

## IN SEARCH OF THE BOUNDARIES BETWEEN HARMLESS AND HARMFUL TAX COMPETITION

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### ABSTRACT

*This paper is based on the endless discussions over tax competition. While the discussions over harmless tax competition and harmful tax competition are not yet closed, one of the key issues that adds on is the distinctive boundaries between the two. That is the focus of this paper, which suggests that, with respect to State tax sovereignty, any tax competition done to attract genuine investment is harmless. Equally is a tax competition whose tools do not make a distinction between residents and non-residents. In contrast, tax competition with ring-fenced tools and tax competition that aims at poaching other countries' tax bases look prima facie harmful. Without claiming having exhaustively drawn the boundaries, this paper contributes to the discussions over the distinction between harmless and harmful tax competition by shedding the light on some elements distinguishing harmless from harmful tax competition.*

**Keywords:** (harmful) tax competition, sovereignty, globalisation

### I. Introduction

This paper overviews the practices of tax competition in its two key aspects: harmless tax competition as opposed to harmful tax competition. It does so in consideration of the two diverging consequences thereto attached, namely the broad acceptance of harmless tax competition and the broad condemnation of harmful tax competition. The determination of the distinctive border between the two is of paramount importance. This paper, therefore, aims at shedding the light on tax competition through an exploration of the grounds that underlie the distinction between bad (harmful) tax competition from good (harmless) tax competition.

In that respect, section one introduces the paper while section two attempts to foster an understanding of tax competition in its key features, namely the natural and the retaliation characters. The third section elaborates on the reasons that make relevant the discussions over tax competition. This mainly involves the principle of State fiscal sovereignty, which entails the right to design own preferred tax system including tax competition policies. The same section elaborates on the global practices of tax competition as part of the reasons that ground its discussions. Following that, the fourth section elaborates on the impact of globalisation on tax competition, while the fifth section digs deep on the need and the grounds of distinguishing harmless tax competition from harmful tax competition. The same section also attempts to set out the boundaries between the two. Thereafter the paper ends with a conclusion.

### II. What is (Harmful) Tax Competition?

In a search of understanding what a tax competition is, reference is herein made to the concept itself and the key characteristics of tax competition. The reason to engage in tax competition, its

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impact, and dimensions also contribute to understanding it more. All these aspects are elaborated on below.

## II.1. Conceptual Framework

The concept 'tax competition' has several definitions. From a variety of available definitions, three elements are key in the definition of tax competition. These elements are the parties involved, the way tax competition is done, and the reasons to engage in tax competition.

In an attempt to define tax competition, it becomes evident that this phenomenon happens between sovereign and independent States. In this respect, tax competition is defined with reference to its occurrence between sovereign and independent States.<sup>1</sup> In other words, tax competition is practiced by and between the governments of sovereign States while competing for economic activities.<sup>2</sup> The next point is how is tax competition done.

In engaging in tax competition, States use their tax-setting powers to work on their tax systems' features by trying to offer the most attractive and competitive tax environment.<sup>3</sup> This is done by lowering the internal tax burden<sup>4</sup> through tax rates or tax bases reductions.<sup>5</sup> Even though interdependent, that is mostly, if not always, done in a strategic uncooperative way, by which each sovereign State determines its fiscal policy in disregard of other States' interests.<sup>6</sup> Why then is this done?

States' motivation in tax competition is also referred to when defining this phenomenon. The motivation is described as the sake of gaining a large share of the international tax base.<sup>7</sup> To this end, attraction of investment, business or economic activities, capital, and profits is very

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<sup>1</sup>J Englisch and A Yevgenyeva, 'The Upgraded Strategy against Harmful Tax Practices under the BEPS Action Plan', *British Law Review* 5, 2013, p. 621; C Pinto, *Tax Competition and EU Law*, Ph.D Thesis, University of Amsterdam, 2002, pp. 297-98; P J Wattel, 'Forum: Interaction of State Aid, Free Movement, Policy Competition and Abuse Control in Direct Tax Matters', *World Tax Journal*, 2013, p. 138.

<sup>2</sup>R Teather, 'The Benefits of Tax Competition', IEA Hobart Paper No. 153, 2006, p. 25, at: [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=878438](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=878438) (accessed on 3 August 2019); A Semeta, 'Competitive Tax Policy and Tax Competition in the EU' Speech/11/712, 2<sup>nd</sup> Taxation Forum of Diario Economico/OTOC, 2011, p. 3, at: [https://ec.europa.eu/commission/presscorner/detail/en/SPEECH\\_11\\_712](https://ec.europa.eu/commission/presscorner/detail/en/SPEECH_11_712) (accessed on 14 August 2019); A P Morriss and L Moberg, 'Cartelizing Taxes: Understanding the OECD's Campaign against Harmful Tax Competition' *Columbia Journal of Tax Law* 4(1), 2012, p. 5.

<sup>3</sup>Semeta 2011, Id., p. 3; C Pinto, 'EU and OECD to Fight Harmful Tax Competition: Has the Right Path Been Undertaken?', *Intertax* 26(12), 1998, p. 386; D M Ring, 'Democracy, Sovereignty and Tax Competition: The Role of Tax Sovereignty in Shaping Tax Cooperation' *Florida Tax Review* 9(5), 2009, pp. 561-62; V Sobotková, 'Revisiting the Debate on Harmful Tax Competition in the European Union', *Acta Universitatis Agriculturae et Silviculturae Mendelianae Brunensis* 36(4), 2012, p. 344.

<sup>4</sup>Pinto 1998, Ibid.; Sobotková 2012, Ibid.

<sup>5</sup>Teather 2006, supra note 2, p. 25; M Wróblewska, 'Harmful Tax Competition in a Globalized World: Does the World Trade Organization Deal with this Issue?', *Studia Iuridica* 1, 2016, p. 15.

<sup>6</sup>Englich and Yevgenyeva 2013, supra note 1, p. 621; B B Kristiaji, *Incentives and Disincentives of Profit Shifting in developing Countries*, (Master Thesis, Tilburg University), 2015, p. 12; P Dietsch, *Catching Capital: The Ethics of Tax Competition*, OUP, 2015, p. 2 and 36; P Dietsch, 'Whose Tax Base? The Ethics of Global Tax Governance', in P Dietsch and T Rixen (eds), *Global Tax Governance: What is Wrong with it and How to Fix it*, ECPR Press, 2016, p. 232.

<sup>7</sup>Pinto 2002, supra note 1, pp. 297-298.

important and is often mentioned in attempts to define tax competition.<sup>8</sup> Thus, a combination of the above three elements would lead to defining tax competition as States' strategic practices to lower the internal tax burden for the sake of gaining a large share of the international tax base through business attraction.

Closely associated with tax competition, is the concept of 'harmful tax competition'. Even though important, and contrary to tax competition *per se*, this concept has not been given many definitions. Even the key institutions that are generally considered as the pioneers of regulating the tax competition expressed low interest in defining that concept. This applies to the OECD whose 1998 Report on harmful tax competition deals with 'harmful tax competition' without defining what a harmful tax competition is.<sup>9</sup> In fact, the OECD frankly admitted the absence of the exact technical meaning of harmful tax competition.<sup>10</sup> The same is true of the 1997 EU Code of conduct on business taxation.<sup>11</sup> Yet, the two are internationally recognised for having played a pioneering role in the discussions and regulations of harmful tax competition.

Consequently, scholars describe as impossible the provision of an exact definition of harmful tax competition,<sup>12</sup> to an extent that so far there is no agreed-upon legal nor scientifically accepted definition of harmful tax competition.<sup>13</sup> Even so, harmful tax competition has been synonymously termed tax poaching and/or tax piracy.<sup>14</sup>

Synonymously used with tax poaching, harmful tax competition stands as a negative continuation of tax competition. This understanding justifies embracing the definition that describes harmful tax competition as referring to a '*country's exploitation of the interaction of the tax systems by enacting special tax provisions which principally erode the tax base of other countries*'.<sup>15</sup> Here, the main and most qualifying element is the erosion of other countries' tax bases, but not your own. This transmits the same message as poaching other countries' taxes.

Besides harmful tax competition, there is also a concept of harmful tax practices. This concept is interchangeably used as harmful tax competition and unfair tax competition. The existence of the two interchangeable terms is mainly rooted in the OECD Reports. This

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<sup>8</sup>Englisch and Yevgenyeva 2013, supra note 1, p. 621; D M Ring, 'What's at Stake in the Sovereignty Debate: International Tax and the Nation-State', *Virginia Journal of International Law* 49(1), 2008, p. 184; Teather 2006, supra note 2, p. 25; Ring 2009, supra note 3, pp. 561-62; Semeta 2011, supra note 2, p. 3; Sobotková 2012, supra note 3, p. 344; Pinto 1998, supra note 3, p. 386; Wróblewska 2016, supra note 5, p. 15.

