Tax Justice in the Era of Mobility and Fragmentation

Tsilly Dagan[1]

Globalization and the transformation of tax sovereignty

The traditional analysis of tax justice envisions a state that is ruled by a sovereign which is entrusted with exclusive legislative powers concerning tax, seeking (at least ideally) to pursue normatively desirable goals. Zooming out to the global level, however, we realize that the powerful sovereign is only one of approximately 200 sovereigns competing with one another for resources as well as (at least to some extent) for residents. This market of states is decentralized (as each state is setting its own policies) and competitive. Taxation is, to a large extent, the currency of this competition, with states luring investments as well as residents to their jurisdiction with attractive taxing and spending 'deals'. As countries attempt to tailor their sovereign-provided-goods to attract desirable mobile constituents and resources, tax policies almost inevitably become marketized. Two features of such competition are particularly relevant to our understanding of tax sovereignty and particularly the interaction between states and their constituents in the era of globalization: mobility and fragmentation.

a. Mobility—Competitive Sovereignty

Competition has transformed sovereignty generally, and it has certainly transformed tax sovereignty. Although sovereign states still insist on preserving their formal exclusive authority in tax matters, the truth of the matter is that under conditions of competition, it is all too often the invisible hand of the international market of states, rather than the individual sovereign state, that shapes tax policies. In competing for investments, residents, and tax revenues, states no longer design their own policies in a vacuum, for this competition provides taxpayers with an alternative: to shift their capital, their activities or their residency and, for individuals, even their citizenship to another jurisdiction.

Taxpayers—both individuals and, even more so, businesses—are increasingly mobile. This enables them to choose from among alternative jurisdictions to relocate their places of residence, investments, and business activities. States often encourage such mobility by offering certain privileges and

[1] Tsilly Dagan is Professor of Taxation Law at Oxford University and a Fellow of Worcester College.

incentives to desirable potential residents and investors. Residents-in-demand relocate to more appealing jurisdictions, as states lure away investors, corporate headquarters, production facilities, R&D as well as young and talented ~~residents.~~individuals.

With this intensified mobility, sovereign states have found themselves in an unfamiliar position: once defined by their coercive powers and control over their citizenry and territory, they must now try to lure residents and investments away from competing sovereigns and offer competitive terms to their own constituents, assuming they wish to expand or even simply sustain their domestic economies. By providing taxpayers with a viable alternative, tax (and often other regulatory) competition has turned the decision-making process on its head. The state can no longer be perceived as making compulsory taxation demands on its subjects in order to promote the collective goals of a given group of constituents but, rather, it increasingly acts as a recruiter, soliciting investments in order to facilitate increased economic activity and bidding for residents in an attempt to build the best possible team. The legal rules that apply in a certain jurisdiction and the applicable tax rules and rates are important considerations for the globally mobile (certainly for businesses but even for certain individuals) when weighing their residency options and the potential locations for their economic activities. Hence, tax rules and rates have become, to a large extent, the currency of state competition.

Under these conditions of competition, tax has increasingly become a price which taxpayers are willing to pay for residing, investing, and conducting their business in an attractive state as opposed to a civil obligation they should fulfill, while for states, tax rates and public policies have become subject, to a considerable extent, to the rules of supply and demand in the market for states. In its extreme version, tax competition changes taxation from a mandatory regime to a regime that is essentially elective or, to be more precise, elective for some. This is true for individuals but even more so for multinational enterprises ('MNEs'), for which the decision of where to incorporate or otherwise set up residence for tax purposes is often a business decision. In a world where tax competition is prevalent, states increasingly resemble firms offering goods and services that aim to appeal to (and keep) investors and residents, for an attractive tax 'price'.

Consequently, policymakers find it necessary to take into account considerations that are more similar to those weighed by firms competing on the market. To maximize the benefits derived from individuals and businesses residing and investing in their state jurisdiction, policymakers cater to the most 'valuable' taxpayers and those most likely to relocate for tax reasons (and curiously enough, should invest less effort in keeping the ones who are most committed to the country). They pursue

taxpayers that will bring the most material benefits to the state, such as jobs, R&D, capital investments, spillover of technological and managerial skills, and simply talent. In terms of tax (and other) policies, this means offering the public goods and services that are most attractive to such constituents and lowering taxes for the most mobile.

