax rates are set by individual governments and MNE market participants, tax rates will settle into an equilibrium. Self-regulation will cause tax rates to stabilize at a rate between the lowest rate governments would be willing to implement, and the highest rate at which MNEs would still be able to carry on a profitable business within that nation.[13]

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economic development, reduce poverty, and precipitate the social and moral improvement of humankind").

6. *See* PHILLIP AREEDA, LOUIS KAPLOW, & AARON EDLIN, ANTRITRUST ANALYSIS: PROBLEMS, TEXT, AND CASES 3 (6th ed. 2004) (stating that antitrust is concerned with private economic power as controlled through law and "focus[es] on that area within which competition—in contrast to extensive regulation or government-owned enterprise—is the accepted technique of social control").

7. Chris Edwards & Veronique de Rugy, *Economic Freedom of the World: 2002 Annual Report* 43 (Vancouver: Fraser Institute) (2002).

8. *Id.*

9. *Id. See also* Amina Lahreche-Revil, *Who's Afraid of Tax Competition? Harmless Tax Competition from the New European Member States* 10 (Centre D'Etudes Prospectives et D'Informations Internationales, Working Paper No. 2006-11, 2006) (arguing that increasing international integration imposes a growing pressure on tax policies, as raising taxes creates an incentive for mobile tax payers to relocate abroad and finding that FDI does react to tax incentives when choosing location).

10. *Id.* at 43. *See also* Kojo Yelpaala, *The Efficacy of Tax Incentives Within the Framework of the Neoclassical Theory of Foreign Direct Investment: A Legislative Policy Analysis*, 19 TEX. INT'L L.J. 365, 367-68 (1984) (stating that "MNEs view the world as their economic space" and use their affiliates to benefit from characteristics of many jurisdictions).

11. *E.g.*, ORG. FOR ECON. COOPERATION & DEV., HARMFUL TAX COMPETITION: AN EMERGING GLOBAL ISSUE (1998), *available at* http://www.oecd.org/dataoecd/33/0/1904176.pdf [hereinafter OECD]; *Communication from the Commission to the Council, The European Parliament and the Economic and Social Committee: Tax Policy in the European Union – Priorities for the Years Ahead*, COM (2001) 260 final (May 23, 2001).

12. For example, tax competition should probably be limited to deal with tax avoidance and evasion, *see infra* Part II.C. Also, limiting tax competition for financial and mobile investment may be important. *See infra* Part II.D. *But see* infra note 43 and accompanying text (arguing that mobile investment is not always a negative development). Moreover, in a market like the European Union, limiting tax competition to reduce cross-border compliance costs is important. *See infra* note 59 and accompanying text.

13. This comment does not argue that there would be a single tax rate across the board internationally.

As a preliminary matter, this comment is limited to tax competition for Foreign Direct Investment ("FDI"). FDI generally means investment in foreign companies giving investors a significant measure of management power or control in the company.[14] Such investment can consist of financial capital investment (equity) in a foreign company,[15] "greenfield" investment,[16] or control gained through mergers or acquisitions of a foreign corporation.[17] Internationally, FDI is generally defined as at least 10% ownership in a company.[18] Much of the concern about tax competition does not include FDI, but is about mobile investment activity.[19] Mobile investment activity can be Foreign Portfolio Investment,[20] financial investment, and 'paper' investment that is simply matter of accounting.[21] As fleshed out below, mobile investment activity was thought to be particularly dangerous to national tax bases because it would move from jurisdiction to jurisdiction, seeking only the best tax rates with little or no concern for detrimental effects from lost tax revenue on a host jurisdiction.[22] As a result, the Organisation for Economic Cooperation and Development set out specifically to limit tax competition for mobile investment.[23] On the other hand, the European Union sought to include not only mobile investment, but also business taxation—or FDI.[24]

Although the OECD report focuses on mobile investment activity, this comment focuses on international tax incentive competition aimed at attracting FDI. Specifically, this comment argues that the European Union's inclusion of limits on tax competition for FDI was a mistake. Instead, it will argue that tax

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Instead, it argues that in each individual investment interaction between an MNE and a government, there would be an optimal, equilibrium rate that would be reached through free market economics.

14. U.N. INSTITUTE. FOR TRAINING AND RESEARCH, UNITAR/SHU SERIES ON INTERNATIONAL ECONOMICS AND FINANCE, FOREIGN DIRECT INVESTMENT FOR DEVELOPMENT FINANCING, AN INTRODUCTION AND PRIMER ON FOREIGN DIRECT INVESTMENT BY RICHARD J. HUNTER, JR., (Hiroshima, Japan May 2005) *available at* http://www.unitar.org/hiroshima/programmes/ief06/test/materials/IEF06_ Hunter_Primer. . . .pdf [hereinafter UNITAR].

15. Frederic Beauregard-Tellier, *Canadian Foreign Direct Investment: Recent Trends* 2 (Library of Parliament Parliamentary Research Branch, Econ. Division, Research Paper No. PRB 03-35E, 2004) (citing C. Lajule, *Foreign Direct Investment: A Driving Force in Economic Globalization* (Statistics Canada, Research Paper No. 67F0001MIB01020)).

16. *Id.* (defining "greenfield" FDI as incorporation or investment in a new productive product in a foreign country—basically a startup investment).

17. UNITAR, *supra* note 14.

18. *Id.*

19. *See, e.g.*, William A. Barker, *Optimal International Taxation and Tax Competition: Overcoming the Contradictions*, 22 NW. J. INT'L L. & BUS. 161, 163-164, 179 (arguing that capital movements are of greater concern because they may not represent movement of real resources and may be simply accounting transfers).

20. *See infra* note 43 and accompanying text.

21. Barker, *supra* note 19, at 163-64, 179. The use of accounting to create investment is present when an MNE makes a transaction look like it took place, but in actuality only exists on paper.

22. *See infra* note 44 and accompanying text.

23. OECD, *supra* note 11, at 7.

24. *See infra* note 41 (pointing out that while the European Union claimed to be using the OECD tax competition guidelines, it extended their application to business taxation in general).

competition for FDI, when used as part of an overall economic development plan, is an invaluable component of the global marketplace.

In addition, this comment is limited to international tax competition as a matter of general national policy. A common, and one-sided, characterization of tax competition places MNEs at the center of the problem, playing different governments against each other to gain the best possible tax incentives, regardless of any possible detriment to the respective nations.[25] While this situation may sometimes exist,[26] international tax competition often involves general tax rates set by national governments that are applicable to corporate activity across the board.[27] In such situations, governments generally choose to set fixed, low tax rates to attract FDI, and competition ensues between nations for the lowest rates and most attractive investment environment.[28] The basic theory is that by setting a corporate income tax rate lower than other nations, the incentives will entice FDI and create positive inward investment flows.[29] This comment is limited to that particular type of international competition—national governments developing tax incentives specifically to attract FDI.[30]

This comment will argue that tax competition is best left to self-regulation under natural market forces—the invisible hand. It will argue that rather than applying across the board regulations to international taxation, it is best to allow the tax participants, namely businesses and governments, to reach the most efficient results themselves through the natural market forces of competition. Specifically, Sections II and III analyze the guidelines for combating harmful tax competition proposed by the Organisation for Economic Co-Operation and Development and the European Union respectively. Section IV analyzes Ireland's investment tax regime, focusing primarily on the successful use of tax incentives to gain competitive advantage in attracting FDI and the Irish government's active involvement in those policies. The Irish legislation could serve as a model for how and when to embrace tax competition. Finally, Section V provides a brief look at lessons from past experience with tax competition

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25. JOHN H. MUTTI, FOREIGN DIRECT INVESTMENT AND TAX COMPETITION 11 (Institute for International Economics 2003).

26. *See, e.g. id.* (describing an individual firm negotiation, albeit a domestic example, where the U.S. state of Alabama successfully outbid other states for the location of a Mercedes-Benz assembly plant).

27. *Id.*

28. *E.g.*, Lahreche-Revil, *supra* note 9 at 10; U.N. CONF. ON TRADE & DEV., WORLD INVESTMENT REPORT 2003, 123, U.N. Sales No. E.03.II.D.8 (2003) [hereinafter UNCTAD]. *See also* Yelpaala, *supra* note 10, at 378-83 (arguing that although the theory is flawed, setting low tax rates is based on the capital arbitrage theory—that governments will set low rates assuming that it will attract investment interested in maximum rates of return).

29. *See* UNCTAD, *supra* note 28, at 123 (stating that investment incentives can induce new investors to establish a presence, to expand an existing business, or not to relocate elsewhere).

30. A simple definition of such tax incentives is "a special tax provision granted to qualified investment projects that has the effect of lowering the effective tax burden . . . on those projects, relative to the effective tax burden that would be borne by investors in the absence of the special tax provision." Howell Zee et al., *Tax Incentives for Business Investment: A Primer for Policy Makers in Developing Countries*, 30 WORLD DEV. 1497, 1498-99 (2002).

while also suggesting that they guide future regulation. Specifically, the lessons that should be kept in mind are that MNEs can be informed market participants in the same manner as governments and legitimate tax law avoidance and evasion problems can be addressed without suppressing tax competition.

II. INTERNATIONAL REGULATION OF TAX INCENTIVE COMPETITION: A REPORT BY THE ORGANISATION FOR ECONOMIC COOPERATION AND DEVELOPMENT

Not surprisingly, international tax competition is a complex topic and so is any method for its regulation. The OECD Report on harmful tax competition is no exception. For the purposes of this comment, the Report is important for several reasons. First, it represents one of the most prominent attempts to regulate tax competition. Second, it addresses some legitimate concerns regarding tax competition, including, for example, tax avoidance and evasion.[31] Third, the Report's chosen method for dealing with tax competition may prove ineffective in practice.[32] Finally, the Report highlights the differences in mobile investment and FDI and begins the discussion of why tax competition for FDI is not harmful.[33]

A. *An Overview of the OECD Approach Toward Harmful Tax Competition*

In May of 1996, the Ministerial Communique called upon the Organisation for Economic Co-Operation and Development ("OECD") to "develop measures to counter the distorting effects of harmful tax competition on investment and . . . report back in 1998."[34] Following the request, the Committee on Fiscal Affairs created the "Special Sessions on Tax Competition"[35] and drafted its report *Harmful Tax Competition: An Emerging Global Issue*.[36]

An understanding of the Report is important because it represents an attempt to both identify and limit tax competition.[37] The OECD "intended to develop a better understanding of how tax havens and harmful preferential tax regimes, collectively referred to as harmful tax practices, affect the location of financial and other services."[38] The ultimate goal was and is to limit and combat tax competition, because the OECD believes such practices "erode the tax bases of

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31. *See infra* Part II.B (discussing dealing with avoidance and evasion by regulating tax competition).

32. *See infra* Part II.C (discussing the OECD as a tax cartel and the reasons its regulations may be doomed to fail).

33. *See infra* Part II.D (discussing why FDI was intentionally left out of the report).

34. OECD, *supra* note 11, at 7.

35. *Id.*

36. *Id.*

37. *E.g.* Mitchell B. Weiss, *International Tax Competition: An Efficient or Inefficient Phenomenon*, 16 AKRON TAX J. 99, 122 (2001) (reporting that the OECD's report is the latest attempt on the "losing side [of the tax competition debate] try[ing], futilely, to impede its progress").

38. OECD, *supra* note 11, at 8.

other countries, distort trade and investment patterns, and undermine the fairness, neutrality and broad social acceptance of tax systems generally."[39] While such altruistic goals may appear noble, and despite the fact that substantial capital is moving to low tax jurisdictions, the OECD's concerns remain largely uncorroborated by existing studies.[40] In any event, the Report has been misunderstood in application by other bodies, such as the European Union ("EU").[41]

At the outset, it is important to note that there are several limitations to the OECD Report. The initial request for the tax competition report specifically limited the study of international tax policies and harmful tax competition to "[t]ax schemes aimed at attracting financial and other geographically mobile activities."[42] This is an important limitation for several reasons. First, and most significantly, FDI is not generally the type of mobile activity with which the OECD was concerned, placing it outside the scope of the Report.[43] Moreover, the economic arguments cited by opponents of tax competition,[44] translate poorly to

39. *Id.*

40. Weiss, *supra* note 37, at 122.

41. As discussed more in depth below, the EU paid lip service to the OECD proposals, including suggesting differentiation between legitimate use of tax incentives and those aimed at investments with no actual presence. However, the EU Code of Conduct sought to limit and investigate business tax incentives that affect the location of a business within the European Community. *See* Conclusions of the ECOFIN Council Meeting Concerning Tax Policy (Annex 1) (Dec. 1, 1997). In addition, the OECD, after the EU announced its Code of Conduct, recognized the same. Specifically, the OECD stated, "[w]hilst the EU Code and the OECD Guidelines are broadly compatible, particularly as regards the criteria used to identify harmful preferential tax regimes . . . the Code looks at business activities in general, although with an emphasis on mobile activities." OECD, *supra* note 11, at 11.

