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**Harmful tax competition in the East African community:
the case of Rwanda with reference to EU and OECD
approaches**

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2 TAX COMPETITION GENERAL PANORAMA

This chapter provides a general overview of (harmful) tax competition. It does so seeking to answer the question of the boundaries between good and bad tax competition. The chapter's aim is to present the general aspects of the phenomenon of harmful tax competition. More specifically, the aim is to present the background of bad (harmful) tax competition as opposed to good (harmless) tax competition. This is done with the aim of reaching the established boundaries between the two. In this respect, the chapter runs through the existing body of knowledge on the subject and does not intend to coin a new boundary.

The chapter is structured as follows: section one attempts to foster an understanding of the main features of tax competition and how it arises. Section two focuses on the principles that guide discussions on tax competition. The main focus is on the principle of state fiscal sovereignty, which implies the right to design one's own preferred tax system, including tax competition policies. The same section highlights the vicious circle between tax sovereignty and competition and addresses the tax competition practices that are currently taking place around the world. The third section reviews two economic schools of thought on tax competition. It also highlights the normative perspectives on tax competition, namely the interactions between tax competition and regional integration, and the development of international standards to palliate the absence of an international legal order on the subject. The fourth section highlights the need to distinguish bad tax competition from good tax competition and clarifies the boundaries between the two. Thereafter comes a conclusion.

2.1. Conceptual and historical background

In a search of understanding what tax competition is, reference is herein made to the concept itself and its key characteristics. The reason to engage in tax competition, its impact, and dimensions also contribute to a better understanding of tax competition. All these aspects are elaborated on below.

2.1.1. A triangular conceptual framework

The phenomenon of tax competition involves three terms, namely tax competition *per se*, harmful tax competition, and harmful tax practices. Starting with the term 'tax competition', its

introduction is largely associated with C. Tiebout in 1956¹ and it has several definitions. From a variety of available definitions, three elements are of central importance, namely the parties involved, the way tax competition is done, and the reasons to engage in tax competition.

In an attempt to define tax competition, and without undermining the economic consideration of local tax competition, i.e. between municipalities or federations, tax competition happens between sovereign and independent states.² In other words, tax competition is practiced by and between governments of sovereign states.³

Engaging in tax competition, states use their tax-setting powers to work on their tax systems' features by trying to provide the most attractive and competitive tax environment.⁴ This is done by lowering the internal tax burden⁵ through tax rates or tax base reductions.⁶ Although interdependent, this is usually, if not always, done in a strategic uncooperative manner, by which each sovereign state determines its tax policy in disregard of other states' interests.⁷

In this way, states seek to gain a large share of the international tax base.⁸ To this end, attracting investment, business, economic activities, capital, and profits is very important and

¹ N E Mitu, 'Tax Competition: Areas of Display and Effects' (2009) *European Research Studies* XII(2), p. 67.

² C Pinto, *Tax Competition and EU Law* (Ph.D Thesis, UVA 2002), p. 297-98; J Englisch and A Yevgenyeva, 'The Upgraded Strategy against Harmful Tax Practices under the BEPS Action Plan' (2013) *British L.Rev.* 5, p. 621; P J Wattel, 'Forum: Interaction of State Aid, Free Movement, Policy Competition and Abuse Control in Direct Tax Matters' (2013) *WTJ*, p. 138; A Renda, 'Reflections on the EU Objectives in Addressing Aggressive Tax Planning and Harmful Tax Practices' (2020) Final report to European Commission, p. 16 <http://aei.pitt.edu/102468/1/KP0419785ENN.en_.pdf> accessed 29 April 2020.

³ R Teather, 'The Benefits of Tax Competition' (2006) IEA Hobart Paper No. 153, p. 25 <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=878438> accessed 03/08/2019; A Semeta, 'Competitive Tax Policy and Tax Competition in the EU' (2011) Speech/11/712, 2nd Taxation Forum of Diario Economico/OTOC, p. 3 <https://ec.europa.eu/commission/presscorner/detail/en/SPEECH_11_712> accessed 14/08/2019; A P Morris and L Moberg, 'Cartelizing Taxes: Understanding the OECD's Campaign against Harmful Tax Competition' (2012) *CJTL* 4(1), p. 5.

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

⁵ Pinto, EU and OECD, Ibid.; Sobotková, Ibid., p. 344.

⁶ Teather, The Benefits of Tax Competition (n 3) p. 25; M Wróblewska, 'Harmful Tax Competition in a Globalized World: Does the World Trade Organization Deal with this Issue?' (2016) *Studia Iuridica* 1, p. 15.

⁷ Englisch and Yevgenyeva (n 2) p. 621; B B Kristiaji, *Incentives and Disincentives of Profit Shifting in developing Countries*, (Master Thesis, Tilburg Univ. 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.

⁸ Pinto, Tax competition (n 2) pp. 297-98.

is often mentioned in definitions of tax competition.⁹ Thus, a combination of the above elements would lead to defining tax competition as strategic practices of states to lower the internal tax burden in order to gain a larger share of the international tax base through business attraction.

Taken as such, the situation would not raise many questions at the outset, especially in the eyes of lawyers. The challenges come when the qualification ‘harmful’ is added. Although important, this concept has not received many definitions. Even the major institutions that are generally considered to be at the forefront of regulating tax competition have shown little interest in defining that term. This is true of the OECD, whose 1998 Report addressed harmful tax competition without defining exactly what it is.¹⁰ Indeed, the OECD frankly admitted that there is no technical meaning of harmful tax competition.¹¹ The same is also true of the 1997 EU Code of Conduct on business taxation.¹² Yet, the two organizations are internationally recognized for having pioneered the discussions and regulations of harmful tax competition.

Moreover, scholars note that it is impossible to provide an exact definition of harmful tax competition,¹³ to an extent that so far there is no generally accepted legal or academic definition of harmful tax competition.¹⁴ In this context, it has been argued that harmful tax competition cannot be defined because it has no intrinsic meaning.¹⁵ Nevertheless, harmful tax competition is synonymously referred to as tax poaching and/or tax piracy¹⁶ and is widely

⁹ Ring, *Democracy, Sovereignty and Tax Competition* (n 4) pp. 561-62; Teather, *The Benefits of Tax Competition* (n 3) p. 25; Semeta (n 3) p. 3; Sobotková (n 4) p. 344; Pinto, *EU and OECD* (n 4) p. 386; Wróblewska (n 6) p. 15; Renda (n 2) p. 16; Englisch and Yevgenyeva (n 2) p. 621; D M Ring, ‘What’s at Stake in the Sovereignty Debate: International Tax and the Nation-State’ (2008) *Va.J.Int’l.L.* 49(1), p. 21

¹⁰ 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)’ (2000) *Pace International L.Rev.* 12(183), p. 186 and 197; B J Arnold and M J McIntyre, *International Tax Primer* (2nd edn, Wolters Kluwer 2002), p. 138.

¹¹ OECD (1998), *Harmful Tax Competition: An Emerging Global Issue*, OECD Publishing, p. 20.

¹² Wróblewska (n 6) p. 16; P Boria, *Taxation in European Union* (2nd edn, Springer 2017), p. 166.

¹³ Arnold and McIntyre (n 10) p. 138; C M Radaelli, ‘Harmful Tax Competition in the EU: Policy Narratives and Advocacy Coalitions’ (1999) *JCMS* 37(4), p. 672.

¹⁴ Wróblewska (n 6) p. 16; C M Radaelli, ‘The Code of Conduct against Harmful Tax Competition: Open Method of Coordination in Disguise’ (2003) *Public Administration* 81(3), p. 522; H Gribnau, ‘Soft Law and Taxation: EU and International Aspects’ (2008) *Legisprudence* 2(2), p. 76; O Pastukhov, ‘Counteracting Harmful Tax Competition in the European Union’ (2010) *Sw.JIL* 16, p. 161; L V Faulhaber, ‘The Trouble with Tax Competition: From Practice to Theory’ (2018) *Tax L.Rev.* 71(311), p. 312 and 314.