In short, competitive sovereignty focuses on assembling the most attractive 'team' of constituents and economic actors by offering the most attractive public services deals at an attractive price. This is very different, of course, from sovereignty that seeks to provide the best possible public services to a set group of constituents who share common goals and aspirations and that wields the power and legitimacy to accomplish this using coercive measures so as to prevent collective action problems.

b. Fragmentation— Unbundled Sovereignty

The mobility of residents and their resources—and the accompanying marketization of the government-constituent relationships it entails—are only the tip of the iceberg. No less significant, and too often overlooked, is the ability of (certain) individuals and businesses (most notoriously, MNEs) to unbundle and then reassemble packages of sovereign goods tailored to their specific needs. In the current market of states, individuals and businesses are able not only to shop for their jurisdiction of choice but also to buy 'a-la-carte' fractions of regimes of different state sovereignties. This fragmentation of sovereignty occurs in many areas of state regulation,[2] but tax—formerly the quintessential tight, all-encompassing coercive legal regime—seems particularly amenable to such tailoring by skilled tax-planners.

Contrary to their coercive all-encompassing character under a purely domestic setting, in the era of globalization tax laws have become notorious for being virtually elective (at least for some). The conditions that can trigger the application of tax laws in different jurisdictions vary widely, which has produced a fragmented international tax scene with a diversity of mix-and-match components: differing residency rules; source rules; rules for allowing deductions; withholding rates; and over 3000 tax treaties between jurisdictions. Sophisticated and well-advised taxpayers can pick and choose among these components in ways that do not necessarily overlap with any of the regimes governing their other affairs.[3]

[2] Tsilly Dagan, 'The Global Market for Tax & Legal Rules', 21 FLA. TAX REV. 148, 168 (2017).
[3] For a brief description of the tax planning techniques employed by tax planners, see Tsilly Dagan, *International Tax Policy: Between Competition and Cooperation* (Cambridge University Press 2017) 27–30.

As a result, taxpayers who plan their affairs can simultaneously reside in one jurisdiction (and consume its publicly provided goods and services), incorporate in another (and thus enjoy its corporate governance), do business in a third, use the court system of a fourth, invest in a labor intensive plant in a fifth (and reap the benefits of a publicly-provided services such as an educated workforce), register its IP in a sixth; and be subject to the tax rates, if any, of another jurisdiction altogether. The case of MNEs is an extreme example. MNEs are (or at least used to be until recent attempts to curtail 'base erosion and profit shifting' by the OECD[4]) notoriously able to tax-plan their activities in ways that created what was famously called 'stateless income' – that is income that, due to tax planning and tax competition between countries is subject to extremely low rates across the globe.[5]

Some of the features of this fragmented international tax and regulatory regime are the result of sheer planning techniques – designed solely to manipulate the system in order to avoid certain taxes, duties or regulations. But fragmentation is also a structural phenomenon which is the direct result of the decentralized market of states (and would be present even if profit-shifting-type tax planning would be eliminated). In the absence of coordination, each country is free to tax (and regulate) whatever features it sees fit and adopt whatever tax regime it desires. Hence, some countries can 'sell' their residency very cheaply. Others may be able to collect rents for their natural resources, human talent or their good weather. None of these features should necessarily be bundled with others, although some countries may, certainly, do so.