42. OECD, *supra* note 11, at 7.

43. Mobile investment activity can be Foreign Portfolio Investment (which is short term, non-FDI, financial investment) or simply movement of capital either by way of accounting transfers or movement of capital without the movement of any real resources. Barker, *supra* note 19, at 163-164, 179. Mobile investment is thought to be more easily manipulated because of its mobility, and thus is a larger problem because it can easily erode the tax bases of nations. Although the arguments for and against tax competition for mobile capital are beyond the scope of this comment, it is true that while mobile capital may be manipulated, it is not necessarily as big a problem as critics of tax competition believe. For example, where money is channeled to a low tax jurisdiction, it does not allow the corporation a total windfall, because in order for the low or no tax benefits to remain in place, the money would have to stay trapped in the tax haven. In actuality, the capital is usually lent to other companies or subsidies and there is a:

> "virtuous cycle [where] tax haven profits of a multinational group are generally used to reinvest in the group, by funding expansion projects . . . This is in fact an example of how tax havens promote investment and the growth of wealth . . . Tax can still be collected when the company's profits flow out to the shareholders (either when dividends are paid or when the shareholders sell the shares for a profit) . . . By the sensible use of tax haven subsidiaries companies can avoid this problem and create an internal pool of capital to fund investment and expansion."

RICHARD TEATHER, THE BENEFITS OF TAX COMPETITION 74 (Inst. of Econ. Affairs 2005). Other commentators have argued that the effects of destroying tax havens would have further detrimental repercussions. *See e.g.* Javier G. Salinas, *The OECD Tax Competition Initiative: A Critique of Its Merits in the Global Marketplace*, 25 HOUS. J. INT'L L. 531, 555 (2003) (stating that harmonization will lead to higher transaction costs, create less return on capital investment, and make developing nations more dependent on foreign aid, which is a burden on developed countries).

44. For example, a common argument against allowing tax incentives for mobile activities and financial

activities characterized by actual corporate presence in the nation—a point recognized by the OECD itself.[45]

Turning to the OECD Report, it begins with a basic background, overview, and statement of position about tax competition,[46] followed by criteria for identifying harmful tax competition.[47] It ends with specific guidelines for dealing with and counteracting harmful tax competition.[48] As a whole, the Report is important to understanding what problems led to the push for international tax harmonization, and in what instances it might be beneficial.

B. *The OECD Definitional Approach to Harmful Tax Competition*

The basis for the definition of harmful tax competition is the above mentioned formal request, calling upon the OECD to prepare its report. The closest it comes to a definition is by directing the research to "[t]ax schemes aimed at attracting financial and other *geographically mobile activities* [that] create harmful tax competition between States, *carrying risks of distorting trade and investment and could lead to the erosion of national tax bases*."[49] The limitation of the Report to mobile investment activity is key to understanding the OECD's goals because it is a prerequisite for any counteractive measures and serves as the foundational theme for identifying "harmful" tax competition.[50] From the initial definition, the OECD Report further divides examples of harmful tax competition into tax havens and preferential tax regimes.[51]

services is that they allow those "[m]obile taxpayers [to benefit by] free-riding on less mobile tax payers, receiving the benefits provided by high tax jurisdictions" to the detriment of both the less mobile tax payers (such as property, personal income tax, etc.) and the tax bases of those jurisdictions. Weiss, *supra* note 37, at 128.

45. *See* OECD, *supra* note 11, at 8 (excluding specifically tax incentives designed to attract investment characterized by plant, building and equipment).

46. *Id.* at 6.

47. *Id.*

48. *Id.*

49. *Id.* at 7 (emphasis added).

50. OECD, *supra* note 11, at 6. The report itself states that it is focused only on mobile investment activities, including, for example, financial and other services. Moreover, it specifically states that "[t]ax incentives designed to attract investment in plant, building and equipment have been excluded at this stage, although it is recognized that the distinction between regimes directed at financial and other services on the one hand and at manufacturing and similar activities on the other hand is not always easy to apply." Including investment consisting of actual corporate presence becomes an important issue as the EU begins to develop its own tax competition policy, as discussed below. *See also* Weiss, *supra* note 37. Weiss criticizes the OECD's Report as a "waffling definition of 'harmful tax competition'" and points out that it fails to provide a definitive list of factors, or the relative weights to attach to the factors that have been provided. *Id.* at 124. Ultimately, Weiss argues that the introduction and request is unfortunately the "closest the OECD Report comes to defining" harmful tax competition. *Id.*

51. OECD, *supra* note 11, at 19.

Within the two divided categories, the OECD provides identification factors for harmful tax competition.[52] According to the OECD, tax havens share one or more of the following characteristics:[53]

- No or only nominal taxes
- Lack of effective exchange of information
- Lack of transparency
- No substantial activities

For preferential tax regimes the characteristics are:[54]

- No or low effective tax rates
- "Ring fencing" of regimes[55]
- Lack of transparency
- Lack of effective exchange of information
- [And within the category of other factors listed] The regime encourages purely tax-driven operations or arrangements.[56]

The first factors in both lists are concerned with secrecy and are meant to address tax evasion problems. The logic is that if legislative secrecy is reduced, it would help protect national tax bases from nominal or 'paper' investment,[57] reduce opportunities for international tax evasion and avoidance[58] and provide

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52. *Id.* at 23, 27.

53. *Id.* at 23.

54. *Id.* at 27.

55. *Id.* at 23, 27. Ring fencing exists where a tax regime isolates its own economy from the effects by either excluding resident tax payers from taking advantage of the benefit or prohibiting enterprises that enjoy such benefits from participating in the host market.

56. *Id.* at 34. The first factors are listed as the main identifying factors, and the "purely tax-driven operation" factor is listed under a set of "other factors" for identifying harmful preferential regimes. The Report elaborates on the meaning by saying that it suggests a tax regime was designed to attract investment involving no substantial activities.

57. Such investments typically are the sort of geographically mobile investments that initially concerned the OECD. A good example would be portfolio or other purely monetary investments in a foreign jurisdiction. "For example, American bank deposit and portfolio interest paid to foreigners is exempt from American taxation [which has] helped attract more than $1.1 trillion in foreign deposits to American banks and made Miami a banking center for Latin America." Edwards & Rugy, *supra* note 7, at 43. Opponents of tax competition argue that such investments erode the available tax bases of the host country, at the expense of less mobile tax payers (such as resident income or property taxes.) Essentially it is a free-riding problem where mobile taxpayers take advantage of the less mobile and thus are "receiving the benefits provided by high-tax jurisdictions while paying low or no taxes." Weiss, *supra* note 37, at 128. The OECD itself recognized the free-riding problem, stating that harmful tax competition would cause undesirable shifts in the tax burden to less mobile tax payers. OECD, *supra* note 11, at 70.

58. The concept of international tax evasion is complicated, but the basic idea can be fairly easily laid out. Generally, international taxation could be divided into two types. Source taxation is tax imposed on income by the home/source country of the investor/investment. Host taxation is tax imposed by the foreign jurisdiction in which the investment is located. The difference between the two tax regimes creates the motivation and opportunity for tax evasion. Typically, the host country will tax the investment, and in some nations, tax is sourced based, meaning that international investment could be subject to double taxation, at home, and in the

lower tax compliance costs for MNEs.[59] The last factor in both lists is lack of substantial activity—an important reiteration of the Report's limitation to financial and mobile investment activity.[60] In other words, the Report is suggesting that lack of activity commensurate with the investment makes it look like harmful tax competition because it is attracting only financial or mobile investment. Considering the presence of activity as compared to the investment amount would generally mean that incentives aimed at attracting FDI would not be characterized as harmful tax competition because of corporate presence associated with FDI.[61] To ensure investment such as FDI is not included, the Report suggests that an investigating party ask whether there is a correlation between the "presence and level of activities in the host country [and] the amount of investment or income."[62] This further illustrates that the guidelines are not generally applicable to FDI characterized by corporate presence, because it does not carry the same risk as mobile investment.

There are several reasons why FDI has intentionally been left out of the harmful taxation factors listed by the OECD.[63] The short answer is that if there is actually corporate presence, then benefits may present themselves to the host jurisdiction in the form of technology transfer or other positive spillover effects.[64]

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foreign jurisdiction. This will lead to one or both of the tax regimes to exempt the income. If a home tax regime exempts foreign source income, and the investors seek out a foreign jurisdiction that exempts foreign source investment, then the jurisdictional choice is made so that the investment does not owe tax to either a home or a host nation—successfully evading income tax altogether. *See e.g.*, Assaf Razin & Efraim Sadka, *Vying for Foreign Direct Investment: An EU-Type Model of Tax Competition* 3-4 ((Nat'l Bureau of Econ. Research, Working Paper No. 11991, 2006) (explaining the concepts of source and host taxation and the methods in which MNEs may avoid payment of either).

59. Because of its open market policies, the European Union has been the frontrunner for decreasing tax compliance costs of MNEs. The guidelines requiring tax regime transparency and harmonization are, in part, meant to reduce the burden on MNEs from different tax regimes in several countries. The idea is that if it is easier to comply with differing tax regimes, there will be less costs for compliance and therefore more efficient resource allocation. *See Communication from the Commission to the Council, the European Parliament and the Economic and Social Committee: Towards an Internal Market Without Tax Obstacles: A Strategy for Providing Companies with a Consolidated Corporate Tax Base for Their EU-wide Activities*, (Oct. 23, 2001) [hereinafter *Towards an Internal Market*].

60. OECD, *supra* note 11, at 23. The report suffers by not defining substantial activity, but it suggests that if the investment creates activity in the jurisdiction—jobs, plant, etc.—then it is not mobile investment that is ready to skip town at the hint of a tax rate rise and to the detriment of the national tax base. *See* Weiss, *supra* note 37, at 124-25 (discussing definitional problems with the OECD Report).

61. The idea is that if FDI attracts "substantial activity" or more appropriately corporate presence, then the benefit to the jurisdiction is increased tax revenue. This can be expressed by showing that although tax rates have declined in OECD nations, corporate tax revenue as a share of GDP has not declined. MUTTI, *supra* note 25, at 26-30.

62. OECD, *supra* note 11, at 35. The idea is that if there is substantial activity commensurate with the investment, it looks less like mobile activity and is not the Report's concern.

63. This is discussed in greater depth *infra* at Part II.D.

64. The concept of technology transfer is that the presence of foreign investment allows technological advances and scientific knowledge to spill over into the host economy—through research and development and simply by way of employees' learning new technology through employment. For example, following WWI that technology transfer to the US included important intellectual property rights including the rights to dyestuff, Bayer aspirin, DuPont chemical products, etc. and ultimately gave the US technology it might not have

If such benefits accrue in the host economy, then the investment does not look so much like a free rider on less mobile tax bases because the host economy is receiving benefit from the investment.[65] In short, the OECD's purposeful omission of FDI is vital to understanding where the EU confused the issue, and why nations attempting to attract FDI should not be deprived of beneficial tax competition.[66]

C. The OECD Guidelines: Forming the Tax Cartel

To counteract tax competition, the OECD drafted counteractive measures to encourage international cooperation and to assist domestic legislation and tax treaties in dealing with the issue.[67] Like the guidelines themselves, the counter-active measures suggested in the Report are mostly concerned with preventing erosion of tax bases, international tax evasion, and decreasing compliance costs for MNEs.[68] To achieve those goals, the general theme of the counteractive measures is that tax regimes should be open for analysis to encourage cooperation and allow nations to be more aware of possible loopholes which permit some taxpayers to avoid tax liability altogether.[69]

In order to prevent mobile capital from exploiting tax competition between nations,[70] the Report offered recommendations to address the problem. These recommendations take several different approaches[71] aimed at domestic legislation, tax treaties, and international tax cooperation in general.[72] In aiming its recommendations specifically at avoidance and evasion, the OECD recognizes that are different forms of harmful tax competition which will inevitably need different solutions.[73] The Report characterizes the problems of avoidance and evasion as being attributable to exploitation of certain offshore tax regimes and

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otherwise possessed. EDWARD M. GRAHAM & DAVID M. MARCHICK, US NATIONAL SECURITY AND FOREIGN DIRECT INVESTMENT 4-6 (Institute for International Economics 2006).