<sup>9</sup>G M Melo, 'Taxation in the Global Arena: Preventing the Erosion of National Tax Bases or Impinging on Territorial Sovereignty (A Critique of the OECD'S Report: Harmful Tax Competition: An Emerging Global Issue)', *Pace International L.Rev.* 12(183), 2000, pp. 186, 197; B J Arnold and M J McIntyre, *International Tax Primer*, 2<sup>nd</sup> edn, Wolters Kluwer, 2002, p. 138.

<sup>10</sup>OECD, *Harmful Tax Competition: An Emerging Global Issue*, Paris, OECD Publishing, 1998, p. 20.

<sup>11</sup>Wróblewska 2016, supra note 5, p. 16; P Boria, *Taxation in European Union*, 2<sup>nd</sup> edn, Springer, 2017, p. 166.

<sup>12</sup>Arnold and McIntyre 2002, supra note 9, p. 138.

<sup>13</sup>Wróblewska 2016, supra note 5, p. 16; C M Radaelli, 'The Code of Conduct against Harmful Tax Competition: Open Method of Coordination in Disguise', *Public Administration* 81(3), 2003, p. 522; H Gribnau, 'Soft Law and Taxation: EU and International Aspects', *Legisprudence* 2(2), 2008, p. 76; O Pastukhov, 'Counteracting Harmful Tax Competition in the European Union', *Southwestern Journal of International Law* 16, 2010, p. 161; L V Faulhaber, 'The Trouble with Tax Competition: From Practice to Theory', *Tax Law Review* 71(311), 2018, pp. 312, 314.

<sup>14</sup>M G Asher and R S Rajan, 'Globalisation and Tax System: Implications for Developing Countries with Particular Reference to Southeast Asia', *ASEAN Economic Bulletin* 18(1), 2001, p. 127.

<sup>15</sup>Pinto 1998, supra note 3, p. 340.

Organization's 1998 Report used the concept harmful tax competition, while its 2001 Progress Report changed to adopt the use of harmful tax practices.<sup>16</sup> Even so, both concepts are still used today and are mostly used interchangeably. Besides the definitions, tax competition has two fundamental characteristics, as detailed below.

## II.2. Natural Character

Tax competition is contended to be a natural phenomenon among other forms of competition. In this respect, tax competition stands as unpreventable, natural, and necessary with regard to the international tax systems' structure.<sup>17</sup> This is because of inevitable differences in tax rules, where States, naturally, have different tax laws in terms of tax bases, tax rates, deductions, etc.<sup>18</sup> In other words, it becomes possible for the States to compete against each other using available natural and unavoidable tax differences such as the statutory or effective tax rates.<sup>19</sup>

The natural essence of tax competition is also overhauled by its long existence coupled with its probability of continuing to exist in the future.<sup>20</sup> In fact, it is evident that countries have and will increasingly compete with each other to attract investments.<sup>21</sup> In the same vein, competing for investment using tax policies has existed for centuries to the extent that scholars describe it as old as governments' income taxation.<sup>22</sup>

Beyond the natural character, tax competition is also vested with a retaliation character that considers tax competition developments as broadly associated with human creations as detailed below.

## II.3. Retaliation Character

In contrast to the view of tax competition's natural essence, there is another approach that views it as a coined policy. The coined policy view is mainly based on retaliation as one of the intrinsic features of tax competition. With this approach, tax competition exists as a result of retaliation, through which the first pioneers of tax competition receive retaliation from their peers. In this school of thought, tax competition develops in two stages: first, the pioneer countries alter their tax systems to lower tax rates, and second, other countries respond by lowering their tax rates too.<sup>23</sup>

The sequence of retaliation stands as the foundation of tax competition based on the theory according to which '*people respond to tax differentials by moving tax bases to jurisdictions where tax rates are the lowest*'.<sup>24</sup> Thus, in consideration of the pioneer reduction of tax burden (first round), that behaviour gets retaliated against by a reduction (second round), to which the

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<sup>16</sup> Morriss and Moberg 2012, supra note 2, p. 49.

<sup>17</sup> Faulhaber 2018, supra note 13, p. 312 and 321; D C Elkins, 'The Merits of Tax Competition in a Globalized Economy', *Indiana Law Journal* 91(3), 2006, pp. 905, 909.

<sup>18</sup> Morriss and Moberg 2012, supra note 2, p. 14.

<sup>19</sup> F Wishlade, 'When Policy Worlds Collide: Tax Competition, State Aid, and Regional Economic Development in the EU', *Journal of European Integration* 34(6), 2012, p. 586.

<sup>20</sup> Asher and Rajan 2001, supra note 14, p. 125; R Azam, 'Ruling the World: Generating International Tax Norms in the Era of Globalization and BEPS', *Suffolk University Law Review* 50(4), 2017, p. 523; M C Durst, 'Poverty, Tax Competition, and Base Erosion', *Tax Notes International* 89(12), 2018, p. 1196.

<sup>21</sup> Asher and Rajan 2001, Ibid.

<sup>22</sup> Faulhaber 2018, supra note 13, pp. 312, 326; Morriss and Moberg 2012, supra note 2, p. 23; Y Brauner, 'What the BEPS?', *Florida Tax Review* 16(2), 2014, p. 64.

<sup>23</sup> Teather 2006, supra note 2, p. 25; L Wang, *Influences of Preferential Tax Regimes Provided to Attract Non-resident Investment*, Master Thesis, University of Toronto, 2006, p. 57.

<sup>24</sup> Teather 2006, Id., p. 62.

pioneers of reduction respond by reducing again (third round), and the sequence can continue like that.

As an example of retaliation, the European countries respectively reduced their CIT rates responding to the Ireland and the UK's initiative. This happened when the UK introduced a substantial reduction in the CIT rate in 1984 from 52% to 35%, which pushed France to reduce its CIT rate from 50% to 45% in 1985 and to 42% later in 1988, and Germany from 56% to 50% in 1990.<sup>25</sup> In the same vein, another example is from Ireland. In the 1980s, Ireland reduced its CIT rate to 12.5%. Responding to the competitive pressure of Ireland, some other EU countries promptly reduced their CIT rates too, such as Portugal that lowered from 30% to 20%, Austria which cut from 34% to 25%, and Greece which cut the 5% off its CIT.<sup>26</sup>

Another similar example, by the way, coupling with the above, is the US Portfolio Interest Exemption case. In 1984, the United States unilaterally abolished a withholding tax of 30% on foreign residents who earn portfolio interest income from sources within the US, including interest on US governmental and corporations bonds, interest on US bank accounts, and certificates of deposit.<sup>27</sup> In retaliation, withholding taxes on interest have been abolished in all major economies on a fear of losing mobile capital flows to the USA.<sup>28</sup> Major capital importing countries also failed to impose a similar tax fearing to drive mobile capital elsewhere.<sup>29</sup> In support of that, in 1992, the European Committee of Independent Experts on Company Taxation issued a report concluding that '*recent experience suggests that any attempt by the European Communities to impose withholding taxes on cross-border interest flows could result in a flight of financial capital to non-European Communities countries*'.<sup>30</sup>

In support of the above, R S Avi-Yonah rightly opines that countries may refrain from offering tax incentives if they can be assured that no other country shall offer them.<sup>31</sup> That statement identifies tax competition as a game arbitrated by fear, legitimate or not, of what others are doing or may do.<sup>32</sup> Thus, the problem of tax competition becomes essentially qualified as a problem of coordination and trust.<sup>33</sup> With this approach, the game of tax competition becomes a vicious cycle orchestrated by retaliation and mutual influence.

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<sup>25</sup> J Bossons, 'International Tax Competition: The Foreign Government Response in Canada and other Countries', *National Tax Journal* 41(3), 1988, p. 350; M P Devereux, 'Business Taxation in a Globalized World', *Oxford Review of Economic Policy* 24(4), 2008, p. 629.

<sup>26</sup> D Mitchell, 'Europe has Caught Tax-Cut Fever', *Wall St. J. Eur.*, 3 March 2004, A8 cited in Pastukhov 2010, supra note 13, p. 167.

<sup>27</sup> R S Avi-Yonah, 'Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State', *HarvLRev* 113(7), 2000, pp. 1579-81.

<sup>28</sup> L A Mello, *Tax Competition and the Case of Bank Secrecy Rules: New Trends in International Tax Law* (SJD Dissertation, University of Michigan, 2012, pp. 18-19.

<sup>29</sup> R S Avi-Yonah, 'Bridging the North/South Divide: International Redistribution and Tax Competition', *Michigan Journal of International Law* 26, 2004, p. 376; R S Avi-Yonah, 'Globalization and Tax Competition: Implications for Developing Countries', *Cepal Review* 74, 2001, p. 60.

<sup>30</sup> EU Com., Report of the Committee of Independent Experts on Company Taxation, Brussels, Mar. 1992, p. 201, at: <https://op.europa.eu/en/publication-detail/-/publication/0044caf0-58ff-4be6-bc06-be2af6610870> (accessed on 22 January 2019).