¹⁵ Faulhaber, *Id.* p. 359.

¹⁶ Pinto, *EU and OECD* (n 4) p. 390; Boria (n 12) p. 166; M G Asher and R S Rajan, ‘Globalization and Tax System: Implications for Developing Countries with Particular Reference to Southeast Asia’ (2001) *ASEAN Economic Bulletin* 18(1), p. 127; T Edgar, ‘Corporate Income Tax Coordination as a Response to International Tax Competition and International Tax Arbitrage’ (2003) *CTJ/RFC* 51(3), p. 1141; B J Kieckhefer, *Harmful Tax Competition in the European Union, Code of Conduct, Countermeasures and EU Law*, Deventer, Kluwer, 2004, 8-9 cited in C Biz, ‘Countering Tax Avoidance at the EU Level after ‘Luxleaks’ A History of Tax Rulings, Transparency and BEPS: Base Erosion Profit Shifting or Bending European Prospective Solutions? (2015) *DPTI*

associated with tax havens and harmful preferential tax regimes (HPTR).¹⁷ The details of tax havens and HPTRs are provided in this book's chapter four, the fourth sub-section of the first section.

Leaning on the synonymous use 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*'.¹⁸ Here, the most important and qualifying element is the erosion of the tax base of other countries, which, in one way or another, says the same thing as poaching the taxes of other countries. Harmful tax competition thus concerns tax rules that erode other countries' tax bases, but not one's own tax base, which remains intact. That would be made more specific by pointing out that the fact that a country can increase its tax base by policy competition may not in itself be considered harmful. The harmfulness arises from ring-fencing, whereby a state ensures that its favorable tax measures are not available to investors already resident in its jurisdiction.

In addition to harmful tax competition, there is also the concept of harmful tax practices. Like harmful tax competition, the definition of harmful tax practices is considered complex by scholars, with no general agreement, academic or political.¹⁹ Nevertheless, the term 'harmful tax practice' is used interchangeably with 'harmful tax competition'. The interchangeable use stems from the OECD reports. This Organization's 1998 Report used the term 'harmful tax competition', while the 2001 Progress Report adopted the term 'harmful tax practices'.²⁰ Even before that, an annex to the 1998 confidential document of the OECD used the term 'harmful tax competition' while its appendix used the term 'harmful tax practices'.²¹ Nevertheless, both terms are used today and are herein used interchangeably.

XII(4), pp. 1039-40; M Ronzoni, 'Tax Competition: A Problem of Global or Domestic Justice?', in P Dietsch and T Rixen (eds), *Global Tax Governance: What is Wrong with it and How to Fix it* (ECPR Press 2016), p. 204; E Traversa and P M Sabbadini, 'State Aid Policy and the Fight against Harmful Tax Competition in the Internal Market: Tax Policy Disguise', in W Haslener, G Kofler and A Rust (eds), *EU Tax Law and Policy in the 21st Century* (Kluwer Law International 2017), p. 111.

¹⁷ I Calich, *The Impact of Globalization on the Position of Developing Countries in the International Tax System* (Ph.D Thesis, LSE 2011), pp. 59-60.

¹⁸ Pinto, EU and OECD (n 4) p. 340.

¹⁹ Englisch and Yevgenyeva (n 2) p. 622.

²⁰ Morriss and Moberg (n 3) p. 49.

²¹ OECD, Confidential draft Recommendation on Counteracting Harmful Tax Competition, C(98)17 (17 Feb. 1998), p. 8 and 10, <[https://one.oecd.org/document/C\(98\)17/en/pdf](https://one.oecd.org/document/C(98)17/en/pdf)> accessed 29/08/2021.

Based on the above, and despite several initiatives dealing with tax competition, this area is characterized by a paucity of definitions of the main concepts underlying it. This has led to considering attempts to define tax competition and harmful tax competition as multifaceted.²² Furthermore, that leads to describing it with reference to the ‘elephant test’ and statements such as ‘you’ll know one when you see it’.²³ Left unresolved, that paucity exists along with some other manifold discussions, including the origins of tax competition.

2.1.2. Natural background

Tax competition is contended to be a natural phenomenon among other forms of competition. In this respect, it stands as inevitable, natural, and necessary with regard to the structure of international tax systems.²⁴ This is due to the unavoidable differences in tax rules, where states, naturally, have different tax laws in terms of tax base, tax rates, deductions, etc.²⁵ This nature, therefore, enables states to compete against each other using the available natural and unavoidable tax differences such as statutory or effective tax rates.²⁶

The natural essence of tax competition is also overhauled by its long existence coupled with the likelihood to continue in the future.²⁷ Indeed, it is evident that countries have competed and will increasingly compete to attract investments.²⁸ Moreover, competing for investment through tax policies has existed for centuries to such an extent that scholars consider it as old as governments’ income taxation.²⁹ Some practices that are now considered as forms of tax competition, like tax havens, already existed in the 1920s and 1930s.³⁰ In the 1950s, tax competition was also complicated by the proliferation of pioneer ring-fenced tax regimes with

²² Pastukhov (n 14) p. 163.

²³ Ibid.

²⁴ Faulhaber (n 14) p. 312 and 321; D C Elkins, ‘The Merits of Tax Competition in a Globalized Economy’ (2006) *Indiana LJ* 91(3), p. 905 and 909.

²⁵ Morriss and Moberg (n 3) p. 14.

²⁶ F Wishlade, ‘When Policy Worlds Collide: Tax Competition, State Aid, and Regional Economic Development in the EU’ (2012) *Journal of European Integration* 34(6), p. 586.

²⁷ Asher and Rajan (n 16) p. 125; R Azam, ‘Ruling the World: Generating International Tax Norms in the Era of Globalization and BEPS’ (2017) *SuffolkU.L.Rev.* 50(4), p. 523; M C Durst, ‘Poverty, Tax Competition, and Base Erosion’ (2018) *Tax Notes International* 89(12), p. 1196.

²⁸ Asher and Rajan, Ibid.

²⁹ Faulhaber (n 14) p. 312 and 326; Morriss and Moberg (n 3) p. 23; Y Brauner, ‘What the BEPS?’ (2014) *Fla.Tax.Rev.* 16(2), p. 64.

³⁰ I Calich, *The Impact of Globalization on the Position of Developing Countries in the International Tax System* (Ph.D Thesis, LSE 2011), p. 51.

reduced or exempted taxes to entities doing business abroad.³¹ Beyond its natural character, tax competition is broadly associated with retaliation, which makes it a human creation.

2.1.3. Retaliation background

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 most important features of tax competition. In 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.³² In other words, the pioneer reduction of the tax burden (first round), gets retaliated against by a reduction (second round), to which the pioneers of reduction respond by reducing again (third round), and the sequence can continue like that.

That 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 lowest*'.³³ This reasoning motivates the opinion that early practices of tax competition were accidental before governments discovered the importance of effective tax rate reductions to attract investment.³⁴ Thus, investment attraction stands as a motive for retaliation.

As an example of retaliation, European countries reduced their CIT rates in response to the UK and Ireland initiatives. This happened when the UK introduced a substantial reduction in the CIT rate from 52% to 35% in 1984.³⁵ The next year (i.e 1985) France reduced its CIT rate from 50% to 45% and later in 1988 to 42%, and Germany from 56% to 50% in 1990.³⁶ Another example comes from Ireland. In the 1980s, Ireland reduced its CIT rate to 12.5%. In response to Ireland's competitive pressure, some EU countries promptly reduced their CIT rates too, such as Portugal which reduced from 30% to 20%, Austria which reduced from 34% to

³¹ Morriss and Moberg (n 3) p. 28.