65. Weiss, *supra* note 37, at 128. The OECD itself recognized that if the investment is characterized by corporate presence and activity, it is less likely to be harmful tax competition. It forces this result by "requir[ing] a subjective evaluation of whether the additional activities created in the country with the preferential tax regime are commensurate with the amount of investment or income generated." OECD *supra* note 11, at 35.

66. *See infra* Part II.D (discussing why FDI is not the OECD's concern).

67. OECD, *supra* note 11, at 39.

68. *Id.* at 37.

69. *See generally id.* at 37-38.

70. *Id.* at 37. The Report specifically says "[g]overnments cannot stand back while their tax bases are eroded through the actions of countries which offer *taxpayers ways to exploit tax havens and preferential regimes* to reduce the tax that would otherwise be payable to them."

71. The Report describes the Recommendations as taking different angles, which include encouraging individual nations to refrain from adopting harmful legislation, attempting to offset the benefit for taxpayers from certain harmful tax competition, and also by focusing specifically on the problem of tax avoidance and evasion. *Id.* at 39.

72. OECD, *supra* note 11, at 39.

73. *Id.* at 40.

the use of bank secrecy to avoid payment of source taxes or even any tax whatsoever.[74] The risk is that sophisticated investors will find ways to move capital into a jurisdiction where neither source nor host tax is due.[75] The recommendations are based on the idea that if tax laws are more transparent, investors will no longer be able to use secrecy provisions and unknown loopholes because both source and host nations will realize the problem and simply close the loophole. [76]

Another concern the Report addressed is that tax evasion may be the result of intentional legislation on the part of one nation offering "a preferential tax regime . . . to facilitate the evasion of tax properly owed to other countries."[77] In such situations, openness in tax legislation would allow nations who are injured by such legislation to react defensively, or at least to impose a source tax.[78] In any event, the recommended measures to combat harmful tax competition are intentionally geared toward openness.

While the push for openness might help nations root out and correct harmful tax competition, encouraging information sharing may have highly problematic economic implications when applied across the board to tax competition between nations.[79] Understanding those implications requires a brief return to antitrust law and its foundational economic principles, specifically those surrounding cartels.[80] At its heart, antitrust law is concerned with achieving a perfectly competitive market, based on the premise that the greatest benefit to the community can only be achieved by removing restraints upon competition.[81] Price fixing, or other acts designed to eliminate competition, would generally violate provisions of antitrust law.[82] The OECD Report is not ashamed of trying to restrict competition—its

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74. *Id.* at 39.

75. *See supra* note 58.

76. OECD, *supra* note 11, at 40 (suggesting that different tax measures require different counter measures, some being harsh and some merely being exchange of information and cooperation in tax legislation).

77. *Id.*

78. *Id.* at 3. There is a slight problem with this logic. The OECD wants to encourage cooperation and openness to stop nations from offering tax regimes aimed at evasion, and the solution is to foster cooperation. However, the Recommendations aren't compulsory, so there really is not much incentive for nations who benefit from regimes to comply. Nevertheless, the openness would serve to close many of the exploitable provisions and loopholes.

79. Weiss, *supra* note 37, at 128.

80. *Id.*

81. Standard Oil Co. v. United States, 337 U.S. 293, 309 (1949) (stating that "it is the theory of the antitrust laws that the long-run advantage of the community depends upon the removal of restraints upon competition").

82. *See* AREEDA, ET AL, *supra* note 6, at 113 ("per se prohibition against price fixing has become settled law"). Although the Sherman Act is an American law, its underlying policies apply equally to the anti-competitive conduct of the OECD and the EU. *See* Alexander Townsend, Jr., *The Global Schoolyard Bully: The Organisation for Economic Cooperation and Development's Coercive Efforts to Control Tax Competition*, 25 FORDHAM INT'L L.J. 215 (2001) (applying the Sherman Act and case law to the OECD efforts to stop tax competition). Collusive action between competitors to restrain trade is illegal under the Sherman Act. Sherman Act, 26 Stat. 209 (1980), codified as amended, 15, U.S.C. §§1-7. That collusion may take the form of a cartel or

purpose is to specifically use information-sharing to set tax rates and end competition.[83]

On some level, the OECD recommendations read like a manual for the formation of a price-fixing cartel. To understand the OECD tax cartel analogy, the tax is the price—for businesses it is the price of doing business in the jurisdiction. The information sharing and cooperation proposed by the OECD amount to an expressed agreement to price-fix, by setting tax rates and policies at uniform levels. Unfortunately for proponents of the harmonization agreements, "like all cartels, this one also carries the seeds of its own destruction."[84]

The single largest problem in any cartel is cheating.[85] If any one member of the cartel cheats by undercutting the agreed upon price, that member benefits from increased business at the expense of the others in the cartel.[86] The more members there are in a cartel, the harder it is to detect and punish cheating. In this case, the number of nations involved would make enforcement nearly impossible, because when one cheater realizes benefit, others are soon to follow, and the cartel will implode.[87] Besides those internal complications, other nations outside the cartel have increased incentive to set their own tax rates well below the cartel and gain a competitive edge over all the members.[88]

Although tax avoidance and evasion are problems, dealing with them in this manner is unwise, and unlikely to succeed. In the end, rather than fix prices, it would be best to allow the market to self-regulate, setting optimum tax rates and

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other oligopoly, where competitors join together and agree to eliminate competition among themselves AREEDA, ET AL, *supra* note 6, at 202-03.

83. OECD, *supra* note 11, at 1. The forward indicates that it is meant to counter harmful *competition*. Government participation is not surprising because government activity is usually immune from antitrust challenge. Parker v. Brown, 317 U.S. 341, 350-51 (1943). However, there is further motivation of the OECD because "member governments believe that they are losing unacceptable (to the governments at least) amounts of tax revenue due to the tax havens and so, like corrupt businessmen facing tough competition, they find it easiest to form a cartel (and nobble anyone outside it)." Richard Teather, *Harmful Tax .Competition?*, IEA ECONOMIC AFFAIRS, December 2002, at 59.

84. Weiss, *supra* note 37, at 127.

85. AREEDA, ET AL, *supra* note 6, at 115.

86. *Id.*

87. *Id.* One cheater may begin by reaping benefits at the expense of the others, but thereafter other cartel members will follow and the cartel price becomes unenforceable, causing the cartel to implode. This is similar to self-regulation because the self interest of each competitor (cartel member) means that they want the greatest benefit, so they lower their prices and others may follow. The end result is the same, efficient prices (or tax rates), but getting there through anti-competitive conduct is the problem. *Id.* at 114 ("The harm caused by such a cartel would equal that resulting from the hypothetical monopoly. Consumers are harmed by the cartel's high prices [and s]ocietal wealth falls.").

88. *See infra* note 147 and accompanying text (describing how members outside a harmonization agreement would simply set their rates below the group and benefit to the exclusion of the cartel group). The OECD itself recognized this problem, stating that failing to control tax competition in non-OECD countries "will cause a shift of the targeted activities to economies outside the OECD area, giving them an unwarranted competitive advantage and limiting the effectiveness of the whole exercise." ORG. FOR ECON. COOPERATION & DEV., TOWARDS GLOBAL TAX CO-OPERATION: PROGRESS IN IDENTIFYING AND ELIMINATING HARMFUL TAX PRACTICES 22 (2000).

pushing the market as a whole toward greatest efficiency.[89] The push toward tax harmonization is a form of price fixing that is primarily a lack of faith in the long-term benefits of free market economics.[90] Although using law to define the parameters of the market and to push toward perfect competition may be economically sound,[91] destroying the market entirely by harmonization and price fixing is not, and is probably bound to fail in the long run.

D. The OECD Report is Not Concerned With FDI

The OECD Report focuses only on investment activities that are highly mobile,[92] leaving FDI out of the equation.[93] A primary reason for the limitation is the concept of the tax base.[94] The simplest definition of a tax base is the total sum of taxable activity or capital within a jurisdiction, which in turn would mean the total revenue a jurisdiction could expect to collect for funding public services and providing public goods.[95] A major concern is that investors may be able to avoid taxation and thus tax bases will shrink, leaving some nations with insufficient funding for public spending.[96] Foreign investors are important players in the tax game because opponents of tax competition fear that increasingly sophisticated investors will use tax competition to reduce their tax burden significantly, or even escape liability altogether.[97] As a result, the tax burden will shift to less mobile factors, allowing more sophisticated taxpayers to benefit at the expense of

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89. *See infra* Part V.B (discussing dealing with legitimate tax problems at their source without destroying tax competition generally); *see also infra* note 244 and accompanying text (stating that the best benefits come to those who embrace free market principles rather than engage in protectionism).

90. TEATHER, *supra* note 43, at 24 (stating that the motives of those seeking to stifle tax competition are the same as all who protest free market economics—namely worrying about risks rather than opportunity, desiring to preserve the status quo, and a distrust of economic freedom).

91. *See* AREEDA, ET AL, *supra* note 6, at 3 (stating that American antitrust law, concerned with protecting competition, takes the accepted technique of simply defining the area in which competition takes place).

92. OECD, *supra* note 11, at 38.

93. This is the point missed by the European Union when it chose to expand the tax regulation to all tax competition. Rather than spend a lot of time focusing on what is present within the OECD Report, it is most important at this point to recognize what is noticeably absent from both the definition of a problem and something that is listed as needing to be dealt with—substantial activities (such as corporate investment in the form of FDI) and the tax policies that attract them.

94. OECD, *supra* note 11, at 3. In the forward, the OECD specifically states its intention to "counter the distorting effects of harmful tax competition on . . . national tax bases." *Id. See also, e.g.*, Reint Gropp & Kristina Kostial, *The Disappearing Tax Base: Is Foreign Direct Investment (FDI) Eroding Corporate Income Taxes?* (Int'l Monetary Fund, Working Paper No. WP/00/173, Oct. 2000) (questioning whether tax base reduction is a problem caused by FDI tax incentives).

95. InvestorWords.com, The Biggest, Best Investing Glossary on the Web—Tax Base, http://www.investorwords.com/4885/tax_base.html (last visited Feb. 8, 2007).

96. *See generally*, Gropp & Kostial, *supra* note 94, at 3 (questioning whether FDI really does lead to a tax base reduction).

97. *Id.* at 3.

the tax bases of nations with "harmful" legislation.[98] The concern is that because globalization has made it increasingly easy for mobile capital to minimize and avoid taxes,[99] if investment is attracted to a tax regime and the regime changes,[100] the investment will simply re-locate to a jurisdiction with favorable treatment. In such a case, the argument goes, the only concern from the investment end is the lowest possible tax rate and no attention is given to the tax base or other detrimental effects such legislation may have on the host jurisdiction.[101] Host tax bases are more susceptible to erosion from mobile capital because it moves around without experiencing negative effects attributable to the tax base reduction. This is the impetus behind the limitation to mobile activities—they are easy to move from regime to regime, much easier than FDI anyway, which could require moving an entire corporation.[102]

Ultimately, the economics and debate swirling around tax competition afford at least three valuable lessons. First, attempts to limit tax competition through price fixing are bound to fail because self-interest and cheating means the agreed upon price will be unsustainable.[103] Second, it may be possible to leave the tax competition 'market' to self-regulation in order to achieve the best 'price' and greatest efficiency.[104] Third, the justifications for regulating the ability of mobile capital to benefit from 'harmful tax competition' translate especially poorly to FDI because it provides other benefits to a host economy.[105] Unfortunately, the necessary differentiation was ignored by the European Union as it began to look at international tax competition.