<sup>31</sup> Avi-Yonah 2001, supra note 29, p. 63; Avi-Yonah 2004, supra note 29, p. 381; M P van der Hoek, 'Tax Harmonization and Competition in the European Union', *eJournal of Tax Research* 1(1), 2003, p. 23.

<sup>32</sup> Avi-Yonah 2001, Id. p. 63.

<sup>33</sup> Id., p. 64; Avi-Yonah 2004, supra note 29, p. 382; P Letete, 'Between Tax Competition and Tax Harmonization: Coordination of Value Added Taxes in SADC Member States', *Law Democracy and Development* 16, 2012, p. 124.

The cycle turns around by the fact that one country's practice calls for retaliation by other countries. It is, therefore, against that background that tax competition becomes described as a coined policy with the retaliation factor in the centre. Thus, it may be opined that countries may prefer to keep their tax rates higher if there was no retaliation pressure forcing them to adjust to other countries' tax policies. But does (harmful) tax competition even matter?

### III. Why Does (Harmful) Tax Competition Matter?

Tax competition lays its foundations on some chains of reasoning, mainly dominated by State fiscal sovereignty. Separate but closely related to that, States justify tax competition as one of their inalienable rights to compete for nation-building. This section discusses the confrontation between an accepted principle of State sovereignty and the States' freedom of competition. In addition to that, this section discusses tax competition as a global phenomenon, which needs global solutions.

#### III.1. Tax Competition Impacts State Sovereignty

State sovereignty is broadly accepted as a key element forming a State as a State. Further to State sovereignty in general, tax sovereignty is key to State self-determination. Both State general sovereignty and State fiscal sovereignty are discussed below.

##### a. State General Sovereignty

State sovereignty is one of the key elements in international law. State sovereignty, as a concept and a principle, is embodied in several international legal instruments and emphasized in most domestic legal instruments.<sup>34</sup> It is also significantly discussed in academic debates, let alone the practice of international law. Its relevance has been widely accepted to an extent that it is equated to statehood while its absenteeism would amount to there being no State.<sup>35</sup>

According to the theory of State sovereignty, all States are sovereign and equal. Further to that, sovereignty entails States' authoritative power to control their internal affairs while keeping independence among each other.<sup>36</sup> The non-interference constitutes a core value of what is commonly referred to as Westphalian sovereignty, or external sovereignty.<sup>37</sup> It is as well considered as negative sovereignty by virtue of the rights to non-interference in States' political, social, and economic affairs.<sup>38</sup> It further stands as a right and an obligation. In other words, each sovereign State has a right not to be interfered with by any other State as any State has an obligation to refrain from interfering in internal affairs of any other State.

Put in legal matters, State sovereignty entails a State's right to freely promulgate, adjudicate and enforce legal rules within its territory, tax laws included.<sup>39</sup> The motive and purpose of such

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<sup>34</sup> United Nations Charter, 1945, article 2 (1) and (4); Constitutive Act of the African Union, article 3 and 4; Treaty for the Establishment of the East African Community (As amended on 14 December 2006 and 20 August 2007), article 6 (1) (a).

<sup>35</sup> Avi-Yonah 2001, *supra* note 29, p. 60; D Pinto, 'Governance in a Globalized World: Is it the End of the Nation State?', in R Biswas (ed), *International Tax Competition: Globalization and Fiscal Sovereignty*, Commonwealth Secretariat, 2002, p. 72.

<sup>36</sup> Ring 2008, *supra* note 8, p. 4.

<sup>37</sup> P Dietsch, 'Rethinking Sovereignty in International Fiscal Policy', *Review of International Studies* 37, 2011, p. 2109; L van Apeldoorn, 'International Taxation and the Erosion of Sovereignty', in P Dietsch and T Rixen (eds), *Global Tax Governance: What is Wrong with it and How to Fix it*, ECPR Press, 2016, p. 217.

<sup>38</sup> L van Apeldoorn 2016, *Id.*, p. 218.

<sup>39</sup> *Id.*, p. 217.

rules stay the discretionary power of the adopting sovereign State. Beyond that, sovereignty in its broadest meaning encompasses different aspects among which is the tax sovereignty.

## b. State Tax Sovereignty

State tax sovereignty is posed like a continuation or a specific element of the State sovereignty, among others. In other words, fiscal policy is regarded as part of the State's general sovereignty.<sup>40</sup> Taxation is also considered as a classical attribute of State sovereignty<sup>41</sup> and a heart of national sovereignty.<sup>42</sup> On that basis, scholars affirm that nothing is closer to State sovereignty than taxation<sup>43</sup> to an extent that no significant issue in international taxation can be discussed without referring to sovereignty.<sup>44</sup>

Furthermore, State fiscal sovereignty is one of the oldest determiners of general State sovereignty. In fact, since antiquities, a State's absolute right to tax its subjects is broadly recognised.<sup>45</sup> Even today, it is considered an essential ingredient for an effective government.<sup>46</sup> For instance, the 1998 OECD Report notes, as a matter of principle, each country's freedom to design own tax system.<sup>47</sup> Indeed, OECD made it clear and expressly emphasized in many of its reports that each country is sovereign to decide the appropriate tax rates.<sup>48</sup> OECD further insisted that it does not seek to dictate to any country, member or not, nor to impose any tax nor any tax rate nor any tax system structure.<sup>49</sup> OECD further reiterated in its 2004 Consolidated Application Note that tax levels and structures are political decisions for national governments adding that, as acknowledged by its 1998, 2000, and 2001 Reports, there is no special nor a particular reason for countries to have the same.<sup>50</sup>

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<sup>40</sup> P. Lampreave, 'Fiscal Competitiveness versus Harmful Tax Competition in the European Union', *Bulletin of International Taxation* 65(6), 2011, p. 4.

<sup>41</sup> A C Santos and C M Lopes, 'Tax Sovereignty, Tax Competition and the Base Erosion and Profit Shifting Concept of Permanent Establishment', *EC Tax Review*, 2016, p. 296.

<sup>42</sup> Ayi-Yonah 2004, supra note 29, p. 386; M C Webb, 'Defining the boundaries of legitimate state practice: Norms, transnational actors and the OECD's project on harmful tax competition', *Review of international political economy* 11(4), 2004, p. 788.

<sup>43</sup> J Li, 'Tax Sovereignty and International Tax Reform: The Author's Response', *Canadian Tax Journal / Revue Fiscale Canadienne* 52(1), 2004, p. 144.

<sup>44</sup> Ring 2008, supra note 8, p. 1.

<sup>45</sup> Melo 2000, supra note 9, p. 186.

<sup>46</sup> Ring 2008, supra note 8, p. 187.

<sup>47</sup> OECD 1998, supra note 10, p. 15; P T Scanlan, 'Globalization and Tax-Related Issues: What are the Concerns?' in R Biswas (ed), *International Tax Competition: Globalization and Fiscal Sovereignty* Commonwealth Secretariat, 2002, p. 45; T Rixen, 'Taxation and Cooperation: International Action against Harmful Tax Competition', in S A Schirm (ed), *Globalization: State of the Art and Perspectives* Routledge, 2007, p. 72.

<sup>48</sup> OECD, The OECD's Project on Harmful Tax Practices: The 2001 Progress Report, Paris, OECD Publications, 2001, p. 4; OECD, The OECD's Project on Harmful Tax Practices: The 2004 Progress Report, Paris, OECD Publications, 2004, p. 4; OECD, The OECD's Project on Harmful Tax Practices: The 2006 Progress Report, Paris, OECD Publications, 2006, p. 3.

<sup>49</sup> OECD 2006, *Ibid.*; OECD 2004, *Ibid.*; D Mitchell, 'Between the Lines: Havens can wait', *Foreign Policy* 131, 2002, p. 71; A W Oguttu, 'International tax competition, Harmful tax practices and the 'Race to the bottom': a special focus on unstrategic tax incentives in Africa', *CILJSA* 51(3), 2018, p. 46; I Calich, *The Impact of Globalization on the Position of Developing Countries in the International Tax System* (Ph.D Thesis, The London School of Economics and Political Science), 2011, p. 61.

<sup>50</sup> OECD, *Consolidated Application Note in Applying the 1998 Report to Preferential Tax Regimes*, Paris, OECD Publishing, 2004, p. 21; Wróblewska 2016, supra note 5, p. 16; Lampreave 2011, supra note 40, p. 4.