In contrast to the classic mobility story, which tends to be constructed around a market of states offering take-it-or-leave-it package deals of legal rules, services, and taxes, the fragmentation perspective highlights the electivity and flexibility of these packages. Instead of looking at individuals' and businesses' ability to shift their choice of jurisdiction *en-bloc* by moving their residency to a new jurisdiction, fragmentation stresses their leeway to *mix-and-match* legal jurisdictions. The fragmentation of the state-citizen relationship and the fact that individuals and businesses are not exclusively connected to a single state but, rather, interact simultaneously with many states on various planes, mean that this relationship cannot, and does not, necessarily bundle together all the dimensions of the potential interaction between taxpayers and states. This reality impacts the strategies used by both taxpayers and states. Whereas absent this jurisdictional fragmentation, the optional strategies for

[4] The 'OECD G20 Base Erosion and Profit Shifting Project' is an OECD project to set up an international framework to combat tax avoidance by MNEs using base erosion and profit shifting tools. The project behand in 2013 and is not in its implementation phase. See, https://www.oecd.org/tax/beps/about/.

[5] See, Edward Kleinbard, 'Stateless Income', 11 FLA. TAX REV. 699, 706 (2011).

residents are essentially either voice (using their political power to shape state policy) or exit (relocating to a jurisdiction that offers a more favorable regulatory package),[6] they now have an array of options that will maximize their benefits; they can *diversify* their state-related interactions.

Thus, in this market for public goods, people—and, even more so, corporations—can choose, not only between jurisdictions in their entirety, but also from amongst different combinations of fractions of these jurisdictions. States must also adjust their strategies to the reality of electivity under fragmentation. They must internalize the fact that they operate as competitive players in multiple 'markets' simultaneously. Tradeoffs between various aspects of their public services are much harder to pull off. Hence, a state's advantageous geographical location, excellent school system, or strong legal tradition will not necessarily compensate for a high corporate tax rate or strict employment rules, when residents and businesses can often simply choose to opt out of the less desirable features. Sadly, fragmentation, and the creative tax planning it facilitates, also allows taxpayers to free ride on some of the public goods which states offer. Where a state cannot collect taxes from individuals and businesses that find ways to avoid them by tax planning, states cannot ensure the participation of all taxpayers in the financing of such services.

This type of unbundling is often desirable when pure market transactions are at stake, as it increases the competitiveness of the market and allows consumers greater freedom in selecting their desirable goods. But in the context of the interaction between the state and its constituents, unbundling raises serious challenges for both states and their constituents, particularly challenges for justice.

The Challenges for Tax Justice

The competitive and fragmented reality of tax under conditions of globalization is transforming tax sovereignty. It undermines the coercive power of the state and threatens to transform the state from a coercive institution designed to enforce the collective will of its subjects into a market-like actor and its constituents into 'clients' that need to be catered for. This transformation of tax sovereignty challenges justice in two important ways: it threatens states' redistributive capacity and it challenges the principle of equal respect and concern for all.

[6] Using the concepts developed by Hirschman, see Albert O Hirschman, *Exit, Voice, and Loyalty: Responses to Decline in Firms, Organizations, and States* (Harvard University Press 1970).

a. A Challenge for States' Redistributive Capacity

Competition has dramatically diminished the coercive power of the sovereign state in tax matters and thereby altered its relationship with its constituents. Although it would be inaccurate to claim that states' taxing power has completely collapsed, due to tax competition, states' inability to enforce taxation equally due to competition has certainly undercut this power, and especially states' ability to enforce a redistributive scheme. Mobility, with the relocation options it opens up, and the opportunities for sophisticated tax planning which fragmentation offers, enable (some) taxpayers to reduce their tax liability using the array of techniques described above. The result is a serious diminishment in states' coercive taxing power. States can *de-facto* enforce their tax laws predominantly on the immobile segments of society and on those segments that are incapable of effectively tax-planning their operations. They could also collect payments for the public goods which mobile taxpayers are interested in consuming and are willing to pay for. They are unlikely, however, to be able to collect much revenue for redistribution from those who are able to opt out of the system. And since the mobile taxpayers and the ones more likely to tax plan are often also the wealthiest, states are losing their ability to redistribute resources ~~in the society~~among taxpayers. The outcome of states' struggle to attract investments (by lowering their tax rates) and woo residents (individuals as well as multinational enterprises) with attractive taxing and spending deals is thus a restricted ability of states to redistribute wealth domestically. In the most extreme case, driving down tax rates on mobile residents and on the mobile factors of production will shift the tax burden to the less mobile (and often less well-off) constituents This may lead to a reduction in the state's tax revenues and thereby erode its ability to sustain public goods and services and, in particular, redistribution. As Reuven Avi-Yonah established, 'if capital cannot be effectively taxed, the tax base will generally shift – regressively – toward labor. Thus, tax competition impairs the income tax's ability to redistribute wealth from the rich to the poor.'[7]