³² Teather, *The Benefits of Tax Competition* (n 3) p. 25; L Wang, *Influences of Preferential Tax Regimes Provided to Attract Non-resident Investment* (Master Thesis, Univ.Toronto 2006), p. 57.

³³ Teather, *Id.*, p. 62.

³⁴ *Id.*, p. 23.

³⁵ J Bossons, 'International Tax Competition: The Foreign Government Response in Canada and other Countries' (1988) *Nat'l Tax J.* 41(3), p. 350; M P Devereux, 'Business Taxation in a Globalized World' (2008) *Oxford Review of Economic Policy* 24(4), p. 629.

³⁶ *Ibid.*

25%, and Greece which reduced its CIT by 5%.³⁷ Another example in this respect is the 10% WHT on interest paid to bank depositors introduced by Germany in 1988, which was abolished within a few months due to the magnitude of capital flight to Luxembourg.³⁸ However, the above examples were not absolute trigger points as they coincided with the reduction in the US CIT rate in 1986.³⁹

Another example, in terms of retaliation, is the case of the US portfolio interest exemption. In 1984, the US abolished a 30% WHT on foreign residents who earn portfolio interest income from sources within the US.⁴⁰ In retaliation, WHT on interest was eliminated in all major economies for fear of losing mobile capital flows to the US.⁴¹ Major capital-importing countries also failed to impose a similar tax for fear of driving mobile capital elsewhere.⁴² In support of this, the European Committee of Independent Experts on Company Taxation issued a report in 1992 that concluded 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*'.⁴³

In support of the above, R. S. Avi-Yonah rightly opines that countries can refrain from offering tax incentives if they can be sure that no other country will offer them.⁴⁴ This statement identifies tax competition as a game arbitrated by fear, legitimate or not, of what others are doing or may do.⁴⁵ Thus, the problem of tax competition is essentially qualified as a problem

³⁷ D J Mitchell, 'Europe has Caught Tax-Cut Fever', *Wall St. J. Eur.*, 3/03/2004, A8 cited in Pastukhov (n 14) p. 167.

³⁸ R S Avi-Yonah, 'Bridging the North/South Divide: International Redistribution and Tax Competition' (2004) *MichJIntlL* 26, p. 383.

³⁹ Devereux (n 35) p. 629; J G Gravelle, 'International Corporate Tax Rate Comparisons and Policy Implications' (2014) Congressional Research Service Report, p. 2 and 22 <<https://fas.org/sgp/crs/misc/R41743.pdf>> accessed 27/03/2020.

⁴⁰ R S Avi-Yonah, 'Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State' (2000) *HarvLRev* 113(7), pp. 1579-81.

⁴¹ *Id.*, p. 158; L A Mello, *Tax Competition and the Case of Bank Secrecy Rules: New Trends in International Tax Law* (SJD Dissertation, Univ. Michigan 2012), pp. 18-19.

⁴² Ayi-Yonah, Bridging the north/south divide (n 38) p. 376; Avi-Yonah, R S Avi-Yonah, 'Globalization and Tax Competition: Implications for Developing Countries' (2001) *Cepal Review* 74, p. 60.

⁴³ EU Com., Report of the Committee of Independent Experts on Company Taxation, Mar. 1992, p. 201 <<https://op.europa.eu/en/publication-detail/-/publication/0044caf0-58ff-4be6-bc06-be2af6610870>> accessed 22 Jan. 2019.

⁴⁴ Avi-Yonah, Globalization and TC (n 42) p. 63; Ayi-Yonah, Bridging the north/south divide (n 38) p. 381; M P van der Hoek, 'Tax Harmonization and Competition in the European Union' (2003) *eJournal of Tax Research* 1(1), p. 23.

⁴⁵ Avi-Yonah, Globalization and TC, *Id.* p. 63.

of coordination and trust.⁴⁶ With this approach, the game of tax competition becomes a vicious circle orchestrated by retaliation, mutual influence, and fear. The circle turns around the fact that one country's practice entails retaliation by other countries. This retaliatory perspective suggests that many countries would prefer to keep their tax rates higher if there were no retaliatory pressure forcing them to adjust to other countries' tax policies. It is, therefore, against that retaliation background that tax competition becomes described as a coined policy. In other words, tax competition becomes possible through states' interrelations and the situation becomes more exacerbated with globalization.

2.1.4. Globalization impact

To change the subject a bit, tax competition is widely associated with globalization. In this view, globalization is largely seen as a trigger point for the intensification of tax competition.⁴⁷ This view is shared by the OECD, whose 1998 Report identifies globalization as the main factor behind the increase in tax competition.⁴⁸ Tax competition also intensifies as countries become more interdependent as a result of globalization.⁴⁹

In fact, before globalization, tax competition was not as fierce as it is nowadays. At that time, due to the low level of capital mobility early tax policies used to focus primarily on addressing domestic economic and social concerns.⁵⁰ The situation began to change with globalization, which greatly influenced the international mobility of capital and people. Indeed, globalization led to high capital mobility,⁵¹ which created economic uncertainties,⁵² which in turn pushed states to design tax competing policies over investments that have already started to flow to locations with low taxation.⁵³

⁴⁶ Id., p. 64; Ayi-Yonah, Bridging the north/south divide (n 38) p. 382; P Letete, 'Between Tax Competition and Tax Harmonization: Coordination of Value Added Taxes in SADC Member States' (2012) *Law Democracy and Development* 16, p. 124.

⁴⁷ Pinto, EU and OECD (n 4) p. 390; T Baskaran and M L da Fonseca, 'The Economics and Empirics of Tax Competition: A Survey and Lessons for the EU' (2014) *ELR* 1, p. 4.

⁴⁸ OECD 1998 Report (n 11) p. 7.

⁴⁹ S Leviner, 'The Intricacies of Tax and Globalization' (2014) *CJTL* 5(207), p. 213.

⁵⁰ OECD 1998 Report (n 11) p. 13; S Drezgić, 'Harmful Tax Competition in the EU with Reference to Croatia' (2005) *Journal of Economics and Business* 23(1), p. 73.

⁵¹ OECD 1998 Report, Ibid.; Sobotková (n 4) p. 343 and 344; Asher and Rajan (n 16) p. 120.

⁵² Asher and Rajan, Id., p. 127.

⁵³ OECD 1998 Report (n 11) p. 13; Avi-Yonah, TC and Fiscal Crisis (n 40) p. 1575; Avi-Yonah, Globalization and TC (n 42) p. 59 and 60; Sobotková (n 4) p. 343; Morris and Moberg (n 3) p. 28; Pastukhov (n 14) p. 160; Gribnau, Soft law and taxation (n 14) 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' (2005) *CTJ/RFC* 53(3), p. 686.

Furthermore, and notwithstanding the positive effects of globalization on the development of tax systems,⁵⁴ the interactions of globalization and tax competition have created a situation where one country's tax system can potentially have an impact on, or suffer an impact from, other countries' tax systems.⁵⁵ In consequence, countries become unable to set tax rules absolutely in a unilateral way in an era of globalization and tax competition.⁵⁶

The interactions between globalization and tax competition were first seriously noticed and focused on in the 1980-90s.⁵⁷ It was during this time that the EU and the international community began to be mindful of tax competition, especially the so-called 'unfair' tax competition.⁵⁸ It is exactly in the mid-1990s, that the EU and the OECD openly expressed their concern about the link between globalization and tax competition on the one hand and the countries' tax crisis on the other.⁵⁹ Given that interaction, international tax competition came on in two ways: one as a result of capital mobility,⁶⁰ the other as a response to the same capital mobility.⁶¹ In both cases, tax base mobility drives tax competition.⁶² However, globalization does not stand alone and other factors should also be considered.