Moreover, academics and practitioners advocate for tax sovereignty with emphasis on State's right and freedom to adopt tax rules that are believed to further a State's own interest.<sup>51</sup> For instance, M F de Wilde qualifies fiscal sovereignty as a quintessential property of a nation-State, without which, a State cannot function nor exist at all.<sup>52</sup> The EU members also recognise national fiscal sovereignty as important and wish to retain their rights and powers in the tax area.<sup>53</sup>

Additional examples of legal scholarship recognising State tax sovereignty include but are not limited to recognition of a State's tax self-determination,<sup>54</sup> freedom to devise fitting fiscal policies including the tax due, tax base, and tax rate rules,<sup>55</sup> and the legal right to maintain control over own fiscal policies.<sup>56</sup> In this respect, tax design and freedom in tax regime operations remain sovereign among fiscal attributes.<sup>57</sup> In a like manner, scholars describe tax sovereignty as a fundamental component of national sovereignty,<sup>58</sup> inexorable principle,<sup>59</sup> State prerogative,<sup>60</sup> fundamental for the State to effectively govern its territory,<sup>61</sup> inherent and essential right and a component of sovereign States,<sup>62</sup> etc.

However, State tax sovereignty is not absolute and cannot be unless if the concerned country is totally isolated and detached from others.<sup>63</sup> In this vein, the OECD 1998 Report, while recognising each countries' tax sovereignty in designing the tax systems, adds that States should do so abiding by internationally accepted standards.<sup>64</sup> International tax reforms generated by

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<sup>51</sup> F Cachia, 'Analyzing the European Commission's Final Decisions on Apple, Starbucks, Amazon and Fiat Finance & Trade', *EC Tax Review* 1, 2017, p. 34.

<sup>52</sup> M F de Wilde, *Sharing the Pie: Taxing Multinationals in a Global Market*, Ph.D Thesis, Erasmus Rotterdam University, 2015, p. 5.

<sup>53</sup> EU Com., Communication from the Commission to the Council, The European Parliament and the European Economic and Social Committee on Promoting Good Governance in Tax Matters, COM(2009) 201, Brussels, 28 April 2009, p. 5; Pinto 2002, supra note 1, p. 52; J McLaren, *Will Tax Havens Survive in the New International Legal Environment?*, Ph.D Thesis, RMIT University, 2010, p. 125; M Nouwen, 'The European Code of Conduct Group Becomes Increasingly Important in the Fight against Tax Avoidance: More Openness and Transparency is Necessary', *Intertax* 45(2), 2017, p. 138.

<sup>54</sup> A Christians, 'Sovereignty, Taxation and Social Contract', *Minnesota Journal of International Law* 18(1), 2009, p. 101.

<sup>55</sup> van Apeldoorn 2016, supra note 37, p. 215; A Sanni, 'Sovereign Rights of Tax Havens and the Charge of Harmful Tax Competition', 2011, at: [www.thesait.org.za/news/96869/Sovereign-Rights-Of-Tax-Havens-And-The-Charge-Of-Harmful-Tax-Competition.htm](http://www.thesait.org.za/news/96869/Sovereign-Rights-Of-Tax-Havens-And-The-Charge-Of-Harmful-Tax-Competition.htm) (accessed on 30 July 2019); F Boulogne, 'Reviewing the OECD's and the EU's Assessment of Singapore's Development and Expansion Incentive', Singapore Management University School of Accountancy Research Paper 7(1), 2019, p. 10 at: <http://dx.doi.org/10.2139/ssrn.3349404> accessed 14/08/2019.

<sup>56</sup> Sanni, *Ibid.*

<sup>57</sup> Rixen 2007, supra note 47, p. 72; K Carlson, 'When Cows Have Wings: An Analysis of the OECD's Tax Haven Work as it Relates to Favor, Sovereignty and Privacy', *John Marshall Law Review* 35(163), 2002, p. 178.

<sup>58</sup> B Patterson and A M Serrano, 'Tax Competition in the European Union', European Parliament Directorate General for Research Economic Affairs Series WP ECON-105 EN, PE 167.812, 1998, p. 5 at: [http://europarl.europa.eu/workingpapers/econ/pdf/105\\_en.pdf](http://europarl.europa.eu/workingpapers/econ/pdf/105_en.pdf) accessed 21/06/2019.

<sup>59</sup> Sanni 2011, supra note 55.

<sup>60</sup> *Ibid.*

<sup>61</sup> A Townsend, 'The Global Schoolyard Bully: The Organization for Economic Cooperation and Development's Coercive Efforts to Control Tax Competition', *Fordham International Law Journal* 25(1), 2001, p. 219.

<sup>62</sup> Christians 2009, supra note 54, pp. 104,105.

<sup>63</sup> J Li 2004, supra note 43, p. 144; T Dagan (ed), *International Tax Policy: Between Competition and Cooperation*, CUP, 2018, p. 2.

<sup>64</sup> OECD 1998, supra note 10, p. 15; Lampreave 2011, supra note 40, p. 5; Scanlan 2002, supra note 47, p. 45.

international organizations, engagement in the tax treaties<sup>65</sup> as well as the current integrated economy systems<sup>66</sup> also create limitations for absolute State tax sovereignty.

The non-absolute nature of State sovereignty is further due to the fact that States are fiscally interdependent.<sup>67</sup> Thus, a change in the tax system of one country very likely affects the fiscal system in (an) other countries (y).<sup>68</sup> As a result, each national tax system is now unavoidably conditioned by others' tax sovereignties. For instance, one country's tax policy largely influences the allocation of the overall tax base,<sup>69</sup> and each State experiences restriction and competition from others.<sup>70</sup> In that fashion, even if States stay *de jure* sovereign, this means less in practice, which is characterised by *de facto* limited sovereignty.<sup>71</sup>

On that account, sovereignty becomes '*a prima facie general freedom of action by States, which is not absolute but relative and the extent of which cannot be determined in isolation*'.<sup>72</sup> In the same vein, it is added that '*the sovereignty of one State cannot annul the sovereignty of another State*'.<sup>73</sup> This way of reasoning largely dominates the thinking of tax competition practice, which is seen as a State's right to do so, but also supplemented by a State's need to be protected against the negative consequences of other States' tax competition.

Concurring with both sides, it is a less challengeable fact that State fiscal sovereignty implies a State's freedom to design a tax system that better fits its own interests. This is referred to as domestic sovereignty approach.<sup>74</sup> Externally, each State is sovereign to remain independent vis-à-vis other States in terms of fiscal policies. In this context, State's fiscal sovereignty goes further to refuse any outside interference in tax matters, even if the choices made will affect the tax bases of other States.<sup>75</sup> It is within this scope that the issues of tax competition fall.

In fact, considering that customary international law leaves it to the State to decide who its nationals and residents are,<sup>76</sup> it becomes obvious that a State's freedom of taxation can go beyond its territory and tax worldwide by following up its nationals' and residents' establishments. This statement shows the possible extent to which State fiscal sovereignty can be exercised usefully or abusively. It equally shows how State fiscal sovereignty can be exercised within and outside the territorial boundaries. Taking that into consideration, the internal effects of State fiscal sovereignty apparently pose fewer issues. The questions arise when the effects escalate outside the State's boundaries to collide with other States' freedoms.

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<sup>65</sup> Calich 2011, supra note 49, p. 29.

<sup>66</sup> Id., p. 28.

<sup>67</sup> van Apeldoorn 2016, supra note 37, p. 215.

<sup>68</sup> Christians 2009, supra note 54, p. 148; Calich 2011, supra note 49, pp. 28-29; S Bond et al., *Corporate Tax Harmonization in Europe: A Guide to the Debate*, The Institute for Fiscal Studies, London, 2000, p. 49 at [www.ifs.org.uk/comms/r63.pdf](http://www.ifs.org.uk/comms/r63.pdf) (accessed on 24 August 2019).

<sup>69</sup> van Apeldoorn 2016, supra note 37, p. 215.

<sup>70</sup> D Deák, 'Illegal State Aid and Harmful Tax Competition: The Case of Hungary', *Society and Economy* 24(1), 2002, p. 24.

<sup>71</sup> van Apeldoorn 2016, supra note 37, p. 216; A Christians, 'Networks, Norms, and National Tax Policy', *Washington University Global Studies Law Review* 9(1), 2010, pp. 104-114.

<sup>72</sup> S Douma, *Optimization of Tax Sovereignty and Free Movement*, Ph.D Thesis, Leiden University, 2011, p. 81.

<sup>73</sup> Ibid.

<sup>74</sup> Dietsch 2011, supra note 37, p. 2109.

<sup>75</sup> Id., p. 2108.

<sup>76</sup> Douma 2011, supra note 72, p. 22.

### c. States' Fiscal Competition Freedom

Generally considered, States broadly engage in a variety of competitions, tax competition included. A State's freedom to compete stands as a continuation of State sovereignty. The means of competition are different and include tax rules, which are designed to create an environment of tax competition. More than just being viewed as a State's recognised right, tax competition is furthermore compelled by the necessity of not only keeping domestic businesses, but also the need to attract foreign businesses, which triggers the need for an internationally competitive taxation system,<sup>77</sup> i.e. a system that is ideally, competitively designed without engaging in harmful tax competition.<sup>78</sup>

Besides that, the theory of international tax competition is broadly related to the principle of reciprocity. Under international law, the principle of reciprocity entails returning like-for-like behaviour<sup>79</sup> and constitutes a basis and a salient element in the regulation of sovereign States' rational intercourses.<sup>80</sup> The principle of reciprocity pivots international legal relations and States largely rely on it because of the absence of a uniform authority to enforce international law.<sup>81</sup> The core underlying element in States' reciprocity would be simplified in a State's right to respond negatively or positively to another State's behaviour. However, when it comes to international tax competition, the States' behaviour goes beyond the 'right to respond' and becomes the 'right to go even further' by behaving in a more extreme way than other State(s). Thus, what is described in general international law as 'returning like-for-like behaviour' i.e. proportional retaliation, becomes 'returning beyond like-for-like behaviour' in international tax competition. In that scenario, tax sovereignty becomes indistinguishable from tax competition.