In any event, tax competition indisputably brings pressure to bear on states to reduce their taxes and restrict redistribution, or else pay the overall price in terms of the community's welfare. Despite several

[7] See Reuven S. Avi-Yonah, 'Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State', 113 HARV. L. REV. 1573, 1578 (2000). It has been argued that tax competition will drive tax rates down to a suboptimal level, where states will be forced to under-provide public goods. For a formal model supporting this argument, see George R. Zodrow & Peter Mieszkowski, 'Pigou, Tiebout, Property Taxation, and the Underprovision of Local Public Goods', 19 J. URBAN ECON. 356 (1986). Although it is unclear what exactly constitutes the optimal level of public goods (see John Douglas Wilson, 'Theories of Tax Competition', 52 NAT'L TAX J. 269, 270 (1999)), it is pretty evident that redistribution would be reduced.

factors that serve as counterweights to competition's downward pressure on redistribution, the fact of taxpayers' mobility implies that states have no choice but to weigh the benefits of redistribution and the potential costs of driving away wealthy residents and businesses with excessive redistribution. Where tax-planning opportunities are available, they act as further constraints on states' ability to redistribute wealth. For even when a state offers advantages relative to other states, or taxpayers have considerable costs of relocation, the state will find it difficult to convert these advantages or inelasticities into tax revenues that facilitate significant redistribution.

Fragmentation further intensifies the vulnerability of traditional interactions within the state. If, in the past, states were able to bundle together their relative advantages for taxpayers with their preferred political regime and public policies, and thus give weight to principles of solidarity and redistribution, the fragmented international tax field now undermines this ability. Instead of the classic principles of political governance that design bundles of public goods for certain amounts of taxes based on an agreed upon distributive scheme, the interaction between sovereigns and their constituents increasingly follows the market rules of supply and demand, where taxes are determined (for some) by the 'invisible hand of the market'. In a market-like regime, more elastic taxpayers pay lower taxes and are being offered public services that better match their preferences. This might transform the state from a forum for coercive co-authorship of public policies, where justice legitimizes the use of coercion and political decisions are made through mechanisms of voice, into a market actor increasingly constrained by the invisible hand of the market, where taxpayers 'buy' public goods and services and governments 'sell' them for the taxes they collect. This is very close, if not identical to, benefit taxation where taxes serve as prices, not even purporting to support states' duties of distributive justice. In this scenario, tax law might cease to be the main tool for redistribution. Thus, states may find themselves unable to uphold ideals of distributive justice. This may in turn undermine the legitimacy of their coercive powers.

b. A Challenge for Equal Citizenship

Because of the competitive pressure and the considerable difficulty for states of enforcing their rules on mobile taxpayers, they are pushed to offer mobile constituents—or the ones with better planning opportunities—with either significant tax benefits or increased leeway in planning their world-wide tax operations. Things are very different for the immobile taxpayers (and those who lack any planning opportunities). Hence, the rational choice for a state in a competitive market seems to be a regime

that 'price discriminates' among taxpayers based on how elastic their ability to opt out of the jurisdiction is: for some taxpayers, the ones with lower ability or a lower inclination to move, coercive world-wide taxation of their ability to pay would make sense. Yet for others, those with available alternatives, a regime which is more lenient, at times even elective is the more beneficial option in term of tax revenues. In other words, tax competition brings back a unique version of taxation: compulsory taxes *for some*.