III. LOST IN TRANSLATION: THE EUROPEAN UNION TAKES THE TAX COMPETITION BALL . . . AND DROPS IT

The European Union (EU) and some of its member nations are among the most vocal opponents of tax competition.[106] The following section lays out briefly

98. *Id.*

99. *Id.*

100. The change would likely be a raise in the tax rates, making it less attractive than initially.

101. Weiss, *supra* note 37, at 128.

102. *But see* INTERNATIONAL CONFEDERATION OF FREE TRADE UNIONS, HAVING THEIR CAKE AND EATING IT TOO: THE BIG CORPORATE TAX BREAK 11 (2006) [hereinafter ICFTU] (arguing that because of the presence of many different subsidiaries in different locations, MNEs can break themselves up on paper and create phony transactions to move profits away from where they are earned to places where they cannot be taxed). Such abuses may be common, but can be dealt with without suppressing tax competition completely, see *infra* Part V.B. *See also supra* note 43 (arguing that the use of tax competition and havens for mobile investment may be a good thing overall because it can lead to increased capital for growth and development).

103. *See supra* notes 85-88 and accompanying text (describing how a price fixing attempt would fail in a similar manner to a cartel).

104. *See infra* parts IV.C and V.A (arguing that self-regulation by competitive market participants is possible, by nations and MNEs respectively).

105. *See supra* note 64 and accompanying text (arguing that spillover benefits are an important and valuable component of FDI).

106. TEATHER, *supra* note 43, at 24.

the structure of the EU and the manners in which tax competition may be regulated. Following that is a discussion of the manner in which EU tax competition policies differ from prior proposals. Although the common market system of the EU necessarily lends itself to greater regulation, the proposals are a significant deviation even from the OECD Report. For one thing, the EU policies clearly mean to attack tax policy for businesses.[107] For another, rather than allowing any discretion to tax at individual nation levels (in other words, free economic choice by the market participants) the European Union seeks to take away any competitive use of tax policy.[108] This means not only is the EU uncomfortable with allowing free-market economics to control the market, they are uncomfortable with the existence of a free tax market altogether.

A. *The Structure of the European Union as Related to National Sovereignty and Tax Competition*

The major economic structure of the European Union (EU) was established by the European Economic Treaty (EEC Treaty).[109] The EEC Treaty created a single common market[110] and eventually led to the establishment of Economic and Monetary Union (EMU).[111] The EU common market is based on four fundamental freedoms—the free movement of persons, services, goods, and capital[112] and effectively functions as a single market comprised of member states subject to the higher power of the EU and the EEC Treaty. By eliminating exchange rate problems and simplifying transactions, EMU has furthered economic consolidation within the EU, making member economies increasingly interdependent[113] and leading the European Commission[114] to urge for

107. *Supra* note 41 (OECD recognizes that EU Code expressly extends to business taxation).

108. *See infra* notes 135-140 and accompanying text (arguing that the EU has chosen to take away any competitive use of tax policy).

109. Treaty Establishing the European Economic Community, Mar. 25, 1957, [hereinafter EEC Treaty].

110. *Id. See also* European Commission, Activities of the European Union, Summaries of Legislation: Treaty Establishing the European Economic Community, EEC Treaty—Original Text (Non-Consolidated Version), http://europa.eu/scadplus/treaties/eec_en.htm (last visited January 3, 2007).

111. *Europe on the Move: Tax Policy in the European Union* 8-9 (2000), *available at* http://ec.europa.eu/publications/booklets/move/17/txt_en.pdf [hereinafter *Europe on the Move*]. *See also*, Tracy A. Kaye, *Tax Discrimination: A Comparative Analysis of U.S. and EU Approaches*, 7 FLA. TAX REV. 47 (2005). This article includes a more in depth description of the formation of the European Union and the principles guiding the debates, court cases, and general history of tax competition within the EU. EMU, simply put, is the establishment of the euro as the EU common currency.

112. European Commission, Activities of the European Union, Summaries of Legislation: Treaty Establishing the European Economic Community, EEC Treaty—Original Text (Non-Consolidated Version), http://europa.eu/scadplus/treaties/eec_en.htm (last visited January 3, 2007).

113. *Europe on the Move*, *supra* note 111, at 8-9.

114. The European Commission is the central governing body of the EU, comprised of representatives from the member states. It often releases directives or communications that function as a form of "soft law" relying on political pressure to carry them into action. *See* Tracy A. Kaye, *European Tax Harmonization and the Implications for U.S. Tax Policy*, 19 B.C. INT'L & COMP. L. REV. 109,119-125 (1996) (discussing the basic structure of the European Union and the implementation strategies of EU Directives, specifically as related to

strengthened coordination of economic policies—especially in the area of taxation.[115]

For the most part, the European Commission considers tax policy to be central to national sovereignty of the member-states.[116] On the other hand, there are some areas in which the Commission has the jurisdiction to interfere with national tax legislation, such as prohibitions on state aid, tax discrimination that favors domestic product over foreign, and some indirect taxes such as value added tax.[117] Outside of the few exceptions, the Commission has no power to set tax policies in the nations, leaving it instead to national government policy makers.[118] However, due to increased political pressure and the successful integration of the common market, the Commission is starting to concern itself with the member-states' tax policies and may be turning from its former hands-off position.[119]

Before turning to the legislation, it is important to recognize the manner in which the Commission can regulate tax competition. The Commission has stated that when direct taxation impacts the four freedoms established by the EEC Treaty, it may take necessary action to harmonize and coordinate the tax measures.[120] Market wide law is commonly set using the "principle of sub-sidiarity", meaning that when community objectives cannot be achieved by the states acting alone, the Commission can draft its own legislation, as a subsidy to state action, in protection of the four freedoms.[121] The Commission is not alone in the effort to change the tax policies of member-states—the European Court of Justice seems equally convinced of the need to combat national tax systems that may threaten the common market by distorting competition.[122] Nevertheless, even without recourse to the European Court, the Commission itself has begun to adopt a more proactive strategy toward member-state tax policy[123] by pushing

taxation).

115. *Europe on the Move*, *supra* note 111, at 8-9.

116. *Id.* at 3.

117. *Id.* at 6.

118. Kaye, *supra* note 111, at 51.

119. *See Europe on the Move*, *supra* note 111. In this document, published by the European Union, the first sentence is: "Taxation is central to national sovereignty, for without revenue governments cannot conduct policy." *Id.* at 3. However, just two paragraphs later, it recognizes that income tax rates may divert business, skewing production in the common market. Thereafter, it states that the Commission's aim is not to standardize taxes, but to ensure compatibility with the common market and EEC Treaty goals—meaning that the Commission feels it is now necessary to become involved because the tax measures of some states may "distort competition." *Id.* at 6.

120. *Id.* at 7.

121. Kaye, *supra* note 111, at 51. *See also Towards an Internal Market*, *supra* note 59, at 4.

122. Kaye, *supra* note 111, at 51. The Court has decided to "rigorously enforce a constitutionally guaranteed minimum of economic integration" and has heard approximately one hundred cases surrounding direct taxation issues—striking down national legislation in nearly all of them. *Id.* at 52-53 (internal quotations omitted.)

123. Kaye, *supra* note 111, at 73.

further toward complete harmonization and robbing the EU of any benefits that flow from tax competition.

B. The Basic Structure of the European Harmonization Proposals: The Development and Structure of the Code of Conduct for Business Taxation

Taxation has been an important and commonly discussed factor in the development of the common market since its inception.[124] As early as 1962 the Commission began to study the economic effects of corporate tax harmonization.[125] As recently as 1988, a proposal for the harmonization of an MNE tax base failed to carry—due expressly to the reluctance of some member-states to give up sovereignty in such an important area as tax policy.[126] More recently, in 1996 and 1997, the EU Finance Ministers ordered an in depth study of company taxation, the result of which was a "tax package" that added entirely new dimensions to the tax discussion—the Code of Conduct for Business Taxation (Code).[127]

The Code developed out of the 1997 conclusions of the Economic and Financial Affairs Council (ECOFIN) and reflects many of the same concerns and problems addressed by the OECD's harmful tax competition package.[128] Specifically, the Code cites concerns such as loss of tax revenue attributable to mobile investment activity,[129] manipulation of cross-border royalty payments,[130] and general prohibitions on tax policies that operate as forms of state aid.[131] Also, like the OECD approach, the Code[132] provides a list of factors to identify harmful tax competition:

- whether advantages are accorded only to non-residents
- whether advantages are ring-fenced from the domestic market, so that they do not affect the national tax base
- whether advantages are granted even without any real economic activity and substantial economic presence within the Member-State offering such tax advantages

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124. *Towards an Internal Market*, *supra* note 59, at 4.

125. *Id.*

126. *Id.* at 4.

127. *Id.* at 4. The Code is not binding on member states and instead relies on voluntary participation and peer pressure for implementation, operating as a sort of "soft law." MUTTI, *supra* note 25, at 7, 87.

128. *See* Conclusions of the ECOFIN Council Meeting on 1 December 1997 Concerning Taxation Policy No. 98/C 2/01 of Jan. 6, 1998, art. 2, 1998 O.J. (C 2/1) 1 [hereinafter Conclusions of ECOFIN] (stating that its concerns are losses of tax revenue, royalty payment abuse, and cross border taxation problems).

129. *Id.* at 2.

130. *Id.* at 1.

131. *Id.* As a matter of fact, the EU prohibitions on state aid are greater even than those established by the World Trade Organization. MUTTI, *supra* note 25, at 7.

132. Conclusions of ECOFIN, *supra* note 128, at 3-5.

- whether the rules for profit determination in respect of activities within a multinational group of companies depart from internationally accepted principles, notably the rules agreed upon within the OECD
- whether the tax measures lack transparency[133]

It is easy enough to see that at least the second, fourth, and fifth factors deal with principles of non-discrimination and tax avoidance and evasion. As such, they are genuine concerns that should be addressed internationally. However, the Code's factors suffer from similar weakness to the OECD Report because they are not accompanied by any indication of their relative weight. Key terms such as "real economic activity" or "substantial economic presence" are never clearly defined.[134]

The Code, however, does not follow the OECD approach entirely. A significant deviation from the OECD stance is the first factor, which in addition to the EEC Treaty's prohibition on tax discrimination that would favor domestic product over foreign, operates as a reverse state aid prohibition.[135] Instead of preventing discrimination against foreign investment, it prevents a nation from attracting a foreign investor with a competitive tax advantage, at least when it is not afforded to citizens as well.[136] As strange as it is to flip-flop internationally accepted state aid regulations,[137] the Code pushes the envelope even further.

The further deviation from the OECD approach is that the Code extends the definition of harmful tax competition to include "business taxation, [including] those *measures which affect, or may affect, in a significant way the location of business activity* in the Community."[138] Moreover, the Code goes on to state that "*any* tax measures which provide for a significantly lower effective level of taxation, including zero taxation, than those levels which generally apply in the

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133. *Id.* at 3.

134. *Id.*

135. *Europe on the Move*, *supra* note 111, at 7. Prohibitions against state aid and discrimination are accepted concerns for global economics, and part of even WTO guidelines. However, the Code not only includes those same prohibitions against favoring one's citizens over aliens, here a nation cannot favor aliens over its citizens.

136. This is an important fact, and may be a useful way for member nations to get around the prohibitions. Although nations can neither afford preferential tax treatment to citizens or foreigners, they would be "free to adopt general low levels of taxation, but not low rates (or low effective rates) for particular classes of business operations." TEATHER, *supra* note 43, at 135.

137. MUTTI, *supra* note 25, at 7 ("In contrast to the WTO, the European Union has established more rigorous disciplines on its members in the case of state aid.").

138. Conclusions of ECOFIN, *supra* note 128, at 3. The OECD recognized that the extension of its proposals to business activity was a significant deviation from its own ideas. OECD *supra* note 111 at 8 (excluding tax incentives designed to attract investment characterized by plant, building and equipment). In addition, the OECD, after the EU announced its Code of Conduct, specifically stated, "[w]hilst the EU Code and the OECD Guidelines are broadly compatible, particularly as regards the criteria used to identify harmful preferential tax regimes . . . the [EU] Code looks at business activities in general, although with an emphasis on mobile activities." *Id.* at 11.