### d. Cycle of Tax Sovereignty and Tax Competition

Tax sovereignty and tax competition are in principle separate but interlinked, along with vice-versa impact. On one hand, with fiscal sovereignty, States are sovereign and free to design tax systems and policies that they find adequate and necessary, to serve their interests, including tax competing systems. In doing so, they may limit the tax sovereignty of other States and vice-versa. In this consideration, State interdependence of national tax regimes becomes blatant, inevitable,<sup>82</sup> and with fiscal externalities,<sup>83</sup> each State becomes unavoidably affected and conditioned by other States' tax systems.<sup>84</sup>

In addition, tax competition not only undermines States' general sovereignties,<sup>86</sup> but also limits and affects other States' tax sovereignties. In this respect, tax competition limits the effective

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<sup>77</sup> R Teather, *Harmful Tax Competition?*, Blackwell Publishers, 2002, p. 59.

<sup>78</sup> Semeta 2011, supra note 2, p. 5.

<sup>79</sup> F Parisi and N Ghei, 'The Role of Reciprocity in International Law', *Cornell International LJ* 36(93), 2003, p. 94.

<sup>80</sup> P Malanczuk, *Akehurst's Modern Introduction to International Law*, 7<sup>th</sup> edn, Routledge, 1997, p. 6.

<sup>81</sup> S N Fard, *Is Reciprocity a Foundation of International Law or Whether International Law Creates Reciprocity?*, Ph.D Dissertation, Aberystwyth University, 2013, p. 1.

<sup>82</sup> van Apeldoorn 2016, supra note 37, p. 216, Mello 2012, supra note 28, p. 11.

<sup>83</sup> J D Wilson, 'Theories of Tax Competition', *National Tax Journal* 52(2), 1999, p. 272; J M Mintz and M Smart, 'Recent Developments in Tax Coordination: A Panel Discussion by Bev Dahlby, Robert Henry, Michael Keen, and David E. Wildasin', *CTJ/RFC* 48(2), 2000, p. 400.

<sup>84</sup> Lampreave 2011, supra note 40, p. 4.

<sup>86</sup> Oguttu 2018, supra note 49, p. 294; van Apeldoorn 2016, supra note 37, p. 75 and 216; P Dietsch and T Rixen, 'Tax Competition and Global Background Justice', *The Journal of Political Philosophy* 22(2), 2014, p. 152.

freedom of sovereign States to effectively design their fiscal policies,<sup>87</sup> which in turn constraints governments to change their tax structures<sup>88</sup> as long as they want to stay competitive with their peers. In that sense, one country's tax policy and laws largely influence other countries' policies and laws. This situation puts the legal theory in contrast to reality i.e. the exercise of *de jure* sovereignty versus *de facto* sovereignty. In fact, the legal theory advocates for each country's ability to determine its internal tax policy.<sup>89</sup> However, the reality is that the so-called 'internal' tax policies go beyond the countries' borders and affect other sovereign countries, and vice-versa.

At this level, the impact of one country's tax system over other countries as the effect of tax competition becomes unavoidable.<sup>90</sup> Indeed, one State's tax policy choices impede the choices of others<sup>91</sup> and a change in one State's fiscal system may affect the welfare of other States' citizens.<sup>92</sup> Thus considered, tax competition limits other States' sovereignties through the practices that orchestrate the tax policies of others. This leads to tax systems manipulated by external tax policies. Consequent to that, tax sovereignty becomes limited by tax competition as no country is effectively sovereign. Equally, with tax competition, each country's tax jurisdiction becomes limited in practice. Therefore, sovereignty in a strict sense could only exist in a world without the mobility factor, i.e. if no citizen had any opportunity to escape his/her national tax system. This further means that sovereignty cannot be absolute and is very difficult to fully exercise in the current era of high mobility of people, capital, and resources.

On the other side, tax competition is seen as a legitimate exercise of States' tax sovereignty. Thus, fighting against tax competition, even harmful, may be considered and seen as an attack on State sovereignty. Supporters of that argument assert that '*sovereign nations should be able to determine their own tax policies*'.<sup>93</sup> However, this is very difficult to exercise because, even tax cooperation, which is advocated as one of the solutions to counteract harmful tax competition, is also perceived as giving away some aspects of the State tax sovereignty.<sup>94</sup> Undoubtedly, there is an inherent and obvious practical tension between tax sovereignty and tax competition. That tension increases the vicious cycle between State fiscal sovereignty and tax competition by which one influences the other and vice-versa. Beyond that, tax competition has become a global concern as presented below.

### III.2. Tax Competition as a Global Issue

By nature, tax competition is intra-states and concerns competition between national policies.<sup>95</sup> Over time, tax competition practices have spread all over the world to the extent that it is currently practiced everywhere. Tax competition is inevitable as well because of the unavoidable difference in tax rules.<sup>96</sup> Not only differences in tax rules, but also many governments today provide favourable tax rates to ensure their tax systems' international

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<sup>87</sup> van Apeldoorn 2016, Id. p. 215; Teather 2006, supra note 2, p. 10.

<sup>88</sup> Rixen 2007, supra note 47, p. 61.

<sup>89</sup> J Li 2004, supra note 43, p. 147.

<sup>90</sup> Lampreave 2011, supra note 40, p. 3; H J Ault, 'Reflections on the Role of the OECD in Developing International Tax Norms', *Brooklyn Journal of International Law* 34(3), 2009, p. 758.

<sup>91</sup> Christians 2009, supra note 54, p. 148.

<sup>92</sup> Bond et al. 2000, supra note 68, p. 49.

<sup>93</sup> Ring 2008, supra note 8, p. 24.

<sup>94</sup> Dietsch 2011, supra note 37, p. 2108.

<sup>95</sup> Wattel 2013, supra note 1, p. 138.

<sup>96</sup> Morriss and Moberg 2012, supra note 2, p. 14.

competitiveness.<sup>97</sup> International competitiveness is currently an increasing concern and stands as one of the important elements of economic life.<sup>98</sup> Consequently, (harmful) tax competition is now a concern for many if not all nations.<sup>99</sup> Taking into account its widespread, practitioners and scholars consider and describe it as having acquired an inherent global nature.<sup>100</sup> The global nature is evidenced by the fact that both developed and developing countries evidentially practice tax competition, and there is no jurisdiction that could be considered being out of concern.

As a matter of example, from the perspective of developed countries, the OECD member States through a Ministerial Communiqué of May 1996 tasked this Organization to ‘*develop measures to counter the distorting effects of harmful tax competition on investment and financing decisions and the consequences for national tax bases*’.<sup>101</sup> The members of G7 also endorsed the mission given to the OECD and issued an affirming Communiqué in the same year emphasizing the task given to the OECD to establish a multilateral approach under which countries could individually and collectively operate to limit the harmful tax competition practices.<sup>102</sup> Later on, in 1997, the meeting of the OECD Ministers and the G7 Heads of States also emphasised how important to counteract harmful tax competition.<sup>103</sup>

Another example of tax competition in developed countries is a fact that Europe hosts both types of tax competition.<sup>104</sup> Indeed, the EU Code of Conduct on business taxation was established for the desire of curbing harmful tax competition.<sup>105</sup> The Code not only confirmed the existence of both desirable and harmful tax competition in Europe, but also the adoption of the Code of Conduct itself shows that the EU Member States acknowledge the existence of harmful tax competition and the particular need to curtail it.<sup>106</sup> That has been further concretized by the fact that in more than 700 assessments conducted by the Code of Conduct Group between 1998 and 2019, almost 500 regimes are in the EU members and their dependents and associates.<sup>107</sup>

In the same vein, most harmful tax practices are undertaken by the EU member governments<sup>108</sup> and this phenomenon seems to be stronger in Europe than in the rest of the world.<sup>109</sup> Moreover,

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<sup>97</sup> Townsend 2001, supra note 61, p. 217.

<sup>98</sup> Bossons 1988, supra note 25, p. 347.

<sup>99</sup> McLaren 2010, supra note 53, p. 89; M Hearson, ‘The Challenges for Developing Countries in International Tax Justice’, *Journal of Development Studies* 54(10), 2018, p. 1935.