Such other factors are the advent of scientific and technological progress, disappearance of barriers to capital movement, increased and improved transportation and communication technology, and legal and economic developments.⁶³ These factors have made the world very small, which in turn has fueled tax competition.⁶⁴ Hence, the consistent advance of tax competition led to consistent confrontations between the principles of tax competition and its practice, which is the subject of the next section.

⁵⁴ OECD 1998 Report, Id., p. 14; Wróblewska (n 6) p. 13.

⁵⁵ H J Ault, 'Reflections on the Role of the OECD in Developing International Tax Norms' (2009) *BrookJIntlL* 34(3), p. 763.

⁵⁶ Avi-Yonah, Globalization and TC (n 42) p. 65.

⁵⁷ Elkins (n 24) p. 911; Calich (n 30) p. 20; Bossons (n 35) p. 347; Faulhaber (n 14) p. 326.

⁵⁸ Wishlade (n 26) p. 586.

⁵⁹ Id., p. 587.

⁶⁰ Ambrosanio and Caroppo (n 53) p. 686; Avi-Yonah, TC and Fiscal Crisis (n 40) p. 1575.

⁶¹ OECD 1998 Report (n 11) p. 13.

⁶² Avi-Yonah, Bridging the north/south divide (n 38) p. 375; P Genschel and P Schwarz, 'Tax Competition: A Literature Review' (2011) *Socio-Economic Review* 9(2), p. 342; C O F de Almeida and M E Pereira, 'Brazilian Perspectives on Secret, Cooperation and International Tax Competition' (2016) *CIAT/AEAT/IEF Tax Administration Review* 40, p. 62.

⁶³ Pinto, Tax competition (n 2) p. 5; Calich (n 30) p. 21; L B Samuels and D C Kolb, 'The OECD Initiative: Harmful Tax Practices and Tax Havens' (2001) *Taxes* 79(231), p. 232; V Chand and K Romanovska, 'International Tax Competition in light of Pillar II of the OECD Project on Digitalization', Kluwer International Tax Blog, 14/05/2020 <<http://kluwertaxblog.com/2020/05/14/international-tax-competition-in-light-of-pillar-ii-of-the-oecd-project-on-digitalization/>> accessed 29/07/2021.

⁶⁴ Pinto, Ibid.

2.2. Principles and practices of tax competition

Tax competition lays its foundations on some chains of reasoning, mainly dominated by state tax sovereignty. States also justify tax competition as an inalienable right to compete for the nation-building. This section discusses the confrontation between an accepted principle of state sovereignty and the states' freedom to compete.

2.2.1. State sovereignty

State sovereignty is broadly accepted as a key element forming a state as a state. It is extensively discussed both in theory and in practice. Further to state sovereignty in general, tax sovereignty is key to state self-determination. Both general state sovereignty and state tax sovereignty are discussed below.

2.2.1.1. General state sovereignty

State sovereignty is one key element in international law. State sovereignty, as a concept and a principle, is enshrined in several international legal instruments and is emphasized in most national legal instruments. It is also considerably discussed in academic debates, let alone the practice of international law. Its relevance is widely accepted to the extent that it is equated with statehood⁶⁵ while its absence would amount to there being no state.

State sovereignty is enshrined in article 2(1) of the 1945 Charter of the UN, which establishes it as one of the UN fundamental principles. The principle of state sovereignty is also embodied in several international legal instruments such as the AU Constitutive Act, which establishes the defense of member states' sovereignty and territorial integrity as some of the Union's objectives.⁶⁶ Similarly, the EAC Treaty establishes the sovereign equality of members as one of the fundamental principles of the Community.⁶⁷

According to the theory of state sovereignty, all states are sovereign and equal. Sovereignty also entails states' authoritative power to control their internal affairs while keeping

⁶⁵ Avi-Yonah, *Globalization and Tax Competition* (n 42) 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.

⁶⁶ AU Constitutive Act, art. 3 and 4.

⁶⁷ Treaty for the Establishment of the East African Community (As amended on 14/12/2006 and 20/08/2007), art. 6(1)(a).

independence among each other.⁶⁸ Non-interference is a core value of external sovereignty,⁶⁹ and encompasses political, social, and economic affairs.⁷⁰ It further stands as a right and an obligation. This says that every sovereign state has the right not to be interfered with by another state as every state has the duty not to interfere in the internal affairs of another state.

Applied in legal matters, state sovereignty involves the right of a state to freely promulgate, adjudicate and enforce legal rules within its territory.⁷¹ The motive and purpose of such rules are left to the discretion of the adopting sovereign state, as it is free to manage its internal affairs. Beyond that, sovereignty in its broadest sense encompasses various aspects, including tax sovereignty.

2.2.1.2. State tax sovereignty

State tax sovereignty stands as a continuation or specific element of state sovereignty. In other words, taxation policy is part of the state's general sovereignty as the power to tax remains a sovereign right.⁷² In this respect, taxation has been historically linked to sovereignty, and tax sovereignty has been guarded and protected by both states and international law for hundreds of years.⁷³ This leads to considering taxation as a classic attribute of state sovereignty⁷⁴ and at the heart of national sovereignty.⁷⁵ Consequently, nothing is closer to state sovereignty than

⁶⁸ D M Ring, 'What's at Stake in the Sovereignty Debate: International Tax and the Nation-State' (2008) *Va.J.Int'Ll.* 49(1), p. 4.

⁶⁹ P Dietsch, 'Rethinking Sovereignty in International Fiscal Policy' (2011) *Rev.Int'lStud.* 37, 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), pp. 217-18.

⁷⁰ *Id.*, p. 217.

⁷¹ Apeldoorn, *Id.*, p. 217.

⁷² 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; P Lampreave, 'Fiscal Competitiveness versus Harmful Tax Competition in the European Union' (2011) *BFIT* 65(6), p. 4.

⁷³ R Biswas, 'Introduction: Globalization, Tax Competition and Economic Development', in R Biswas (ed), *International Tax Competition: Globalization and Fiscal Sovereignty* (Commonwealth Secretariat 2002), p. 1; B Maurer, 'From the Revenue Rule to Soft Law and Back Again: The Consequences for 'Society' of the Social Governance of International Tax Competition' in F V Benda-Beckmann, K V Benda-Beckmann and J Eckert (eds), *Rules of Law and Laws of Ruling: On the Governance of Law* (Ashgate Publishing 2009), p. 221.

⁷⁴ A C Santos and C M Lopes, 'Tax Sovereignty, Tax Competition and the Base Erosion and Profit Shifting Concept of Permanent Establishment' (2016) *EC T.Rev.* 5/6, p. 296; K Carlson, 'When Cows Have Wings: An Analysis of the OECD's Tax Haven Work as it Relates to Favor, Sovereignty and Privacy' (2002) *J.MarshallL.Rev.* 35(163), p. 178.

⁷⁵ Ayi-Yonah, Bridging the north/south divide (n 38) p. 386; M C Webb, 'Defining the boundaries of legitimate state practice: Norms, transnational actors and the OECD's project on harmful tax competition' (2004) *Review of international political economy* 11(4), p. 788; T Rixen, 'Tax Competition and Inequality: The Case for Global Tax Governance' (2011) *Global Governance* 17, p. 447.

taxation,⁷⁶ to such an extent that no significant issue of international taxation can be discussed without reference to sovereignty.⁷⁷

In the same vein, state tax sovereignty is one of the oldest determinants of general state sovereignty. Indeed, since antiquities, a state's absolute right to tax its subjects is broadly recognized,⁷⁸ and even today, it remains an essential component of effective government.⁷⁹ For instance, the 1998 OECD Report notes, as a matter of principle, each country's freedom to design its own tax system.⁸⁰ On this point, the OECD made it clear and explicitly emphasized in many of its reports that each country is sovereign to decide the appropriate tax rates.⁸¹ The OECD further emphasized 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.⁸² The OECD also reiterated in its 2004 Consolidated Application Note that tax levels and structures are political decisions of 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.⁸³ EU members also recognize national tax sovereignty as important and want to retain their rights and powers in the tax area.⁸⁴

Tax sovereignty has also been recognized and advocated by academics,⁸⁵ with an emphasis on the right and freedom of a state to adopt any tax rule believed to further its own

⁷⁶ J Li, 'Tax Sovereignty and International Tax Reform: The Author's Response' (2004) *CTJ/RFC* 52(1), p. 144.