Member-State in question *are to be regarded as potentially harmful and therefore covered by this code*."[139] Furthermore, the Code widens the definition of harmful tax policies by directing analysis of harmfulness to "the nominal tax rate, the tax base, *or any other relevant factor*."[140]

The Code seems to ban all competitive use of tax—including advantages of lower taxation to foreign investors (measured against domestic tax liability) and any tax incentives that actually do attract investment. It does not seem to matter whether or not the competitive edge is gained by nominal rates, effective rates, the effects on the tax base of the host jurisdiction, or *any other factor*. At the end of the day, no use of tax as a competitive tool is legal under the Code, which leaves one wondering whether such a complete destruction of competition is really economically advisable.

C. Economics Behind the European Union's Tax Policies in General and the Code of Business Conduct

The European Union's common market is a particularly interesting environment for studying tax competition. One reason is that the free movement of capital created by the EEC Treaty has created special problems for both MNEs and governments within the region.[141] Therefore, several components of tax competition and policy harmonization make perfect sense—namely those meant to prevent double taxation of capital, reduce the compliance costs attributable to several different member-state tax regimes, and prevent tax avoidance and evasion.[142] On the other hand, moves toward harmonized corporate tax policies and rates[143] are not products of the same legitimate needs and could lead to several undesirable effects both inside and outside of the EU market.

Although the Commission has been careful not to state directly that it desires a single tax rate or complete coordination, such a move does not appear to be far below the surface.[144] If that coordination came to pass, the results would be devastating.[145] If the EU chose to consolidate its tax rate and regimes, non-

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139. Conclusions of ECOFIN, *supra* note 128, at 3 (emphasis added).

140. *Id.*

141. As for businesses, they are presented with a common market, but there are several different national tax systems requiring compliance. "This causes loss of economic efficiency [and] generates specific compliance costs." *Towards an Internal Market*, *supra* note 59, at 29. As to governments, the problem is that differences in "national systems [can] provide fertile ground for [tax] avoidance and abuse." *Id.* at 16.

142. MUTTI, *supra* note 25, at 6.

143. *See e.g. Towards an Internal Market supra* note 59, at 4 (listing a history of tax coordination attempts in the EU).

144. *See e.g.* Kaye, *supra* note 114, at 171-172 (arguing that although complete rate harmonization may not be the case currently, movement in that direction is inevitable and a logical distinction of tax recommendations already made and the common market integration).

145. *See e.g.* The European Commissioner for Taxation and Customs Union has stated that harmonization relates to "tax base only and does *not* relate to the setting of tax rates. *That* will continue to be the sole prerogative of the Member States." Laszlo Kovacs, Commissioner for Taxation and Customs Union,

member nations would stand to reap significant benefit at the expense of the common market.[146] Quite simply, outsiders would evaluate the tax policies of the EU and adjust their own to gain a competitive edge.[147] The result would likely be that significant capital could end up in the non-member jurisdictions, while the EU member-states have their hands tied by consolidation, cooperation, and requirements of at least majority voting for any proposed changes.[148] Such a widespread loss of capital would not be a favored development.[149] Hence, complete tax harmonization would be a terrible economic development for the EU as a whole.[150]

The economic results of corporate tax harmonization are no more promising when evaluated solely on an internal level. It is certainly true that taxation alone is not the only factor an investment takes into consideration when choosing a location.[151] Instead, factors such as market potential, public services, labor costs, government type, etc. all play important roles in host country evaluation.[152] Pure economic theory, however, would suggest that in a highly integrated market, like the EU, similar economies might be viewed by investors as near substitutes for one another.[153] Thus, taxes might become the standout factor driving location decisions.[154] Recent statistical analyses have shown varied results as to the importance of tax rate differences, but the studies are important for the implications of tax competition in the EU.

The European Commission's Business Taxation Agenda, Address Before the Oxford Centre for Business Taxation (Mar. 23, 2006). *But see Towards an Internal Market, supra* note 59, at 4 (stating very carefully that "*at this point in time*, there is no convincing evidence for the Commission to recommend specific actions on the approximation of the national corporate tax rates or the *fixing of a minimum corporate tax rate*") (emphasis added).

146. Avi Nov, *The "Bidding War" to Attract Foreign Direct Investment: The Need for a Global Solution*, 25 VA. TAX REV. 835, 862 (2006).

147. *See* Weiss, *supra* note 37, at 126 (arguing that those outside of an agreement to harmonize taxes are not bound and would therefore become the main benefactors).

148. Meredith J. Coleman, Comment, *The Republic of Ireland's Economic Boom: Can the Emerald Isle Sustain It's Exponential Growth?* 21 U. PA. J. INT'L ECON. L. 833, 859 (arguing that the tax issue is particularly volatile because it is possible that the EU will move from unanimous to majority voting).

149. *See e.g. Europe on the Move, supra* note 111, at 9; *Towards an Internal Market, supra* note 59, at 5 (stating that company taxation should be in line with the international competitiveness and strategic goals established by the Lisbon European Council).

150. *See* Avi Nov, *supra* note 146, at 862 (pointing out that even if a new World Investment Organization of some sort were created nonparticipating nations would have huge advantages from not joining).

151. *See e.g.* Agnes Benassy-Quere, Lionel Fontagne, & Amina Lahreche-Revil, *Foreign Direct Investment and Company Taxation in Europe* (ENEPRI, Working Paper No. 4, 2001).

152. *See* FOREIGN INVESTMENT ADVISORY SERVICE, FOREIGN DIRECT INVESTMENT AND ECONOMIC DEVELOPMENT: WHAT DO THE STATES NEED TO DO? 15-17 (2002) (listing market demand, growth rate, political stability, macroeconomic stability, infrastructure, regulatory environment, and investment promotion).

153. *See* Gianmarco I.P. Ottaviano & Tanguy van Ypersele, *Market Size and Tax Competition*, 67 J. INT'L ECON. 25, 26-27 (2005) (suggesting that it is differences in countries that make tax competition beneficial to some, but identical countries do not necessarily follow the same patterns).

154. MUTTI, *supra* note 25, at 62.

One such study, conducted by the EU's own European Network of Economic Policy Research Institute (ENEPRI) was undertaken to determine the effect of taxation on investment decisions within the EU.[155] After employing other host country economic factors as control variables,[156] the study considered the effect of harmonization of both effective and nominal tax rates.[157] The results are surprisingly sensible because they show the loss of capital a low tax nation would experience simply by raising its rates. Specifically, Ireland, with the lowest nominal tax rate of 10% in the years of the study, stood to lose the most from market wide rate consolidation.[158]

If nominal rates are harmonized, then investors no longer have incentive to escape from high tax to low tax jurisdictions such as Ireland.[159] The result is a 45% loss of inward investment to Ireland, consisting of $2 billion USD and nearly 70% of the total losses within the EU.[160] The results for effective rates follow the same patterns. In the case of effective rate harmonization, Ireland is no longer the loser. Instead, jurisdictions with the lowest effective rates for the sampled years, Germany and Spain, stand to lose the most.[161] In fact, harmonization of the effective rates would rob Spain of its competitive edge and would drive inward FDI nearly to zero.[162] The study demonstrates that tax competition is important to attracting FDI and that FDI sensitivity flows in expected patterns—namely preferring low taxes over high taxes.

A similar study, published by the Institute for International Economics, also considered the EU primarily for its integrated market but found a different result.[163] This study concluded that once an investment was located within the EU market, tax did not seem to matter.[164] Upon further study, the anomalous result seemed to be the product of the fact that the EU is comprised of mostly high income nations where investment is less sensitive to taxation because high tax rates are mostly offset by other benefits.[165] The reverse, however, is also true—

155. Benassy-Quere, Fontagne, & Lahreche-Revil, *supra* note 151.

156. *Id.* at 18-20 (including market potential, size of the host country, transportation costs between the two relevant markets, and general policy variables).

157. *Id.* at 17-31.

158. *Id.* at 24. The results are primarily based on the idea that any agreed upon rate is likely to be higher than the lowest rate. High rates may come down to an average, but if consolidated rates fall to either side of the median, it is probably the higher side of average.

159. *Id.* at 24.

160. The study stated, "[n]ot surprisingly, the country with the lowest nominal tax rate before the harmonization will be the loser, namely Ireland. Ireland loses USD 2.2 billion, out of USD 5 billion." Benassy-Quere, Fontagne, & Lahreche-Revil, *supra* note 151, at 27.

161. *Id.* at 26.

162. *Id.* at 26. Nevertheless, Ireland is still a low effective tax jurisdiction and would stand to lose some investment.

163. MUTTI, *supra* note 25, at 62.

164. *Id.*

165. *Id.*

meaning that low-income countries benefit from the presence of tax competition and lose from its absence because they may have little else to offer.[166]

Most low-income countries have open trade policies and can successfully use tax incentives to attract export-oriented investment.[167] On the other hand, high income countries, characterized usually by stronger markets, do not use tax incentives often because they do not have to.[168] This may not be a problem for the founding members of the EU, but as the Union expands, so too will the possible number of low income nations in the market. If those low income nations cannot offer tax incentives under EU law, they will not have the necessary competitive edge to attract investment. Thus, the lagging, poorer countries are forced to give up a valuable tool for their economic development by agreeing to such tax harmonization schemes.[169] As a result, the entire common market will suffer.[170]

In the end, the EU provides a useful model for studying the effects and prospects for international tax competition because of its single market. It is unlikely that tax harmonization will develop in the EU because most of the member-states are unwilling to give up control over their national tax policies.[171] Furthermore, because the implementation of any tax harmonization scheme by the EU would result in significant economic windfalls to free-riding outsiders, no sensible nation would approve the scheme. Nevertheless, even if it were found that harmonization made sense within the EU, it is unlikely to take place at a similar level on the international field. The EU benefits from the central authority of the Commission, heightened inter-nation peer pressure, the principal of subsidiarity, and significant source of central development funding to offset negative externalities.[172] Such intense political pressure does not exist at the international level, and neither does similar bait.[173] On the other hand, the EU would be wise to learn some tax lessons from their Irish neighbors about why FDI is integral to economic development and how tax competition can be useful in attracting that FDI.

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166. *Id.* at 40-41.

167. *Id.*

168. MUTTI, *supra* note 25, at 40-41. *See also*, Ottaviano & van Ypersele, *supra* note 153, at 27 (stating that when a small and a large country compete for investment, the larger country can win even with higher taxes because it has locational advantages, including better market access).

169. MUTTI, *supra* note 25, at 99.

170. *See* Daniel J. Mitchell, *A Tax Competition Primer: Why Tax Harmonization and Information Exchange Undermine America's Competitive Advantage in the Global Economy*, HERITAGE FOUNDATION BACKGROUNDER 1460, July 20, 2001, http://www.heritage.org/Research/Taxes/BG1460.cfm (stating that imposition of tax rates from larger countries, including specifically OECD countries, on others will make it harder for poor countries to grow).

171. *See supra note* 145 and accompanying text. *See also Towards an Internal Market*, *supra* note 59, at 4 (indicating a history of reluctance by Member States to cede authority over their tax policies).

172. MUTTI, *supra* note 25, at 99.

173. *Id.* (referring specifically to the EU's use of central funding as bait).

IV. THE IRISH CORPORATE TAX STORY AND LESSONS FROM ITS WINNING STRATEGY

Ireland, as a member of both the EU and the OECD, provides special insight into the possible effects of tax harmonization and demonstrates why few nations are likely to forego the use of tax as a competitive edge. At the outset, it is important to note that there are some who believe that Ireland's tax policies are the most significant, or even the sole contributor to the nation's economic growth.[174] Even skeptics of tax competition's benefits recognize that it is at least partially responsible for the rapid growth of inward FDI in Ireland.[175] To attribute too much responsibility to tax incentives alone would ignore the luck of the Irish[176] and, more importantly, simply neglects too many other economic factors.[177] Nevertheless, because Irish tax policy is an important factor in Ireland's ability to attract FDI, it is important to understanding how and when tax competition works.