<sup>100</sup> OECD, Towards Global Tax Co-operation: Progress in Identifying and Eliminating Harmful Tax Practices, Report to the 2000 Ministerial Council Meeting and Recommendations by the Committee on Fiscal Affairs, Paris, OECD Publications, 2000, p. 22; Wróblewska 2016, supra note 5, p. 14.

<sup>101</sup> OECD 1998, supra note 10, p. 7; Ault 2009, supra note 90, p. 764.

<sup>102</sup> OECD, *Ibid.*

<sup>103</sup> *Ibid.*

<sup>104</sup> Pinto 2002, supra note 1, p. 25.

<sup>105</sup> EU Code of Conduct 1997: Conclusions of the ECOFIN Council meeting of 1 December 1997 concerning taxation policy DOC 98/C2/01, *OJEC* (6.1.98), 1997, C 2/1.

<sup>106</sup> Pinto 2002, supra note 1, p. 25 and 166; Pastukhov 2010, supra note 13, p. 167; M F Nouwen, *Inside the EU Code of Conduct Group: 20 Years of Tackling Harmful Tax Competition*, Ph.D Thesis, University of Amsterdam, 2020, p. 405.

<sup>107</sup> CEU, Overview of the preferential tax regimes examined by COCG since its creation in March 1998, 9639/4/18 REV 4 FISC 243 ECOFIN 557, Brussels, 5 December 2019, at: <https://data.consilium.europa.eu/doc/document/ST-9639-2018-REV-4/en/pdf> (accessed on 24 April 2020).

<sup>108</sup> Teather 2006, supra note 2, p. 12; K M Diaw and J Gorter, ‘Harmful Tax Practices: To Brook or to Ban?’, *Public Finance Analysis* 59(2), 2002-3, p. 250.

some of the non-western tax havens are usually within the jurisdictional sphere of the EU Member States. Important to note is the fact that harmful tax practices in Europe are not new, rather a long-standing issue. For instance, the Isle of Man and Liechtenstein are examples of the oldest tax havens in Europe.<sup>110</sup> Furthermore, the preferential tax regimes surged in the EU in the 1980s-90s, as tax competition remained a high problem in Europe raising as a concern in the late 1990s and early 2000s.<sup>111</sup>

From the perspective of developing countries, the situation is broadly the same as they host (harmful) tax competition too.<sup>112</sup> As an illustration, the East African Community's Legislative Assembly has acknowledged the existence of harmful tax competition within the Community's Partner States.<sup>113</sup> The South African Development Community members also noticed existence of harmful tax competition and signed a Memorandum of Understanding in August 2002 to cooperate in taxation with an endeavour to avoid harmful tax competition.<sup>114</sup> Undertaking, through a Memorandum of Understanding, to avoid harmful tax competition sends a message that the Member States had already felt the existence of or at least a high risk of running harmful tax competition within the Community. These examples undoubtedly prove the practices of tax competition in developing countries.

The discussions in the previous paragraphs prove that tax competition has conquered all parts of the world, which makes it be considered as having gained a global nature. This nature has been recognised by the OECD in its Progress Report of 2000. In this report, the OECD mentioned that harmful tax competition has a very nature of a global phenomenon, whose solution requires a global intervention, non-members included too.<sup>115</sup> The Report adds that any country may either be engaged in harmful tax practices as it may be affected by the harmful tax practices.<sup>116</sup> From that perspective, while the levels of practice and tools used might be different, it is apparent that no single State can claim to be out of the circle of tax competition, hence, justifying the global nature of tax competition. That global nature is currently intensified by globalisation, whose role over tax competition is detailed in the next paragraphs.

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<sup>109</sup> P Genschel, A Kemmerling and E Seils, 'Accelerating Downhill: How the EU Shapes Corporate Tax Competition in the Single Market', *JCMS* 49(3), 2011, p. 601.

<sup>110</sup> S Jogarajan and M Stewart, 'Harmful Tax Competition: Defeat or Victory?', *Australia Tax Forum* 22, 2007, p. 6.

<sup>111</sup> Morriss and Moberg 2012, supra note 2, p. 36; M de Wilde, 'Tax Competition within the European Union: Is the CCCTB Directive a Solution?', *Erasmus Law Review* 1, 2014, p. 24; K Biernacki, 'Tax System Competition: Instruments and Beneficiaries', *Ekonomia I Prawo Economics and Law* 13(2), 2014, p. 276.

<sup>112</sup> Oguttu 2018, supra note 49, p. 299; R Biswas, 'International Trade in Offshore Business Services: Can Developing Countries Compete?', in R Biswas (ed), *International Tax Competition: Globalization and Fiscal Sovereignty*, Commonwealth Secretariat, 2002, p. 121; Y Margalioth, 'Tax Competition, Foreign Direct Investments and Growth: Using the Tax System to Promote Developing Countries', *Virginia Tax Review* 23, 2003, p. 195; L Abramovsky, A Klemm and D Phillips, 'Corporate Tax in Developing Countries: Current Trends and Design Issues', *Fiscal Studies* 35(4), 2014, p. 574.

<sup>113</sup> EAC, 2<sup>nd</sup> Meeting of the 1<sup>st</sup> Session of the 3<sup>rd</sup> East African Legislative Assembly, Oral Answers to Priority Questions, Question: EALA/PQ/OA/3/06/2012, Nairobi, 13 September 2012, p. 10.

<sup>114</sup> A J van Wijk, *Whether Tax Incentives to Stimulate Foreign Direct Investment for Manufacturing in the SADC Region is an Indicator of Harmful Tax Competition*, Master Thesis, University of Cape Town, 2012, p. 67; SADC, Memorandum of Understanding on Cooperation in Taxation and related matters, 8 August 2002, art. 4(3)(a).

<sup>115</sup> OECD 2000, supra note 100, p. 22.

<sup>116</sup> *Ibid.*

#### IV. Impact of Globalisation

The tax competition phenomenon is broadly associated with globalisation. Indeed, globalisation is largely viewed as the trigger point of tax competition intensification.<sup>117</sup> This view is shared by the OECD, whose 1998 Report identifies globalisation as the main factor of tax competition increase.<sup>118</sup> Tax competition also intensifies more as countries become more interdependent as an effect of globalisation.<sup>119</sup>

In fact, tax competition was not as fierce in the past as it is nowadays. Indeed, a low level of capital mobility in the past made early tax policies to primarily focus on addressing domestic economic and social concerns.<sup>120</sup> That situation started to change with globalisation. To a large extent, globalisation highly influenced the international mobility of capital and human beings. The main impact of globalisation on tax competition is seen through its influence that resulted in high mobility of capital.<sup>121</sup> In turn, the high-level mobility of capital created economic insecurities,<sup>122</sup> which pushed States to design tax competing policies over investments that have already started to flow into locations with low taxation.<sup>123</sup> That is how tax competition then intensified among other competitions that States are consistently engaged in.<sup>124</sup>

Furthermore, notwithstanding the discerning influence and the positive effects of globalisation on the development of tax systems,<sup>127</sup> globalisation intensified harmful tax practices and the negative effects thereto associated such as the fact that one country's tax system can potentially have or suffer the impact to or from others' tax systems.<sup>128</sup> In consequence, countries become unable to set tax rules in an absolute and unilateral way in an era of globalisation and tax competition.<sup>129</sup>

Elaborating more on the interactions between globalisation and tax competition, globalisation is considered as not a new phenomenon.<sup>130</sup> Even so, it started to be focused on towards the end of the twentieth century.<sup>131</sup> Coincidentally, it is in the same period, i.e. the 1980s, that tax competition started to stand as a key element of economic life and a greater concern for many

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<sup>117</sup> Pinto 1998, supra note 3, p. 390; T Baskaran and M L da Fonseca, 'The Economics and Empirics of Tax Competition: A Survey and Lessons for the EU', *Erasmus Law Review* 1, 2014, p. 4.

<sup>118</sup> OECD 1998, supra note 10, p. 7.

<sup>119</sup> S Leviner, 'The Intricacies of Tax and Globalization', *CJTL* 5(207), 2014, p. 213.

<sup>120</sup> OECD 1998, supra note 10, p. 13; S Drezgić, 'Harmful Tax Competition in the EU with Reference to Croatia', *Journal of Economics and Business* 23(1), 2005, p. 73.

<sup>121</sup> OECD 1998, *Ibid.*; Sobotková 2012, supra note 3, p. 343 and 344; Asher and Rajan 2001, supra note 14, p. 120.

<sup>122</sup> Asher and Rajan 2001, *Id.*, p. 127.

<sup>123</sup> OECD 1998, supra note 10, p. 13; Avi-Yonah, 2000, supra note 27, p. 1575; Avi-Yonah 2001, supra note 29, pp. 59, 60; Sobotková 2012, supra note 3, p. 343; Morriss and Moberg 2012, supra note 2, p. 28; Pastukhov 2010, supra note 13, p. 160; Gribnau 2008, supra note 13, p. 75; M F Ambrosanio and M S Caroppo, 'Eliminating Harmful Tax Practices in Tax Havens: Defensive Measures by Major EU Countries and Tax Haven Reforms', *CTJ/RFC* 53(3), 2005, p. 686.