⁷⁷ Ring, *Sovereignty Debate* (n 68) p. 1.

⁷⁸ *Id.*, p. 32; Melo (n 10) p. 186.

⁷⁹ Ring, *Id.*, p. 187.

⁸⁰ OECD 1998 Report (n 11) p. 15; Scanlan (n 72) 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.

⁸¹ OECD (2001), *The OECD's Project on Harmful Tax Practices: The 2001 Progress Report*, OECD Publications, p. 4; OECD (2004), *The OECD's Project on Harmful Tax Practices: The 2004 Progress Report*, OECD Publications, p. 4; OECD (2006), *The OECD's Project on Harmful Tax Practices: The 2006 Progress Report* (OECD Publications), p. 3.

⁸² OECD 2006 progress report, *ibid.*; OECD 2004 progress report, *ibid.*; D Mitchell, 'Between the Lines: Havens can wait' (2002) *Foreign Policy* 131, 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' (2018) *CILJSA* 51(3), p. 46; Calich (n 30) p. 61.

⁸³ OECD (2004), *Consolidated Application Note in Applying the 1998 Report to Preferential Tax Regimes*, OECD Publishing, p. 21; Wróblewska (n 6) p. 16; Lampreave (n 72) p. 4.

⁸⁴ 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, 28/04/2009, p. 5; Pinto, *Tax competition* (n 2) p. 52; J McLaren, *Will Tax Havens Survive in the New International Legal Environment?* (Ph.D Thesis, RMIT Univ. 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' (2017) *Intertax* 45(2), p. 138; L de Broe, R J Danon, and V Chand, 'Comments to Public Consultation Document: Global Anti-Base Erosion Proposal (GloBE) – Pillar Two' (2019), p. 13, <https://serval.unil.ch/resource/serval:BIB_D8C1987EFA9C.P001/REF> accessed 10/06/2021.

⁸⁵ W B Vlcek, *Small States and the Challenge of Sovereignty: Commonwealth Caribbean Offshore Financial Centers and Tax Competition* (Ph.D Thesis, Univ.London 2006), p. 105; D Pinto, 'Governance in a Globalised

interests.⁸⁶ This motivates qualifying tax sovereignty as a quintessential property of a nation-state, without which, a state cannot function or even exist at all.⁸⁷ Other examples of legal scholarship that recognize a state's tax sovereignty include the recognition of a state's tax self-determination,⁸⁸ the freedom to develop appropriate tax policies including the tax due, tax base, and tax rates,⁸⁹ and the right to retain control over its own tax policies.⁹⁰ Scholars also describe tax sovereignty as a fundamental component of national sovereignty,⁹¹ inexorable principle,⁹² state prerogative,⁹³ fundamental for the state to effectively govern its territory,⁹⁴ an essential component of sovereign states,⁹⁵ etc.

However, state tax policies are fiercely challenged by international tax developments, which makes state tax sovereignty not absolute except if the concerned country is completely isolated from others.⁹⁶ With this logic, the 1998 OECD Report, while recognizing countries' tax sovereignty, adds that they should do so abiding by internationally accepted standards.⁹⁷ International tax reforms by international organizations, engagement in the tax treaties,⁹⁸ and current integrated economies⁹⁹ also create limitations for absolute state tax sovereignty.

World: Is it the End of the Nation State?', in R Biswas (ed.), *International Tax Competition: Globalisation and Fiscal Sovereignty* (Commonwealth Secretariat, 2002), p. 78; M Gaffney, 'Competition: More Harm than Good' (1999) *Int'l T.Rev.* 10(1), p. 47; Mello (n 41), p. 32.

⁸⁶ F Cachia, 'Analyzing the European Commission's Final Decisions on Apple, Starbucks, Amazon and Fiat Finance & Trade' (2017) *EC T.Rev.* 1, p. 34.

⁸⁷ M F de Wilde, *Sharing the Pie: Taxing Multinationals in a Global Market* (Ph.D Thesis, EUR 2015), p. 5.

⁸⁸ A Christians, 'Sovereignty, Taxation and Social Contract' (2009) *Minn.J.Int'l L.* 18(1), p. 101.

⁸⁹ Apeldoorn (n 69) p. 215; A Sanni, 'Sovereign Rights of Tax Havens and the Charge of Harmful Tax Competition' (2011) <www.thesait.org.za/news/96869/Sovereign-Rights-Of-Tax-Havens-And-The-Charge-Of-Harmful-Tax-Competition.htm> accessed 30/07/2019; F Boulogne, 'Reviewing the OECD's and the EU's Assessment of Singapore's Development and Expansion Incentive' (2019) SMU Sch. of Accountancy Research Paper 7(1), p. 10 <<http://dx.doi.org/10.2139/ssrn.3349404>> accessed 14/08/2019.

⁹⁰ Sanni, *Ibid.*

⁹¹ B Patterson and A M Serrano, 'Tax Competition in the European Union' (1998) European Parliament Directorate General for Research Economic Affairs Series WP ECON-105 EN, PE 167.812, p. 5 <http://europarl.europa.eu/workingpapers/econ/pdf/105_en.pdf> accessed 21/06/2019; B da Silva, 'Taxing Digital Economy: A Critical View around the GloBE (Pillar Two)' (2020) *FLC* 15(2), p. 122.

⁹² Sanni (n 89).

⁹³ *Ibid.*

⁹⁴ A Townsend, 'The Global Schoolyard Bully: The Organization for Economic Cooperation and Development's Coercive Efforts to Control Tax Competition' (2001) *Fordham Int'l L.J.* 25(1), p. 219.

⁹⁵ Christians, *Sovereignty, Taxation and Social Contract* (n 88) p. 105 and 104; J Owens and R McDonell, 'Inter-agency Cooperation and Good Tax Governance in Africa: An Overview' in J Owens et al. (ed.), *Inter-agency Cooperation and Good Tax Governance in Africa* (PULP 2017), p. 3.

⁹⁶ J Li (n 76) p. 144; T Dagan (ed), *International Tax Policy: Between Competition and Cooperation* (CUP 2018), p. 2; Chand and Romanovska (n 63).

⁹⁷ OECD 1998 Report (n 11) p. 15; Lampreave (n 72) p. 5; Scanlan (n 72) p. 45; Gaffney (n 85) p. 47.

⁹⁸ Calich (n 30) p. 29; Chand and Romanovska (n 63).

⁹⁹ *Id.*, p. 28.

The non-absolute nature of state sovereignty is further due to the fact that states are fiscally interdependent.¹⁰⁰ Thus, a change in the tax system of one state very likely affects the tax system in one or more other countries.¹⁰¹ It, therefore, becomes impossible for a national tax system to stay away from the impact of other states' tax sovereignties.¹⁰² For instance, one country's tax policy largely influences the allocation of the overall tax base.¹⁰³ In this respect, each state experiences constraints and competition from others.¹⁰⁴ Thus, even if states remain *de jure* sovereign, this actually means less in practice, which is characterized by *de facto* limited sovereignty.¹⁰⁵ From this, tax sovereignty becomes a *prima facie* freedom, but which is not isolated nor absolute, but rather relative.¹⁰⁶ In the same vein, one state's sovereignty cannot annul another state's sovereignty.¹⁰⁷ This line of reasoning largely dominates thinking about tax competition, which is seen as a state's right to do so, but also complemented by a state's need to be protected against the negative consequences of other states' tax competition.