More specifically, by adjusting their policies to match them with the varying degrees of elasticity among their constituents, states could increase the tax revenues they end up collecting. Assuming that the marginal costs of providing much of the public services to such mobile taxpayers is zero, or close to zero, elasticity-based taxation could result in net gain for the state. If any taxes thus collected would be used to serve the entire population, and be distributed in a just manner, all of the constituents will be better off: not only mobile residents (who will now pay less tax) would benefit from the divergent taxation, but immobile constituents too stand to gain, too. Although the taxes collected from the mobile constituents are modest, they are still better than the zero amount of tax that would have been collected had the mobile taxpayers left. Whatever taxes are collected from the mobile will pay for increased public goods and services. Where, on the other hand, elasticity is low—as in the case of immobile taxpayers—there is no reason for the state not to collect higher taxes from them. The bottom line seems to be that if the state seeks to maximize the welfare pie, tax should be imposed in inverse relation to how elastic taxpayers are. This would mean that the most inelastic (i.e., immobile taxpayers) would end up paying the highest (coercive) taxes, while the mobile ones (with the greatest elasticity) will get a more lenient treatment.

When viewed from a strictly utilitarian perspective, the choice of such a regime – adjusting rates and rules to the elasticity of taxpayers' choices in order to attract as much revenue and benefit as possible – may seem like an almost inevitable strategy for states. But is it? Is the state free to choose among these strategies, or are there any normative limitations on the state when considering these options?

The answer, I believe, depends on the kind of social contract on which the state is based. Does the social contract follow (or rather should it follow) a utilitarian ideal of maximizing our collective interests (a market-inspired ideal)? Or is it about creating a community of equals (a membership ideal)?[8]

[8] For more on this choice see Tsilly Dagan, 'Reimagining Tax Justice in a Globalised World' in Dominic de Cogan, & Peter Harris (Eds.). Tax Justice and Tax Law: Understanding Unfairness in Tax Systems (Hart Publishing, 2020). Digital version available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3602678

Tax Sovereignty at a Crossroad

These challenges for redistribution and for the principle of equal respect and concern dramatically undermine the state's centralized monopolization of the power of taxation and thus alter the relationships of states with their constituents. In this reality, states must decide whether to subject all of their constituents to similar rules and rates of taxation, irrespective of how elastic their choices of residence are, in which case they might lose the ones that are most mobile and wealthy. Pushing the wealthy away may limit the funds available for redistribution. Thus, by imposing equal tax rates and rules, states might be settling for a poorer society, yet less unequal. If, on the other hand, they choose to give weight to taxpayers' varying elasticities, they may enlarge the collective welfare pie, but risk undermining both the redistributive function of taxation *and* equal respect and concern for the immobile ones. Moreover, tailoring tax rules and rates to allow fragmentation may undermine equal respect and concern for the ones unable to unbundle their interactions with the state. Ignoring them may provide the latter with equal respect and concern, but disrespect other constituents by pushing them to make binary choices between staying and leaving.

The significance of this choice for state governance in tax matters cannot be overstated: it juxtaposes two very different ideal-types of state-taxpayer relationships: a utility-maximizing version of the state on the one hand, and a community of equals on the other. Under the first, states surrender to the rules of the market—and operate more like a utility-maximizing organization, which optimizes the tax revenues (and other benefits) they can collect from current and potential residents. To do that, they must give considerable weight to the elasticities of taxpayers' choice of jurisdiction. The result is that exit power prevails over voice and membership. Under the second, the state ignores such elasticities in the name of equal respect and concern and reinforces an equal membership system where one's belongingness to the state dominates her taxation, pushing her to make binary choices between staying or leaving *and* potentially undermining collective welfare.

Could multilateral cooperation provide an answer?

Given the state's fading coercive power in taxation and the challenges of fragmentation, we can no longer assume that ideals of justice can be realized within the parameters of the state. In many cases, it may be only through a cooperative accord that states could regain these powers. Cooperation thus becomes a promising way for states to regain legitimacy by sustaining their ability to ensure the collective action of their citizens and to treat them with equal respect and concern.