A. *The History and Structure of Ireland's Corporate Tax Regime and the Results That Followed*

The roots of Ireland's current tax system begin in the 1950's, when Ireland sought to move from a primarily agrarian culture to one characterized by industry, manufacturing, and growth.[178] To achieve that result, Ireland cut its corporate tax rates to zero.[179] The plan however, backfired and led to an increased need for revenue, mostly for public services.[180] As a result, beginning in 1976, corporate tax rates rocketed to 50%[181] in an attempt to satisfy the need for public revenue.[182] That increase in taxes also backfired by causing a decrease in the tax

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174. *See, e.g.*, Julia R. Blue, Note, *The Celtic Tiger Roars Defiantly: Corporation Tax in Ireland and Competition Within the European Union*, 10 DUKE J. COMP. & INT'L L. 443, 457 (2000) (stating that one of the most commonly cited explanations for Irish growth is its corporate tax policy); Jessica Poyner, *Investment in Ireland: The Enticement of U.S. High-tech Industry to the Emerald Isle*, 10 TRANSNAT'L LAW. 195 (1997).

175. *See, e.g.*, Brendan Walsh, *Taxation and Foreign Direct Investment in Ireland*, *in* MILFORD B. GREEN, TAX REFORM IN CANADA: OUR PATH TO GREATER PROSPERITY (H.G. Grubel, The Fraser Institute 2003).

176. John Peet, *The Luck of the Irish*, THE ECONOMIST, Oct. 14, 2004, at 4. The article points out that the Irish economic boom is not attributable to any one specific factor, but instead to the fact that the right mix of factors came together at the right time.

177. Walsh, *supra* note 175, at 211-20.

178. Blue, *supra* note 174, at 455.

179. *Id.* (applying the zero taxation policies to corporations involved in export industries.)

180. *Id.* at 455.

181. Michael Mikiciuk, Comment, *Foreign Direct Investment Success in Ireland: Can Poland Duplicate Ireland's Economic Success Based on Foreign Direct Investment Policies?*, 14 U. MIAMI INT'L & COMP. L. REV. 65, 101-102 (2006).

182. Walsh, *supra* note 175, at 212.

base from increasing unemployment rates and the flight of both people and capital out of the country.[183]

Following the costly experiences of the late 1970's, Ireland's corporate tax rates tax rates began to decrease substantially[184] in order to attract the inward FDI that its economy needed.[185] The Finance Act of 1980[186] applied a ten percent corporate tax rate for the sales transactions of goods manufactured in Ireland.[187] To increase the positive effects of the legislation, the term "manufacture" was liberally applied in order to allow most corporate activity to satisfy the threshold and qualify for the tax break.[188] Perhaps realizing the success of lowered taxation following the Finance Act of 1980, the list of qualifying activities expanded significantly. The Finance Act of 1981 added fish farming, engineering, and shipbuilding to qualifying activities.[189] A few years later, the Finance Act of 1984[190] granted personal tax relief to investors with at least a 10% interest in companies satisfying the 1980 Act requirements.[191] Furthermore, in 1984 the computer technology sector was included as data processing and software were added.[192] In 1986, research and development was included as a qualifying activity.[193] Let it suffice to say that the list of qualifying activity only grew from there.[194]

The economic results of Ireland's low tax campaign to attract corporate investment have been impressive. In fact, Ireland's attractiveness and growth has earned it one of the highest living standards in the world, sixth highest in the OECD.[195] Within the EU, Irish economic growth has consistently outperformed

183. *Id.*

184. Mikiciuk, *supra* note 181, at 101-102. The decrease began with the Finance Act of 1980 and continued to shrink through the Finance Act of 1999. *Id. See also* Walsh, *supra* note 175 at 212 (stating that in the late 1980's government spending was cut back and the fiscal conservatism lead to economic growth and reductions in tax burdens).

185. Walsh, *supra* note 175, at 212; Mikiciuk, *supra* note 181, at 101-102. Both articles argue that whether or not tax rates were a major factor in attracting the FDI, it was the influx of FDI that led to the Irish economic boom.

186. Finance Act, 1980 (Act No. 14/1980), *available at* http://www.irishstatutebook.ie/ZZA14Y1980.html.

187. Mikiciuk, *supra* note 181, at 101-102.

188. *Id.* at 102.

189. Blue, *supra* note 174, at 456.

190. Finance Act, 1984 (Act No. 9/1984) http://www.irishstatutebook.ie/front.html.

191. Blue, *supra* note 174, at 456.

192. *Id.*

193. *Id.*

194. *Id.* (providing a list of activities including shipping, export sales, plant cultivation, meat processing, computer equipment remanufacture and repair, repair on aircraft, and even newspaper advertising.) Apparently, Irish courts came up with a factor test, that was applied so liberally by the Irish courts that it eventually was expanded to include pasteurization of milk and even the artificial ripening of bananas with ethylene gas. For an in depth discussion of the development of 'manufacture' under the statue, see Coleman, *supra* note 148, at 848-49.

195. Edwards & Rugy, *supra* note 7, at 43 citing *Economic and Financial Indicators*, THE ECONOMIST, March 2, 2002, at 98.

the rest of Europe since 1989.[196] Because the tax rates were successful at attracting substantial FDI, the national debt shrunk[197] and unemployment rates fell from around 17% in 1987 to 4% in 2003.[198] In fact, while the number of citizens at work in Ireland grew by more than 40%, the EU itself did not experience much by way of employment growth.[199] While other economic factors helped attract FDI,[200] Ireland's corporate tax policies played a major role in encouraging the FDI that transformed its agricultural economy to one characterized by growth and success.[201] The Irish model is both admired[202] and imitated on a global scale.[203] Tax competition may not be the silver bullet, but it certainly is a valuable tool in any economy's belt.[204]

B. *Ireland's Economic Policies and Winning Strategy Comes Under Fire*

It did not take long for nations with high tax rates[205] to tire of losing capital resources to Ireland. Following Ireland's implementation of its new tax scheme, several countries sought to enjoin the scheme as 'unfair competition.'[206] Much of the attack on Irish policy surrounded tax policies in the Shannon Airport Customs-Free Zone (SCAZ) and the International Financial Services Center (IFSC) in Dublin.[207] Ireland had likely been aware that its tax policies were subject to attack under the EEC Treaty as preferential tax rates,[208] under general

196. Walsh, *supra* note 175, at 207.

197. Mikiciuk, *supra* note 181, at 103.

198. *Id.*

199. Walsh, *supra* note 175, at 207.

200. Brendan Walsh's article contains a good list of the factors attributable to Irish success, and specific to that nation. His article may have more credibility than one produced, for example, by Irish policy makers and legislators who would like to claim total responsibility. Because his article is part of a study undertaken of Ireland by Canada, it was done with some skepticism so that growth factors for Ireland could be applied in Canada. Besides the economic factors discussed previously in this comment, Walsh finds that important factors included access to the EU common market which provided a convenient outlet for European destination export activity, a favorable FDI climate characterized by tax cuts and grants, the involvement of the Industrial Development Authority on a case-by-case basis, low labor costs, and cultural ties to strong economic markets in North America. *Id.* at 214-220.

201. *Id.* at 207.

202. *Id.* at 207.

203. IRISH TAXATION INSTITUTE, IRISH TAX LAW AS A COMPETITIVE ADVANTAGE 4-5 (2005) ("Jurisdictions around the world that have sought to encourage inward or increased investment have recognized [tax competitiveness] and have made, often in imitation of the Irish model, changes to their tax regimes as a consequence.").

204. Coleman, *supra* note 148, at 837-38 (suggesting that Ireland's economic boom was not attributable to one "silver bullet," but to a number of factors, including a friendly tax structure).

205. Such as Germany with 45% and France with 33% corporate tax. Blue, *supra* note 174, at 457.

206. Mikiciuk, *supra* note 181, at 104.

207. Blue, *supra* note 174, at 458; Walsh, *supra* note 175, at 221.

208. Walsh, *supra* note 175, at 221-22. Tax policies may be attacked because they "hamper the free movement of goods, services and capital or distort competition" or under Article 90's "prohibit[ion of] any tax discrimination which would directly or indirectly give an advantage to national products over products from Member States." *Europe on the Move*, *supra* note 111, at 6. Moreover, under the Code of Conduct for Business

prohibitions on economic subsidies or state aid, or simply because they could distort or threaten to distort competition between member states.[209] Perhaps realizing it might have a hard time continuing operation of SCAZ and IFSC, Ireland settled with the Commission in a compromise that included, in part:

- Allowing the preferential tax rate to apply to manufacturing activities until 2010
- Allowing the preferential tax rate to apply in the IFSC until 2005
- Amending the Finance Act of 1999 so that the corporate tax rates would be raised to 12.5% by 2003.[210]

Fortunately, Ireland's competitive tax policies were in place long enough to learn a few lessons. Primarily, the lessons are that competition is just as beneficial in tax as anywhere else. Tax competition is a check on the government's ability to raise taxes and can boost economic welfare, investment, and employment rates.[211] Most importantly, Ireland specifically demonstrates that tax competition can be successfully used to attract business without significant loss of public revenue[212] and that governments can take active roles in adopting competitive tax strategies to encourage inward investment while simultaneously maintaining appropriate tax levels for provision of public goods and services.[213]

C. Important Economic Lessons from the Irish Experience

Before turning to the specific lessons, it is important to understand how free market economic theories apply to a tax competition market. In such a market, both governments and MNEs could fairly be characterized as buyers and sellers.[214] The governments are the *buyers* of the investment and the cost could be expressed as foregone tax revenue. In the alternative, governments are also *suppliers* of the venue for investment. They sell their venue to the buyers (MNEs) and the price for the venue could be expressed as the MNE's tax liability. Free market theory works because as each participant in the market serves his own self interest, the overall efficiency of the market increases.[215] Opponents of tax competition assume that governments are not informed, market

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Taxation, although it is not legally binding, any tax "that result[s] in a lower effective level of taxation than is usual in the Member State concerned" could be considered harmful and thus subject to attack. *Id.* at 31.

209. Blue, *supra* note 174, at 458.

210. Walsh, *supra* note 175, at 221-22. The time frame for raising rates 10 percent to 12.5 percent has been extended from 2003 to 2010 and will still be among the lowest in the EU. Coleman, *supra* note 148, at 851.

211. TEATHER, *supra* note 43, at 13.

212. *Id.* at 134.

213. IRISH TAXATION INSTITUTE, *supra* note 203, at 5.

214. *See generally* Townsend, *supra* note 82 (applying Sherman Act and case law to demonstrate how proposed government cooperation in taxation is akin to monopoly behavior by buyers and sellers in a market).

215. SMITH, *supra* note 1, at 194.

participants, capable of working for their best interests and that, therefore, increased efficiency is unlikely to result from tax competition.[216] On the contrary, much of what can be learned from Ireland is simply that a government is perfectly capable of market participation and there is no more justification for distrusting free market theory in tax competition than there would be anywhere else.[217]

Many critics characterize government positions in tax competition as being either a prisoner's dilemma leading to a race to the bottom[218] or the similar winner's curse phenomenon.[219] Ireland stands in contrast to these claims, providing a model of active and practical involvement in a growth-oriented national economic policy.[220] The Irish experience and observable trends therein demonstrate that, when used as part of an overall economic development plan, tax competition is a valuable tool, which can sometimes be one of the few tools available for weak economies.[221] The lessons from the Irish economic boom show

216. *See, e.g.*, Stephen Reisbach, *Taxation-Business Taxation*, J. INT'L BANKING L. 1998, 13(3), N33-34, N33 (1998) (stating the concern is "about the issues of tax competition and its potential to distort business behavior and erode revenue bases").

217. Opponents of tax competition are motivated by the same concerns and ill-advised ideas as all opponents of competition, primarily "a tendency to worry more about risks than opportunities, a desire for the status quo, and a distrust of economic freedom." TEATHER, *supra* note 43, at 25.

218. MUTTI, *supra* note 25, at 24. The classic prisoner's dilemma consists of countries A & B, each trying to attract investment, and each competing against each other.