Concurring with both sides, less contestable is the fact that state fiscal sovereignty implies the freedom of a state to design a tax system that better fits its own interests. This is the domestic (internal) side of sovereignty.¹⁰⁸ Externally, each state is sovereign to remain independent vis-à-vis other states in terms of fiscal policies. With this, the state's fiscal sovereignty goes further to refuse any outside interference in tax matters, even if the choices made will affect the tax base of other states.¹⁰⁹ It is within this scope that the issues of tax competition fall.

Besides, because customary international law leaves it to the state to decide who its nationals and residents are,¹¹⁰ it becomes possible for a state's freedom of taxation to go beyond its territory and tax its nationals' and residents' establishments worldwide. This shows the possible extent to which a state's tax sovereignty can be exercised usefully or abusively. It

¹⁰⁰ Apeldoorn (n 69) p. 215.

¹⁰¹ Christians, *Sovereignty, Taxation and Social Contract* (n 88) p. 148; Calich (n 30) pp. 28-29; S Bond et al., *Corporate Tax Harmonization in Europe: A Guide to the Debate* (2000) The Institute for Fiscal Studies, London, p. 49 <www.ifs.org.uk/comms/r63.pdf> accessed 24/08/2019.

¹⁰² Lampreave (n 72) p. 4

¹⁰³ Apeldoorn (n 69) p. 215.

¹⁰⁴ D Deák, 'Illegal State Aid and Harmful Tax Competition: The Case of Hungary' (2002) *Society and Economy* 24(1), p. 24.

¹⁰⁵ Apeldoorn (n 69) p. 216; A Christians, 'Networks, Norms, and National Tax Policy' (2010) *Wash. Univ. Global Studies L.Rev.* 9(1), pp. 104-14.

¹⁰⁶ S Douma, *Optimization of Tax Sovereignty and Free Movement* (Ph.D Thesis, Leiden Univ. 2011), p. 81.

¹⁰⁷ *Ibid.*

¹⁰⁸ Dietsch (n 69) p. 2109.

¹⁰⁹ *Id.*, p. 2108.

¹¹⁰ Douma, *Optimization of Tax Sovereignty* (n 106) p. 22.

equally shows how a state's tax sovereignty can be exercised within and outside its territorial boundaries. Taking this into account, the internal effects of state fiscal sovereignty apparently pose fewer issues. The questions arise when the effects escalate outside the state's borders and collide with the freedoms of other states.

2.2.2. States fiscal competition freedom

States broadly engage in a variety of competitions, including tax competition. A state's freedom to compete fiscally stands as an extension of state sovereignty. The means of competition vary and include tax rules designed to create an environment of tax competition. More than just being viewed as a state's recognized right, tax competition is further compelled by the need to retain domestic businesses, but also to attract foreign businesses, which triggers the need for an internationally competitive tax system,¹¹¹ i.e. a system that is ideally designed to be competitive, but without engaging in harmful tax competition.¹¹²

Moreover, the theory of international tax competition is related to the principle of reciprocity. Under international law, the principle of reciprocity entails returning like-for-like behavior¹¹³ and makes up a basis and a salient element regulating sovereign states' rational intercourse.¹¹⁴ 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.¹¹⁵ The core element underlying state reciprocity, would be simplified in a state's right to respond negatively or positively to another state's behavior. However, when it comes to international tax competition, the state's behavior goes beyond the 'right to respond' and becomes the 'right to go even further' by behaving more extremely than other state(s). Thus, what is described in general international law as 'returning like-for-like behavior' i.e. proportionate retaliation, becomes 'returning beyond like-for-like behavior' in international tax competition. In this scenario, tax sovereignty becomes indistinguishable from tax competition.

2.2.3. Circle of tax sovereignty and tax competition

The two basic theories underlying this study are separate but interlinked, along with a vice-versa impact. On the one hand, with fiscal sovereignty, states are sovereign and free to design

¹¹¹ R Teather, *Harmful Tax Competition?* (Blackwell Publishers 2002), p. 59.

¹¹² Semeta (n 3) p. 5.

¹¹³ F Parisi and N Ghei, 'The Role of Reciprocity in International Law' (2003) *Cornell Int'l LJ* 36(93), p. 94.

¹¹⁴ Ibid; P Malanczuk, *Akehurst's Modern Introduction to International Law* (7th edn, Routledge 1997), p. 6.

¹¹⁵ S N Fard, *Is Reciprocity a Foundation of International Law or Whether International Law Creates Reciprocity?* (Ph.D Dissertation, Aberystwyth Univ. 2013), p. 1.

the tax systems and policies they find adequate and necessary to serve their interests, including competing by their tax systems. In doing so, they may restrict the tax sovereignty of other states and vice-versa. In this regard, the interdependence of national tax systems becomes blatant¹¹⁶ and through fiscal externalities,¹¹⁷ each state is inevitably influenced and conditioned by the tax systems of other states.¹¹⁸ This makes tax competition between states evident and inevitable.¹¹⁹

Moreover, tax competition not only undermines the general sovereignty of a state,¹²⁰ but also restricts and affects the tax sovereignty of other states. Indeed, tax competition limits the effective freedom of sovereign states to design their tax policies,¹²¹ which in turn constraints governments to change their tax structures¹²² as long as they want to remain competitive with their peers. This puts the legal theory in contrast to reality, i.e. the exercise of *de jure* sovereignty versus *de facto* sovereignty. In other words, the legal theory advocates for each country's ability to determine its own internal tax policy.¹²³ However, the reality is that the so-called 'internal' tax policy goes beyond a country's borders and affects other sovereign countries, and vice-versa.

At this level, the impact of one country's tax system on other countries becomes inevitable.¹²⁴ In fact, one state's tax policy choice impedes the choices of others,¹²⁵ and a change in one state's fiscal system may affect the welfare of other states' citizens.¹²⁶ Viewed in this way, the practices of tax competition that orchestrate the tax policies limit other states' sovereignties. This leads to tax systems that are manipulated by external tax policies. Consequent to that, tax sovereignty becomes constrained by tax competition as no country is effectively sovereign. Similarly, with tax competition, each country's tax jurisdiction becomes limited in practice. This further implies that sovereignty cannot be absolute and is very difficult to exercise fully in today's era of high mobility of people, capital, and resources.

¹¹⁶ Apeldoorn (n 69) p. 216.

¹¹⁷ J D Wilson, 'Theories of Tax Competition' (1999) *Nat'l Tax J.* 52(2), 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' (2000) *CTJ/RFC* 48(2), p. 400.

¹¹⁸ Lampreave (n 72) p. 4.

¹¹⁹ *Id.*, p. 3; Mello (n 41) p. 11.

¹²⁰ Oguttu, International tax competition (n 82) p. 294; Apeldoorn (n 69) p. 75 and 216; P Dietsch and T Rixen, 'Tax Competition and Global Background Justice' (2014) *The Journal of Political Philosophy* 22(2), p. 152.

¹²¹ Apeldoorn, *Id.* p. 215; Teather, The Benefits of Tax Competition (n 3) p. 10.

¹²² Rixen (n 80) p. 61.

¹²³ J Li (n 76) p. 147.

¹²⁴ Lampreave (n 72) p. 3; Ault (n 55) p. 758.

¹²⁵ Christians, Sovereignty, Taxation and Social Contract (n 88) p. 148.

¹²⁶ Bond et al. (n 101) p. 49.