2021 has seen an impressive feat of multilateral cooperation when the OECD-initiated two-pillar accord was signed by almost 140 countries. The most promising part of this accord, entitled pillar two, proposes a 15% effective minimum corporate tax rate to be imposed on the biggest multinational corporations. Thus far, discussion has been limited to corporate taxation only, but a similar effort focused on personal income taxation, though extremely hard to apply, could conceivably be imagined. If successful (and that is, no doubt, a big *if*) a multilateral agreement – operating like a cartel-– could potentially support states' ability to redistribute wealth. Presumably, if states cooperated in imposing a cartelistic 'price' of taxation, they could resolve the tension between 'elastic' taxpayers and those left behind, preserve redistribution *and* limit price discrimination based on elasticity.

But even beyond the significant barriers to attaining such a cooperative solution, the multilateral arena raises additional concerns for justice – this time, global justice.

The reason is that the cooperative ideal, which sounds like an inevitably happy scenario that can serve the interests of all cooperating parties, is not necessarily desirable for all. In fact, despite a strong intuition to the contrary, (even) the fact that everyone agrees to the solution does not mean it is good for all parties. This is true not only in the obvious case where one is being coerced or tricked into an agreement. Even in the absence of deception or crude power of coercion, cooperation in itself is no assurance for serving the interests of the cooperating parties. Co-operative mechanisms in and of themselves may provide some actors (notably the ones setting the cooperative standard) with excessive power. While leveraging the collective power of the cooperating parties may be beneficial (e.g., in enforcing tax rules on MNEs, mobile resources and mobile taxpayers), it may also provide incentives for some actors to join the cooperative accord even if they would have preferred a different outcome (or no cooperation at all).

In fact, cases where cooperation harmed some of the cooperating parties is no stranger to international taxation. Throughout the years, cooperative accords in the international tax arena tended to promote the interests of developed countries, favoring them over those of developing ones, and at times even undermining the latter. Even seemingly innocuous instruments, such as treaties for the preventions of double taxation negotiated on a bilateral basis, tend to allocate tax revenues in favor of developed countries at the expense of their developing counterparts.[9]

Many have argued that the 2021 two-pillar accord is similarly tilted against poor countries. Thus, if not properly addressed, there is a risk that a similar flaw might plague future international tax

[9] For more on this see eg, Dagan (n 3) 72–119.

agreements as well. This predicament has to do not only with the superior bargaining power that developed countries often enjoy in negotiating international pacts, but also with the network structure of many of these agreements, as well as the fact that the OECD often sets the agenda for multilateral moves.[10] Hence, caution is warranted in celebrating this achievement as inherently justified, or even as inherently desirable simply because it is co-operative.

But even if the international agreement proves to be beneficial for all the countries involved, is a pareto efficient solution, it should be reevaluated, with inter-nation equity and global justice considerations in mind. The current stage of international cooperation on tax matters is unprecedented. As many have observed, we are currently watching the emergence of a new international tax regime, that—if successful—will replace the 100-year old one initiated in the 1920's by the League of Nations. Some of the world's financial leaders have claimed that with this agreement we are entering the age of multilateralism in international taxation. If this is indeed the case, if we are seeing the formation a global tax community, we need to re-visit the question of what duties of justice such a community must adhere to in order for it to be legitimate.[11]

Global justice may demand that countries of the world, and members of the OECD in particular, abide by an active duty of justice towards poor countries or perhaps towards the poor of the world more generally, instead of simply complying with their bargained-for 'deal'. One need not be a cosmopolitan in order to acknowledge that 2021 represents a new level of international institutional cooperation on tax, one that imposes a duty of justice beyond national borders. The current level of cooperation, I claim, does not only allow countries to work together to maximize the global welfare pie, but also demands that the benefits of this cooperation be fairly allocated across the international community.

[10] For more on this see, ibid 142–184.

[11] For a full analysis of application of the different approaches in political philosophy to international taxation see ibid 185–212.