<sup>124</sup> Morriss and Moberg 2012, supra note 2, p. 3.

<sup>125</sup> Asher and Rajan 2001, supra note 14, p. 120; Sobotková 2012, supra note 3, p. 344.

<sup>126</sup> Ambrosanio and Caroppo 2005, supra note 123, p. 686.

<sup>127</sup> OECD 1998, supra note 10, p. 14; Wróblewska 2016, supra note 5, p. 13.

<sup>128</sup> Ault 2009, supra note 90, p. 763.

<sup>129</sup> Avi-Yonah 2001, supra note 29, p. 65.

<sup>130</sup> Calich 2011, supra note 49, p. 20.

<sup>131</sup> Elkins 2006, supra note 17, p. 911.

countries.<sup>132</sup> A decade after, that is in the 1990s, the impact of globalisation on tax competition intensified. It is during that time that the EU and the international community started to be mindful about tax competition, especially the so-called ‘unfair’ tax competition.<sup>133</sup> It is exactly in the mid-1990s, that the EU and the OECD openly expressed the concern of the impactful relationship between globalisation and tax competition on one hand and countries’ fiscal crisis on the other.<sup>134</sup> International tax competition, therefore, came on in two ways: one as a result of capital mobility,<sup>135</sup> second as a response to the same capital mobility.<sup>136</sup> In both situations, tax base mobility stands as the driver of tax competition.<sup>137</sup> However, globalisation does not stand alone and other factors should also be considered.

Besides, the consistent application of harmful tax competition versus harmless tax competition leads to a question of the boundaries between the two aspects of tax competition.

## V. In Search of the Boundaries between Harmless and Harmful Tax Competition

The distinction between harmful and harmless tax competition surrounds and drives the discussions about tax competition. One of the main issues of discussion is about the dividing line between the two. In other words, from where bad tax competition ceases to be bad and starts to be good. This question is based on the legal consideration that not all tax competitions are harmful, i.e. some are good and beneficial while others are bad and harmful.<sup>138</sup> In an attempt to find the boundaries between the two, this section starts with highlights on the need to distinguish bad tax competition from good tax competition before elaborating on what can be considered as part of the boundaries between the two.

### V.1. Why Distinguishing ‘Harmful’ from ‘Harmless’ Tax Competition?

From a legal perspective, not all tax competitions are necessarily bad.<sup>139</sup> Equally, all tax competitions are not good. Tax competition may be good, beneficial and desirable. It is therefore promotable as it can be bad, i.e. harmful, and therefore curtailable.<sup>140</sup> Good tax competition also exists along with bad tax competition. In this vein, harmful tax practices are not accepted, and they are generally discouraged. In contrast, tax competition *per se* is generally perceived as not problematic. Thus, there comes a need to distinguish bad i.e. harmful tax competition from good i.e. harmless tax competition.

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<sup>132</sup> Bossons 1988, supra note 25, p. 347; Faulhaber 2018, supra note 13, p. 326.

<sup>133</sup> Wishlade 2012, supra note 19, p. 586.

<sup>134</sup> Id., p. 587.

<sup>135</sup> Ambrosanio and Caroppo 2005, supra note 123, p. 686; Avi-Yonah 2000, supra note 27, p. 1575.

<sup>136</sup> OECD 1998, supra note 10, p. 13.

<sup>137</sup> Avi-Yonah 2004, supra note 29, p. 375; P Genschel and P Schwarz, ‘Tax Competition: A Literature Review’, *Socio-Economic Review* 9(2), 2011, p. 342; C O F de Almeida and M E Pereira, ‘Brazilian Perspectives on Secret, Cooperation and International Tax Competition’, *CIAT/AEAT/IEF Tax Administration Review* 40, 2016, p. 62.

<sup>138</sup> Patterson and Serrano 1998, supra note 58, p. v.

<sup>139</sup> Pastukhov 2010, supra note 13, p. 163; Lampreave 2011, supra note 40, p. 8; Avi-Yonah 2000, supra note 27, p. 1610; M Rushton, ‘Interprovincial Tax Competition and Tax Reform in Saskatchewan’, *CTJ/RFC* 48(2), 2000, p. 386; K Dirix, ‘Harmful Tax Competition: Six Belgian Tax Incentives under the Microscope’, *EC Tax Review* 5, 2013, p. 233.

<sup>140</sup> Pinto 2002, supra note 1, pp. 1, 297; M Gaffney, ‘Competition: More Harm than Good’, *Int’l Tax Rev.* 10(1), 1999, p. 46; M Schaper, ‘Tax Law’, in J Hage, A Waltermann and B Akkermans (eds), *Introduction to Law*, 2<sup>nd</sup> edn, Springer, 2017, p. 274.

With that in mind, good tax competition is acceptable, desirable, and is acknowledged in legal scholarship.<sup>141</sup> The desirable acceptance is also confirmed by the OECD instruments and the EU law. Indeed, both organizations accept the potential positive effects of good tax competition.

For instance, the OECD 1998 Report on harmful tax competition accepts the distinction between acceptable and harmful tax competition.<sup>142</sup> The OECD 1998 Report also acknowledged the existence of good tax competition and refers to it as encompassing all tax measures that a sovereign country may adopt without breaching internationally accepted standards.<sup>143</sup> Not only the OECD, but also the EU recognises the existence of good tax competition.

That recognition can be seen through the preamble of the 1997 EU Code of Conduct on business taxation which acknowledges the positive effects of fair competition along with the need to strengthen the EU competitiveness, while also noting the negative effects of harmful tax competition.<sup>144</sup> In the same vein, the EU intention has not been to end all tax competition, but rather to emphasize the need of encouraging good tax competition within the Union.<sup>145</sup> As a matter of exemplification, the Explanatory Memorandum to the 2011 CCCTB Proposal of the European Commission states that:

“Fair tax competition on tax rates is to be encouraged. Differences in rates allow a certain degree of tax competition to be maintained in the internal market and fair tax competition based on rates offers more transparency and allows the Member States to consider both their market competitiveness and budgetary needs in fixing their tax rates.”<sup>146</sup>

In addition, Member States’ fiscal sovereignty is recognised under EU law, which, as a matter of principle, sets tax competition as a norm.<sup>147</sup> From these examples, it is conclusive that, basing on the benefits associated with good tax competition, it needs to be maintained and supported.

In contrast, bad tax competition is generally condemned. Mostly, the richest countries are of the opinion that (harmful) tax competition is bad and needs to be stamped out.<sup>148</sup> Equally, the academic community supports the efforts to combat bad tax competition.<sup>149</sup> That support is due to considering tax competition as a threat<sup>150</sup> along with a number of disadvantages associated

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<sup>141</sup> I Roxan, ‘Limits to Globalization: Some Implications for Taxation, Tax Policy, and the Developing World’, London School of Economics Working Paper 3, 2002, p. 21, at: [http://eprints.lse.ac.uk/46768/1/Limits%20to%20globalisation%20\(lsero\).pdf](http://eprints.lse.ac.uk/46768/1/Limits%20to%20globalisation%20(lsero).pdf) (accessed on 7 May 2019).

<sup>142</sup> OECD 1998, supra note 10, p. 8; Boulogne 2019, supra note 55, p. 12.

<sup>143</sup> OECD 1998, Id., p. 15; Pinto 1998, supra note 3, p. 390.

<sup>144</sup> EU Code of Conduct 1997, supra note 105, C 2/3; Genschel, Kemmerling and Seils 2011, supra note 109, p. 596; Drezgić 2005, supra note 120, p. 80; M Seeruthun-Kowalczyk, *Hard Law and Soft Law Interactions in EU Corporate Tax Regulation: Exploration and Lessons for the Future*, Ph.D Thesis, Edinburgh University, 2011, p. 169.

<sup>145</sup> EU Com., Explanatory Memorandum to a Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), Brussels, COM (2011) 121/4 2011/0058 (CNS) {SEC(2011) 315} {SEC(2011) 316}, 2011, p. 4; CEU, Report from COCG to ECOFIN Council on Code of Conduct, 9655/06 FISC 73 CS/lv DG G I, Brussels, 19 May 2006, p. 37.

<sup>146</sup> EU Com., Explanatory Memorandum, Ibid.

<sup>147</sup> Pinto 2002, supra note 1, p. 52, 78, 300, 302.

<sup>148</sup> Teather 2002, supra note 77, p. 58.

<sup>149</sup> Elkins 2006, supra note 17, p. 914.