On the other hand, tax competition stands as a legitimate exercise of state tax sovereignty. With this logic, the fight against tax competition, even if harmful, can be considered as an attack on state sovereignty. Proponents of this argument claim that '*sovereign nations should be able to determine their own tax policies*'.¹²⁷ Even tax cooperation, which is advocated as one of the solutions to combat harmful tax competition, is perceived as relinquishing some of the state's tax sovereignty.¹²⁸

Undoubtedly, there is an inherent and obvious practical tension between tax sovereignty and tax competition. This reinforces the vicious circle between states' tax sovereignty and tax competition, where one influences the other and vice-versa. Moreover, tax competition has become a global concern as presented below.

2.2.4. Global practices of tax competition

By nature, tax competition is intra-states and concerns competition between national policies.¹²⁹ Over time, tax competition practices have spread all over the world to an extent that it is currently practiced everywhere. Tax competition is as well as inevitable because of the unavoidable differences in tax rules.¹³⁰ Not only differences in tax rules, but also many governments now offer favorable tax rates to ensure the international competitiveness of their tax systems.¹³¹ International competitiveness is currently an increasing concern and stands as one of the important elements of economic life.¹³² Consequently, tax competition is now an issue for many, if not all, nations.¹³³ Considering its widespread nature, practitioners and scholars consider that it has gained an inherent global nature.¹³⁴ The global nature is illustrated by the fact that both developed and developing countries practice tax competition to such an extent that no jurisdiction can claim to be unaffected.

¹²⁷ Ring, *Sovereignty Debate* (n 68) p. 24.

¹²⁸ Dietsch (n 69) p. 2108; B Dickinson and N Nersesyan, *OECD Tax and Development: Principles to Enhance the Transparency and Governance of Tax Incentives for Investment in Developing Countries*, p. 4 <www.oecd.org/ctp/tax-global/transparency-and-governance-principles.pdf> accessed 23/04/2020.

¹²⁹ Wattel (n 2) p. 138.

¹³⁰ Morriss and Moberg (n 3) p. 14.

¹³¹ Townsend (n 94) p. 217.

¹³² Bossons (n 35) p. 347.

¹³³ McLaren, *Will Tax Havens Survive* (n 84) p. 89; M Hearson, 'The Challenges for Developing Countries in International Tax Justice' (2018) *J.Dev.Stud.* 54(10), p. 1935.

¹³⁴ OECD (2000), *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, OECD Publications, p. 22; Wróblewska (n 6) p. 14; C Panayi, 'The Globalization of Tax Good Governance' (2018) Singapore Management University School of Accountancy Research Paper 6(1), p. 16 <<http://dx.doi.org/10.2139/ssrn.3104977>> accessed 01/04/2020.

From the perspective of developed countries, for example, it is a fact that both types of tax competition take place in Europe.¹³⁵ The EU Code of Conduct on business taxation was established with the desire of curbing harmful tax competition.¹³⁶ Not only did this Code confirm the existence of both desirable and harmful tax competition in Europe, but also the adoption of the Code of Conduct itself shows that EU Member States acknowledge the existence of harmful tax competition and the particular need to curb it.¹³⁷ This is further concretized by the fact that in over 700 assessments carried out by the COCG between 1998 and 2021, almost 500 regimes are in EU members and their dependents and associates.¹³⁸

In the same vein, most harmful tax practices are undertaken by EU members,¹³⁹ and this phenomenon seems to be more prevalent in Europe than in the rest of the world.¹⁴⁰ Moreover, some of the non-western tax havens are generally located within the jurisdictional sphere of EU Members. It is important to note that harmful tax practices in Europe are not new, but a long-standing issue. For example, the Isle of Man and Liechtenstein are among the oldest tax havens in Europe.¹⁴¹ Moreover, preferential tax regimes surged in the EU in the 1980s-90s, as tax competition remained an acute problem in Europe raising as a concern in the late 1990s and early 2000s.¹⁴²

From the perspective of developing countries, the situation is much the same, as they host (harmful) tax competition too.¹⁴³ As an illustration, the EAC's Legislative Assembly has

¹³⁵ Pinto, Tax competition (n 2) p. 25;

¹³⁶ EU Code of Conduct 1997: Conclusions of the ECOFIN Council meeting of 1/12/1997 concerning taxation policy DOC 98/C2/01, *OJEC* (6.1.98), C 2/1; Pinto, Tax competition (n 2) p. 166.

¹³⁷ Pinto, Id., p. 25 and 166; Pastukhov (n 14) p. 167; M F Nouwen, *Inside the EU Code of Conduct Group: 20 Years of Tackling Harmful Tax Competition* (Ph.D Thesis, UVA 2020), p. 405.

¹³⁸ CEU, Overview of EU Member States' preferential tax regimes examined since the creation of the COCG in March 1998, 8602/1/20 REV 1 FISC 125 ECOFIN 478, 21/06/2021 <<https://data.consilium.europa.eu/doc/document/ST-8602-2020-REV-1/en/pdf>> accessed 30/07/2021; 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, 05/12/2019 <<https://data.consilium.europa.eu/doc/document/ST-9639-2018-REV-4/en/pdf>> accessed 30/07/2021.

¹³⁹ Teather, The Benefits of Tax Competition (n 3) p. 12; K M Diaw and J Gorter, 'Harmful Tax Practices: To Brook or to Ban?' (2002-3) *Public Finance Analysis* 59(2), p. 250.

¹⁴⁰ P Genschel, A Kemmerling and E Seils, 'Accelerating Downhill: How the EU Shapes Corporate Tax Competition in the Single Market' (2011) *JCMS* 49(3), p. 601.

¹⁴¹ S Jogarajan and M Stewart, 'Harmful Tax Competition: Defeat or Victory?' (2007) *Austl. Tax.F.* 22, p. 6.

¹⁴² Morriss and Moberg (n 3) p. 36; M F de Wilde, 'Tax Competition within the European Union: Is the CCCTB Directive a Solution?' (2014) *ELR* 1, p. 24; K Biernacki, 'Tax System Competition: Instruments and Beneficiaries' (2014) *Ekonomia I Prawo Economics and Law* 13(2), p. 276.

¹⁴³ Oguttu, International tax competition (n 82) 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' (2003) *Virginia Tax Review*

acknowledged the existence of harmful tax competition within the Community's Partner States.¹⁴⁴ SADC members also noticed the existence of harmful tax competition and in 2002 signed an MoU to cooperate in taxation in an endeavor to avoid harmful tax competition.¹⁴⁵ Undertaking, through an MoU, to avoid harmful tax competition is an indication that member states have already perceived the existence or at least a high risk of harmful tax competition within the Community. These examples undoubtedly show the practices of tax competition in developing countries.

The above shows that tax competition has conquered all parts of the world, which explains its global nature. This nature has been recognized by the OECD, which considers harmful tax competition as a global phenomenon, a solution for which also requires global intervention.¹⁴⁶ In fact, any country may as well be engaged in harmful tax practices as it may be affected by harmful tax practices.¹⁴⁷ From this perspective, even though the levels of practice and tools used may be different, no single state can claim to be out of the circle of tax competition, thus, establishing its global practice.

However, such global practices contradict the general trend developed by some international organizations such as the EU and the OECD, which consider harmful tax practices as not permissible. This dichotomy is paired with the indecisiveness of states by the fact that the states that condemn (harmful) tax competition are the same states to engage in the condemned practices. This ultimately ends up being a game of cheating where the states' official statements are not really their beliefs, and therefore, do not reflect what they are actually doing. However, it is worth noting that this is not a particularity of tax competition, but a general situation within international tax law. One scholar described this as an issue of miscommunication and distrust in the international tax debate.¹⁴⁸ The area of tax competition is

23, p. 195; L Abramovsky, A Klemm and D Phillips, 'Corporate Tax in Developing Countries: Current Trends and Design Issues' (2014) *Fiscal Studies* 35(4), p. 574.