> "If neither country offers incentives, each one attracts an equal amount of investment that yields a benefit of $500 million to the host country. If only country A offers incentives, less investment locates in country B, which loses $250 million in benefits compared with the initial situation. But because country A offers an incentive of $150 million to foreign capitalists, its net benefit from the new, higher level of investment is only $600 million. Conversely, if only country B offers the incentive, it gains at the expense of country A. If they both offer incentives, then they have no effect on the allocation of investment, but net of the incentives offered, their gain is only $350 million. *Although both countries are better off if no incentives are offered, the dominant strategy for each country is to offer an incentive.*" *Id.* (emphasis added).

The idea is that each nation is acting in its best interest, but in the end both are worse off. The argument is that this will result in a race to the bottom because "governments competing to attract foreign capital by lowering their taxes would be sucked into a spiral of competitive tax reductions that would result in investment income being tax free." TEATHER, *supra* note 43, at 24.

219. Avi Nov, *supra* note 146, at 843 (arguing that the winning nation may find itself wishing it had not won the investment because the associated costs, including loss of tax revenue, are greater than the benefit from the investment.)

220. *See* Mary Joy Crisafulli, Ireland: The Recurring Economic Miracle? (May 15, 2006) (Honors College Thesis, Pace University), *available at* http://digitalcommons.pace.edu/honorscollege_theses/29 (discussing the Irish government's active involvement in economic growth and tax policy).

221. MUTTI, *supra* note 25, at 40 "The country's stage of development also may be important, if lower-income countries have a weaker bargaining position. . . . The lack of infrastructure in a poor country may force it to offer more attractive tax provisions" although the nation would still have to find a way to benefit from spillover benefits to truly grow. *See also* Townsend, *supra* note 82, at 257 (arguing that low tax jurisdictions in a global economy including "tax haven jurisdictions are appropriately addressing the need to develop their respective economies. Due to a lack of natural resources and capital, alleged tax haven jurisdictions are at a significant disadvantage compared to industrialized nations in their ability to contribute to the global economy. Consequently, the only recourse for these jurisdictions is to provide investment incentives to individuals and multinational corporations in an effort to develop a financial industry that is vital to their success.")

that active government involvement in tax policy makes protection from the "evils" of tax competition completely unnecessary. Perhaps the Irish Taxation Institute put it best:

> "[C]ountries have not indulged in blind reduction in tax rates, but have looked hard at their tax regimes to find the best combination of tax rules that result in increased activity of the type the country wishes to encourage, as well as in the appropriate level of tax for the standard of public services or activity that its citizens wish to enjoy."[222]

1. Government Sensitivity and Involvement in Tax Revenue and Public Spending Issues

The idea that a nation's tax base and citizen welfare will fall victim to tax competition neglects to consider that while governments are certainly interested in securing investment, they are equally concerned with the amount of available tax revenue and their ability to provide public services.[223] Ireland is a perfect example of those dual concerns. Although Ireland expressly chose to pursue an open investment policy, it remained sensitive to tax issues from the beginning.[224] Recalling briefly the history discussed above, when Ireland dropped its rates in the 1950s, the result was insufficient provision of public services.[225] Ireland quickly recognized the problem, and responded with rocketing tax rates.[226] Following major flight of capital from the nation, Ireland simply did what any informed and competitive buyer or seller would do—it sought greater efficiency and competitive edge. Specifically, Ireland embraced free market principles and competition by creating a tax regime characterized by low corporate tax rates and successfully used competitive tax strategies to encourage inward development.[227]

Ireland's decision to seek greater economic efficiency led to the establishment of the Industrial Development Agency (IDA), whose purpose was to attract business investment in Ireland.[228] The activities of the IDA include: finding plant location and staff, facilitating government grants, encouraging research and development, and ensuring that firms meet economic expectations such as job creation and product output requirements.[229] IDA Ireland shows active involvement by the Irish government in tax and economic decisions because each investment is carefully considered and in the end "[t]he unique characteristics of any proposed project, particularly its location, will determine the incentive

222. IRISH TAXATION INSTITUTE, *supra* note 203, at 5.
223. *See* TEATHER, *supra* note 43, at 34-37 (discussing the impact of tax competition on governments).
224. Walsh, *supra* note 175, at 212-23.
225. Mikiciuk, *supra* note 181, at 90-91.
226. Walsh, *supra* note 175, at 212. *See also*, Mikiciuk, *supra* note 181, at 90-91.
227. IRISH TAXATION INSTITUTE, *supra* note 203, at 5.
228. Mikiciuk, *supra* note 181, at 107-08.
229. *Id.* at 110-11.

package available."[230] The careful consideration seems less an example of a government "sucked into a spiral of competitive tax reductions"[231] and more like an example of informed market participation to increase efficiency and gain competitive edge. In other words, the Irish government's activity, as Adam Smith would have likely predicted, may show that "[t]ax competition, like other aspects of globalization, is a fact of modern life, and one that brings great benefits to all society . . . [b]ut the greatest benefits go to those countries that work in harmony with global free markets."[232]

Even today, IDA Ireland's website states expressly that "[t]he primary focus of Ireland's strategy to attract foreign direct investment is to create a favourable economic and fiscal environment which is supportive of industry."[233] Overall, IDA Ireland has been highly successful in attaining that goal[234] and the active investment encouragement has only become more targeted and refined over time.[235] The resultant increase in FDI is the primary factor that led to Ireland's amazing growth and economic development.[236]

Perhaps more importantly, this type of government involvement need not be limited to Ireland. All governments have a natural desire to set tax rates at the point where the revenue loss due to foregone taxes (the investment incentive) and the cost of providing public service for the new investment is less than the revenue brought in by the investment itself.[237] Although many argue that this is the beginnings of a classic race to the bottom,[238] those arguments are flawed because they assume that government would be naturally efficient in the provision of public resources without competition[239] and neglect to consider the benefits of tax competition on government efficiency.[240] Governments engaged in

230. Mikiciuk, *supra* note 181, at 112 (2006).

231. TEATHER, *supra* note 43, at 24.

232. *Id.* at 148.

233. INDUSTRIAL DEVELOPMENT AGENCY IRELAND, GUIDE TO TAX IN IRELAND 2 (2006) [hereinafter IDA IRELAND].

234. Mikiciuk, *supra* note 181, at 109. *See also* IDA IRELAND, *supra* note 233, at 2 (stating that Ireland's competitive strategies have attracted investment in a wide range of businesses from more than 1,000 multinational companies).

235. Walsh, *supra* note 175, at 217.

236. Mikiciuk, *supra* note 181, at 92-93. *See also* Walsh, *supra* note 175, at 227.

237. Andrew L. Kolesar, Note, *Can State and Local Tax Incentives and Other Contributions Stimulate Economic Development*, 44 TAX LAW. 285, 300 (1990). Moreover, taxes are unlikely to plummet to zero because different countries have different characteristics such as differences in market power and other economic advantages (allowing them to tax economic rents earned within their countries). MUTTI, *supra* note 25, at 25 (meaning simply that so long as the costs of securing the investment are less than the benefits, it will be a fiscal success and undertaken by the government).

238. *See supra* note 218 and accompanying text for a description of the race to the bottom theory in tax competition.

239. TEATHER, *supra* note 43, at 34-37.

240. *Id.* at 48-49. "In reality monopoly suppliers have no incentive to be efficient, and little need to provide what the consumers want, and so the government, as the ultimate monopoly supplier (its monopoly position is protected by law, unlike that of most monopolists) is naturally inefficient . . . [O]ne of the advantages of tax competition is that it gives an incentive for governments to act efficiently."

revenue considerations can be perfectly knowledgeable about the results.[241] Some commentators have argued that governments should always undertake fundamental economic analyses when considering potential investment and the incentives that should be offered.[242] In many ways, that is exactly what IDA Ireland does. Not only should the history of the Irish government's active involvement assuage the fears of critics, it should probably serve as a model for those who wish to emulate the Irish miracle.[243] In short, the Irish experience is a real world demonstration that "the greatest benefits go to those countries that work in harmony with global free markets."[244]

2. *Sensitivity of FDI to Tax Rates and Use of Tax Policy in a Competitive and Efficient Manner*

Recalling that it is possible to characterize both governments and MNEs as buyers and sellers in a market for investment, it is also easy to see that MNE's competitive self-interest will lead to the best results in the global marketplace. Although most tax competition critics are concerned with the need to restrict FDI, their concerns about footloose activity and abuse of fiscal policies have mostly turned out to be exaggerations and overstatements.[245] Instead, corporations and societies have mutually benefited from a "virtuous cycle", where the corporations have helped finance societies and the societies have in turn caused the corporations to flourish.[246] While the desire on the part of a government to attract FDI undeniably gives the corporation some market power, that market power is unlikely to be abused because companies are willing to bear higher tax burdens where they are associated with better public infrastructure and public goods.[247] In other words, because MNEs benefit from tax expenditures and provisions of public goods and services, they are unlikely to drive the rates to zero.

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241. Dalibor Rohac, *Evidence and Myths about Tax Competition*, 2 NEW PERSP. ON POL. ECON. 86, 92 (2006).

242. Kolesar, *supra* note 237, at 301.

243. *See generally*, Mikiciuk, *supra* note 181 (suggesting that Poland should look at the Irish model for its own development and policies).

244. TEATHER, *supra* note 43, at 13 (arguing that specifically to tax competition, embracing free market theory leads to much more benefit than protectionism).

245. UNCTAD, *supra* note 28, at 106.

246. ICFTU, *supra* note 102, at 40.

247. Benassy-Quere, Fontagne, & Lahreche-Revil, *supra* note 151, at 2.

3. *Harnessing the Power of Spillover Benefits to Encourage Further Growth and Development*

A significant benefit of FDI is the occurrence of spillover benefits to the host economy.[248] Although benefits such as increased savings, increased employment, and increased available capital argue in favor of decreased taxation,[249] the benefits of lowering taxes are even more apparent when host economies experience further benefit from FDI, in the form of spillovers.[250] Spillovers can include the transfer of technology from the FDI to other sectors of the host economy, knowledge or research and development from FDI, or simply an increase in the available pool of trained workers.[251] Many economists are skeptical about the positive spillover effects of FDI[252] and this is especially true where poorer, less-developed nations are FDI hosts.[253] The lack of benefit, however, is often due to a poor economy characterized by low levels of domestic activity that could benefit from spillover, lack of healthcare and education, or lack of a functioning legal system.[254] Nevertheless, in a free-market, a government such as Ireland, for example, can actively set out to develop an economy that would benefit from FDI,[255] and can thereafter harness the power of spillover to generate even further economic growth.[256]

For example, as IDA Ireland busily worked to attract industry that would most benefit from Ireland's economic advantages, it settled on "high tech industries" such as medical equipment and electrical engineering, pharmaceuticals, software, etc.[257] Ireland was able to attract such industries because its previous focus on education meant that most of those leaving its educational system were well qualified and MNEs could employ them to achieve high productivity.[258] The recent investment in education by the Irish government

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248. *See supra* note 64 and accompanying text.

249. *See generally* TEATHER, *supra* note 43, at 25-37 (listing and explaining the many benefits of tax competition).

250. MUTTI, *supra* note 25, at 22.

251. *Id.*

252. Avi Nov, *supra* note 146, at 869.

253. *Id. See also* MUTTI, *supra* note 25, at 23 (stating that "poorer countries may see less benefit from engaging in tax competition if their economies lack other attributes that are necessary for FDI to create spillovers to others").

254. MUTTI, *supra* note 25, at 23.

255. *See* TEATHER, *supra* note 43, at 20-21 (arguing that globalization and the increased "cross-border flow of capital has allowed the global free market to be a practical reality, providing the finance to allow the developing nations to build and equip the factories . . . that enable them to compete on a global scale.").

256. *See, e.g., id.* at 20 (stating that free market theory has meant increased spin-off employment in developing nations for high value services and intellectual property in addition to the former manufacturing work only).