<sup>150</sup> Morriss and Moberg 2012, supra note 2, p. 57; J Hey, ‘Tax Competition in Europe: The German Perspective’, EATLP Conference, Lausanne, 2002, p. 6, at: [www.eatlp.org/uploads/Members/Germany02.pdf](http://www.eatlp.org/uploads/Members/Germany02.pdf) (accessed on 13 August 2019).

with it such as the tax base erosion, which ends up creating an unbearable situation.<sup>151</sup> Other consequences of bad tax competition include, but are not limited to distorting investment and trade; undermining the integrity, neutrality, and fairness of tax structures; discouraging tax compliance; undesired shifts of the tax burden; increasing administrative costs and compliance burdens; and the diminution of global welfare.<sup>152</sup>

Consequently, bad tax competition has been labelled as unfair and harmful. That consideration led to a need of designing measures aimed at eliminating bad tax competition. In addition, there arises a need to distinguish bad tax competition from good tax competition because the attention should be on what to eliminate and what to maintain. That distinction is a serious matter because a wrong choice would lead to a detrimental effect: either maintaining a practice which is deemed to be part of bad tax competition or eliminating an aspect of good tax competition.

Therefore, it is necessary to establish a clear understanding of the practices that form bad tax competition and practices that form good tax competition. To this end, the main baffling and pending issue remains the point at which one distinguishes harmless tax competition from harmful tax competition. In other words, the question here is when and where does tax competition cease to be good and become bad?

## V.2. What are the Boundaries?

Tax competition is one of the topics that are often discussed in international tax law. Considering each countries' motives for engaging in tax competition as well as the effects of it, there is no expectation or likelihood that these discussions will end in the near future. This scepticism is supported by a number of challenging and provocative ideas on tax competition. An example is the boundary between harmless and harmful tax competitions, which has been always very contentious,<sup>153</sup> difficult,<sup>154</sup> thorny,<sup>155</sup> and even impossible.<sup>156</sup> Furthermore, no practical criterion has been singled out to draw the borderline.<sup>157</sup>

The difficulties are also fuelled by a number of factors, including the very nature of tax competition itself.<sup>158</sup> In fact, all countries engage in tax competition in one way or another, with some using more sophisticated and less transparent mechanisms than others.<sup>159</sup> The lack of a uniform definition of harmful tax competition also stirs the discussions on the distinction between good tax competition and bad tax

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<sup>151</sup> Sobotková 2012, supra note 3, p. 343.

<sup>152</sup> OECD 1998, supra note 10, p. 16; K van Raad, *Materials on International & EU Tax Law*, 13<sup>th</sup> edn, International Tax Center, 2013, p. 1309.

<sup>153</sup> Ault 2009, supra note 90, p. 765.

<sup>154</sup> Lampreave 2011, supra note 40, p. 3; de Almeida and Pereira 2016, supra note 137, p. 64; L Cerioni, 'Harmful Tax Competition Revisited: Why not a Purely Legal Perspective under EC Law?', *Euro. Tax.*, 2005, p. 267.

<sup>155</sup> Pinto 2002, supra note 1, p. 8.

<sup>156</sup> H G Petersen (ed), 'Tax Systems and Tax Harmonization in the East African Community', Report for the GTZ and the General Secretariat of the EAC, 2010, p. 25.

<sup>157</sup> Pinto 2002, supra note 1, p. 15.

<sup>158</sup> S J C Hemels, 'Fairness and Taxation in a Globalized World', 2015, p. 17, at: <http://dx.doi.org/10.2139/ssrn.2570750> (accessed on 29 July 2019).

<sup>159</sup> A Christians, 'BEPS and the New International Tax Order', *BYU Law Review* 2016(6), 2017, p. 1630.

competition.<sup>160</sup> Not only that, but also what constitutes harmful tax competition has no absolute legal agreement so far.<sup>161</sup> More than that, instead of engineering a clear definition of harmful tax practice, the pioneering institutions in curtailing that practice such as the OECD and the EU elaborated on the components of harmful tax practices and the criteria to base on when determining whether a regime is harmful or not. Even though, the established criteria keep changing the weight from time to time.

Consequently, today there is so far no clear borderline of demarcation between fair and unfair tax competitions. Countries and international organizations have also failed to reach a settlement, not only on the definition of harmful tax competition, but also on when the harmfulness begins.<sup>162</sup> Moreover, all efforts to curtail tax competition are challenged by the impossibility to have it totally eliminated. This impossibility is justified by the fact that the world free of tax competition would entail a world of one tax system, which is not possible in the near future.

Even so, a variety of attempts have been undertaken to draw a borderline between harmful and harmless tax competitions. For instance, tax competition is acceptable if it is an expression of a country's fiscal sovereignty meant to attract new and genuine investment.<sup>163</sup> Here, the main element is the attraction of genuine investment. Thus, favourable tax measures targeting manufacturing, investment in assets, and the like, are generally not harmful.<sup>164</sup>

Favourable tax measures which are applicable to all, and are not targeting foreigners also generally qualify to be not harmful.<sup>165</sup> In this consideration, harmless tax competition occurs when the country decides to reduce the tax burden to both residents and non-residents, either by lowering tax rates or by granting tax credits.<sup>166</sup> In this context, harmful tax competition would be defined as:

“Fiscal policy implemented on the initiative of a country that offers a wide range of tax incentives and advantages to attract mobile factors (investment) to that country in the absence of transparency and the effective exchange of information with other countries.”<sup>167</sup>

The above definition is centred on the attraction of mobile investment. Much associated with that is the ring-fencing, which is one of the considerable elements in the determination of harmful tax practices. Indeed, tax competition which boosts a country's economy and benefits all taxpayers is harmless and desirable while a tax competition which directly aims at the business attraction at the expenses of fellow States is bad and harmful.<sup>168</sup>

Additionally, a preferential tax regime which causes little incidental harm to other countries, but which provides substantial benefits to the host country is justified.<sup>169</sup> In contrast, a favourable tax measure which ends up poaching other countries' tax bases spontaneously qualifies as

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<sup>160</sup> Pastukhov 2010, supra note 13, p. 162; Arnold and McIntyre 2002, supra note 9, p. 138.

<sup>161</sup> Patterson and Serrano 1998, supra note 58, p. 8.

<sup>162</sup> Faulhaber 2018, supra note 13, pp. 312, 345.

<sup>163</sup> Rixen 2007, supra note 47, p. 72; Pinto 1998, supra note 3, p. 390.

<sup>164</sup> OECD 1998, supra note 10, p. 8; Carlson 2002, supra note 57, p. 165; L B Samuels and D C Kolb, 'The OECD Initiative: Harmful Tax Practices and Tax Havens', *Taxes* 79(231), 2001, p. 234.

<sup>165</sup> Elkins 2006, supra note 17, p. 947.

<sup>166</sup> Lampreave 2011, supra note 40, p. 6.

<sup>167</sup> *Ibid.*

<sup>168</sup> Pinto 2002, supra note 1, p. 1.

<sup>169</sup> Lampreave 2011, supra note 40, p. 8.

harmful.<sup>170</sup> In the same vein, tax competition becomes harmful when ‘*States merely damage each other’s budget, without creation of economic activity being at issue, but rather artificial cross-border shifts of activities (or at least profit-reporting for those activities), and causing a tax loss for the whole*’.<sup>171</sup>

## VI. Conclusion

In a legal perspective, this paper focused on searching the boundaries between harmless and harmful tax competition. The paper started with understanding the key features of (harmful) tax competition alongside the definitions of (harmful) tax competition. Afterward, two rivalry sets of views on the emergence of tax competition have been elaborated on. One set views tax competition as natural based on the phenomenon’s long existence while the other set views tax competition as a human creation, mainly dominated by the retaliation process. Subsequently, it has been elaborated on why tax competition matters. Two grounds have been highlighted, namely the impact of tax competition on State sovereignty and the current global character of tax competition, which is mainly exacerbated by the globalisation. That was basically a set of the ground to enter into the core aspect of the paper: the search of the boundaries between harmful and harmless tax competitions. The main issues have been the reason of seeking at establishing the boundaries, and what the boundaries are. In this regard, it has been established that an expression of a country’s fiscal sovereignty meant to attract new and genuine investment is acceptable. Thus, tax competition that happens in that context is harmless. Tax competition whose measures are applicable to all, without a distinction between residents and non-residents is also not harmful. In contrast, tax competition conducted with ring-fenced measures is qualified harmful. Equally, tax competition that aims at or that results in poaching other countries’ tax bases is harmful. In brief, tax competition becomes harmless or harmful depending on the country’s intention and the measures used. It is worth mentioning that tax competition discussions are endless. Thus, this paper does not claim to exhaust all issues pertaining to its subject matter. Even so, the key elements have been fairly elaborated on.

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<sup>170</sup> OECD 1998, supra note 10, p. 16; Oguttu 2018, supra note 49, p. 294.

<sup>171</sup> OECD, *Countering Harmful Tax Practices More Effectively Taking into Account Transparency and Substance: Action 5 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, Paris, OECD Publishing, 2015, p. 21, at <http://dx.doi.org/10.1787/9789264218970-en> (accessed on 21 May 2019); H Gribnau, ‘The Integrity of the Tax System after BEPS: A Shared Responsibility’, *Erasmus Law Review* 1, 2017, p. 12.