257. Walsh, *supra* note 175, at 217.

258. *Id.* at 218.

has meant that the younger generation, possessing necessary high-tech skills, made Ireland an attractive "knowledge economy."[259] Not only has that human environment made Ireland more attractive, it has lead to increasing returns on capital accumulation due to the added knowledge spillovers into the economy.[260] Ultimately, while it is true that if a nation lacks attributes to benefit from FDI spillover, it is also true that once a threshold level of economic development is reached, spillover benefits will accrue in the host economy and lead to further development.[261] The positive spillovers generated by foreign investment in Ireland, coupled with the availability of skilled labor, have led to a self-perpetuating cycle where the spillover leads to a better workforce, which leads to its being a more attractive investment environment, which leads to further economic growth in both domestic and foreign industries.[262]

V. ECONOMIC PRINCIPLES FROM GLOBAL TAX COMPETITION EXPERIENCE THAT SHOULD GOVERN FUTURE DEBATE, TREATIES, AND LEGISLATION

Insights from the global debate and controversy surrounding the Irish experience have shown that tax competition is beneficial and useful to society.[263] The benefits which can accrue from allowing tax competition to flourish should be kept in mind for future debates on the topic.[264] This section briefly addresses two very important principles that should not be ignored. First, MNEs are also participants in a tax market, who can, like governments, be effectively restrained by market forces and competition. Second, while there are legitimate problems in the area of taxation, such as tax avoidance or evasion, they can be dealt with at the root of each problem, rather than getting rid of tax competition generally.

A. *The Truth About FDI's Sensitivity to Tax Rates and Their Active Involvement as Market Participants*

For quite some time, economists have questioned whether FDI actually is sensitive to tax competition and different rates among nations.[265] Although tax is just one of many factors considered by FDI when choosing investment locations,

259. *See* Coleman, *supra* note 148, at 842-43.

260. *See* Crisafulli, *supra* note 220 (suggesting that the human environment helped fuel Ireland's economic growth).

261. *See* MUTTI, *supra* note 25, at 22-23 (suggesting that where a government develops sufficient infrastructure, spillover benefits will accrue).

262. Mikiciuk, *supra* note 181, at 115-16.

263. *See generally* TEATHER, *supra* note 43 (arguing that tax competition's benefits are greater global wealth, more efficient global capital markets, business growth, and government restraint and development).

264. *Id.* (listing many of the benefits of tax competition).

265. *See, e.g.*, Barker, *supra* note 19, at 198 (2002); Gropp & Kostial, *supra* note 94 (both arguing that although mixed results have been attained in past studies, most evidence suggests that FDI sensitivity to tax competition is increasingly apparent).

it is generally true that taxation is an important factor in location decisions.[266] Because both the nations seeking to attract investment and the investing MNEs are led by their own self-interest, it is those varying interests that lead to efficiency, as with any competition.

Specifically, the self interests of nations mean that their governments set rates at the point where the revenue loss due to foregone taxes (the investment incentive) and the cost of providing public service for the investment is less than the revenue brought in by the new investment itself.[267] In the same manner, nations are concerned with the tax policies of other nations. For example, nation A will set its rate at a low enough level to attract investment but also at the highest level possible without allowing another nation to attract investment away from A.[268] In contrast, a company will only locate in a jurisdiction where it is able "to yield a before-tax return high enough to . . . pay the tax and still earn the same after-tax return available elsewhere."[269] If the tax rate is low enough, the company will earn a higher after-tax return than is available elsewhere. That is the basic problem. Many argue that the desire by MNEs to have the highest available after-tax returns will lead to a situation where nations are pressured by both the MNEs and the responses of other nations to lower their taxes, until the rates converge at zero and public services are under provided.[270] The problem with such a scenario, however, is that it assumes MNEs have no interest in the provision of public services or the jurisdictions in which they choose to reside.[271]

In actuality, those engaged in FDI are most often evaluating a host jurisdiction based on long-term growth and market potential—making it less likely to react adversely to changes in the law by leaving.[272] In fact, even those who advocate against tax competition seem to realize that MNEs base their own success on societal competitiveness as measured by host society characteristics.[273] Moreover, corporations benefit from the growth of the societies they help create, and this virtuous cycle helps both corporations and host societies grow together.[274]

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266. Reuven S. Avi-Yonah, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 HARV. L. REV. 1573, 1590-91 (2000) *citing* JAMES R. HINES, JR., TAX POLICY AND THE ACTIVITIES OF MULTINATIONAL CORPORATIONS IN FISCAL POLICY: LESSONS FROM ECONOMIC RESEARCH 401, 414-415 (Alan J. Auerbach ed., 1997). *See also* MUTTI, *supra* note 25, at 5 (arguing that tax competition is an important factor in a MNC's location choice).

267. *See supra* note 237 and accompanying text.

268. Ottaviano & van Ypersele, *supra* note 153, at 42.

269. MUTTI, *supra* note 25, at 13.

270. *See, e.g.*, Kolesar, *supra* note 237, at 285 (stating that when governments choose to offer incentives to attract businesses, many believe that they are "unnecessary expenditures that deplete government revenue sources and erode the level of government services").

271. Barker, *supra* note 19, at 198-99 (arguing that FDI is highly interested in government goods and services).

272. FOREIGN INVESTMENT ADVISORY SERVICE, FOREIGN DIRECT INVESTMENT AND ECONOMIC DEVELOPMENT: WHAT DO THE STATES NEED TO DO? 6 (2002). In other words, because FDI is a more permanent investment, the companies are less likely to seek favorable reductions in the law, take whatever they can, and get out of town with no concern for what happens to the host jurisdiction.

273. ICFTU, *supra* note 102, at 41.

274. *Id.* at 40.

Not only do MNEs view the success of their host societies as reflective of their own success, they:

> "rely on the societies they are born out of and operate in for: a) material infrastructure, from roads and ports to postal services and telecommunications; b) effective governance and regulatory systems, general legal security and IPR enforcement for example, and c) immaterial infrastructure from brain power in the form of education, training and general skills enhancement, to public investment in research and development, diffusion of technology, and other quality public services."[275]

At a general level, FDI is not unlike any other consumer—it wants the best possible product (host jurisdiction) for the lowest possible price (tax rate.)[276] In fact, rates are unlikely to go to zero because the attractiveness of low tax rates is only applicable up to a point.[277] In other words, setting tax rates too low will lead to decreasing marginal returns—if tax is too low, not only will it not attract further investment, it may actually drive interested investment away.[278]

MNEs are acutely aware of the differences in tax rates, and while they are pursuing their interests in lowered taxes, they are also aware of and tied to the characteristics of a host nation.[279] In the end, the desire for MNEs to have the best tax rates works along with the desire of a nation to have optimal tax rates. The competition between all nations, and all MNEs, leads both groups to the most efficient rates for all involved. The self interest of both groups means that rates are unlikely to converge to zero,[280] and ultimately "[c]ompetition will dictate the best location of investments for the greatest return on capital."[281]

B. Dealing With Legitimate Taxation Problems at Their Source

Tax may be one area of law that is highly susceptible to being abused and broken.[282] There are many common abuses of tax laws. For example, MNEs may use subsidiaries to set up phony, paper profits or transactions, allowing them to

275. *Id.* at 45.

276. *See* MUTTI, *supra* note 25, at 50-51 (demonstrating the interplay between tax rates and public infrastructure by stating that in low-income nations FDI is more sensitive to tax rates than in high-income nations because of the public goods benefit offset).

277. Lahreche-Revil, *supra* note 9, at 10.

278. *Id.* at 35 (recognizing that although few nations have reached the too low rate threshold, the negative effect of too much tax cutting is a definite possibility).

279. MUTTI, *supra* note 25, at 58 (pointing out that the decision to locate in a particular jurisdiction considers many characteristics of that, and alternative jurisdictions).

280. Lahreche-Revil, *supra* note 9, at 10.

281. Salinas, *supra* note 43, at 533.

282. ICFTU, *supra* note 102, at 3 (stating that businesses continually find more and more ways around paying taxes and employ "small armies of lawyers and accountants to find them new tax loopholes").

show activity in a low tax jurisdiction that never really happened.[283] Among the most widespread areas of tax abuse is transfer pricing.[284] Other common abuses are income stripping[285] and intra-firm royalty payment abuses.[286] In all of the examples, no loss is actually experienced by the MNE because all of the money stays within the group.[287]

Without deciding whether or not such practices can be economically beneficial,[288] they can be dealt with at the root, through a number of anti-avoidance laws or legislation that addresses the problem.[289] For example, in the United States, the IRS has enacted subpart F of the U.S. Tax Code which works by "deny[ing] tax deferral where a service subsidiary is separated from manufacturing or similar activities of a related corporation and organized in another country primarily to obtain a lower rate of tax."[290] Without commenting on the effectiveness of subpart F, such provisions represent a way to deal with individual problems without destroying tax competition generally.

Tax competition is an increasingly important part of globalization and can bring benefits to the global economy if those benefits are embraced.[291] Addressing small problems and abuses by denying competition altogether is akin to throwing the baby out with the bath water. The simple fact that competition may lead to unethical behavior is no reason to launch a frontal assault on competition itself.[292] In other words, it may be that some problems and issues

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283. *Id.* at 11, 33. Evidence of this practice can be seen by the fact that a five-story building in the Cayman Islands is the official address of 12,748 companies. *Id.* at 35.

284. *Id.* at 33-34. Transfer pricing is a complex transaction, and a major problem. It generally consists of trade between subsidiaries of the same company or trade between parent and subsidiary. The basic scheme is to avoid payment of taxes in one of the jurisdictions by having the subsidiary in one jurisdiction sell a unit at a reduced cost so that no profit is made and thus no tax is due in the first jurisdiction. On the other hand, a subsidiary might buy an item at market price and sell it to a company in a high tax jurisdiction at an inflated price so that the high tax jurisdiction company resells it at a loss, and no tax is due. Losses from transfer pricing have been estimated at $42.7 billion in 1999 to $44.6 billion in 2000. *Id.* at 33.

285. Income stripping is accomplished by lending money

> "by an offshore subsidiary to a parent company or another subsidiary in a country with high corporate tax rates and paid back to the offshore subsidiary at exorbitant interests. Those interests can then be deducted against income that would otherwise have been taxed in the home country. Finally, this income will then either be only tax insignificantly or not taxed at all."

Id. at 34-35.

286. Abuse of royalty payments is sometimes called parking of intellectual rights. It refers to the practice of "transferring the ownership of a trade name, often a very valuable asset, to a low-tax location and then charging a company's taxable operations large royalties to use the name." *Id.* at 35.

287. TEATHER, *supra* note 43, at 70.

288. *See id.* at 70 (suggesting that they are simply further ways for companies to take advantage of tax competition and make it more effective). He further suggests that it is possible such practices could be viewed as "sensible use of tax haven subsidiaries [to] create an internal pool of capital to fund investment and expansion." *Id.* at 74.

289. TEATHER, *supra* note 43, at 71.

290. Kaye, *supra* note 114, at 154.

291. TEATHER, *supra* note 43, at 148.

292. *See generally* National Society of Professional Engineers v. U.S., 435 U.S. 679, 696 (1978) (arguing that although competition may not be "entirely conducive to ethical behavior . . . that is not a

need to be addressed, but suppression of competition is hardly the best way to do so.

VI. CONCLUSION

So long as it is economically viable to use taxes to gain a competitive edge, nations will continue to do so. That being said, while there are some legitimate concerns about tax laws, most notably avoidance and evasion, tax competition is a reality in and a welcome member of the global economy. Tax policies should not be overly regulated, but instead left to self-regulation by the invisible hand of free market competition. Ireland in particular stands out as a model of a nation that chose to use tax competition as a tool for economic development.

The Irish model is important because of its success and its contrast to characterizations of governments disadvantaged by the presence of tax competition. Ireland chose to be competitive and improve its position in the global economy by actively and purposefully developing a pro-investment and tax-friendly economy. Ireland's self-interest and the competition driving it ultimately shows how competition and the invisible hand lead to the most efficient results in tax just as anywhere else. The benefits from tax competition will not materialize overnight because development takes time. Likewise, international acceptance of free market competition is also unlikely to develop very quickly because those fearful of competition will not easily relinquish their positions. However, given time to develop and room to work in a global economy, competitive taxation will eventually be recognized as a worthwhile endeavor.

reason . . . for doing away with competition).

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