¹⁴⁴ EAC, 2nd Meeting of the 1st Session of the 3rd East African Legislative Assembly, Oral Answers to Priority Questions, Question: EALA/PQ/OA/3/06/2012, Nairobi, 13/09/2012, p. 10.

¹⁴⁵ 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, UCT 2012), p. 67; SADC, Memorandum of Understanding on Cooperation in Taxation and related matters, 08/08/2002, art. 4(3)(a).

¹⁴⁶ OECD 2000 progress report (n 134) p. 22.

¹⁴⁷ Ibid.

¹⁴⁸ University of Amsterdam, Inaugural Lecture Sjoerd Douma: Miscommunication and Distrust in the International Tax Debate, 12 June 2018 <www.uva.nl/en/shared-content/faculteiten/en/faculteit-der-rechtsgeleerdheid/news/2018/06/inaugural-lecture-sjoerd-douma-miscommunication-and-distrust-in-the-international-tax-debate.html> accessed 01 February 2019.

thus a pretty good and conclusive example of distrust where the players wear two hats at the same time.

Be that as it may, the field of tax competition encompasses a variety of areas. It broadly interacts with some economic elements along with the legal concerns. This is the subject of the next section.

2.3. Normative and economic perspectives

Tax competition can be viewed from different perspectives, including normative and economic. It is worth mentioning that in both perspectives, tax competition is always a controversial issue.¹⁴⁹ This section begins with the economic perspectives before continuing with the normative perspectives. The economic study of tax competition focuses on two dominant schools of thought, an overview of which is provided below.

2.3.1. Economic schools of thought on tax competition

From an economic perspective, tax competition theories are mainly concerned with the potential benefits and futility of tax competition. In short, both schools of thought on tax competition converge on the reduction of tax revenues, but diverge on the desirability of tax competition. In this respect, the main concern is about the possible positive or negative effects of tax competition. Therefore, tax competition becomes contended to be good and beneficial as it may be bad and harmful. Thus, there are two opposite opinions as to what the effect of tax competition is and, in particular, whether tax competition is inherently damaging. Two schools of thought can, therefore, be distinguished.¹⁵⁰ The first is the race to the public poverty school whose main arguments reflect fears that the tax base could be eroded and result in the under-provision of public services. The second is the taming of the Leviathan school, which mainly argues that tax competition can play a useful role in controlling public spending.¹⁵¹ The two schools are detailed below.

¹⁴⁹ A Cassee, 'International Tax Competition and Justice: The Case for Global Minimum Tax Rates' (2019) *Politics, Philosophy & Economics* 18(3), p. 243.

¹⁵⁰ Ault (n 55) p. 764; H G Petersen (ed), 'Tax Systems and Tax Harmonization in the East African Community' (2010) Report for the GTZ and the General Secretariat of the EAC, p. 22; V Moutarlier, 'Reforming the Code of Conduct for Business Taxation in the New Tax Competition Environment', in I Richelle, W Schön, and E Traversa (eds), *State Aid Law and Business Taxation* (Springer 2016), p. 76.

¹⁵¹ Wishlade (n 26) pp. 586-587.

2.3.1.1. Public poverty school

The public poverty school arguments relate to the effects of tax competition on the loss of tax revenues due to lowering taxes, thus leading to a regressive national system and dangerous fiscal degradation.¹⁵² This occurs when states engage in tax competition in retaliation to pioneers' tax rates reduction. In this process, the philosophy of tax competition is orchestrated by revenge as it becomes necessary to respond with the same behavior or more behavior to remain competitive among peers.¹⁵³ On that account, tax competition is caused by rivalry between countries for the international tax base.¹⁵⁴ A continued retaliation process leads to tax minimization, which, when pushed to the extreme, can eventually fall to zero.¹⁵⁵ At this level, governments collect too little tax revenue to cover public services for the unjustified benefit of internationally mobile capital.¹⁵⁶ Economists label this as a race to the bottom, which poses a threat to tax revenues and creates an unbearable situation for all countries involved.

The race to the bottom is destructive and leads to permanent fiscal degradation.¹⁵⁷ The fiscal crisis ends with a state's inability to provide government services to its citizens, including even the minimum of necessary social conditions.¹⁵⁸ The former Dutch Minister of finance Wouter Bos labeled that as a 'race to public poverty'¹⁵⁹ and the European Commission as 'fiscal degradation.'¹⁶⁰ The IMF also highlighted a similar point in its 2008 report on tax competition in the EAC.¹⁶¹ In this context, tax competition limits a state's ability to pursue social welfare,¹⁶²

¹⁵² I O Ozai, 'Tax Competition and the Ethics of Burden Sharing' (2018) *FordhamInt'lL.J.* 42(1), p. 75; Pinto, Tax competition (n 2) p. 9; Avi-Yonah, Globalization and TC (n 42) p. 60; B J M Terra and P J Wattel, *European Tax Law* (5th edn, Kluwer 2008), p. 111; Sobotková (n 4) p. 344.

¹⁵³ K Z Yanting, *How Do Tax Incentives Affect the Composition of Foreign Direct Investment (FDI) in North-East Asia*, (Master Thesis, AUT 2009), p. 14; R H J Lemmens, *Tax Competition: How Harmful is Tax Competition Really* (Master Thesis, Tilburg Univ. 2014), p. 6.

¹⁵⁴ Sobotková (n 4) p. 344; Pinto, Tax competition (n 2) p. 298; J C Sharman, 'Norms, Coercion and Contracting in the Struggle against 'Harmful' Tax Competition' (2006) *Aust.J.Int'l Aff.* 60(1), p. 146.

¹⁵⁵ Teather, The Benefits of Tax Competition (n 3) p. 42; Wang (n 32) pp. 57-58.

¹⁵⁶ Wattel (n 2) p. 135.

¹⁵⁷ *Ibid*; Pinto, EU and OECD (n 4) p. 387.

¹⁵⁸ Avi-Yonah, Globalization and TC (n 42) p. 60; Avi-Yonah, TC and Fiscal Crisis (n 40) p. 1578; Petersen (n 150) p. 22; Ault (n 55) p. 764; Pinto, EU and OECD (n 4) p. 387; B I Bai, 'The Code of Conduct and the EU Corporate Tax Regime: Voluntary Coordination without Harmonization' (2008) *Journal of International and Area Studies* 15(2), p. 122; P Harris and D Olivier, *International Commercial Tax* (CUP 2010), p. 105; Ozai (n 152) p. 71.

¹⁵⁹ Elkins (n 24) p. 905; Teather, The Benefits of Tax Competition (n 3) p. 55; Bos, W. 'Harmful Tax Competition', Speech to the OECD, Dutch Finance Ministry, 29/06/2000, cited in Lemmens (n 153) p. 6.

¹⁶⁰ Wattel (n 2) p. 135.

¹⁶¹ IMF, 'Kenya, Uganda and United Republic of Tanzania: Selected Issues' (2008) IMF Country Report No. 08/353, p. 5 <www.imf.org/external/pubs/ft/scr/2008/cr08353.pdf> accessed 14/05/2019.

¹⁶² Englisch and Yevgenyeva (n 2) pp. 622-23.

which contributes to human suffering because of the state's under-provision of public goods and services.

In addition, with the race to the bottom, the overall result becomes no tax at all on mobile capital.¹⁶³ This compels the states to shift the burden of tax to immobile tax bases, therefore placing a heavy tax burden on them, which jeopardizes distributive justice.¹⁶⁴ At this level, the main sufferers are the less mobile tax bases such as labor, consumption, and property.

The link between tax competition and the race to public poverty led to total condemnation, as tax competition from this perspective looks bad. An example of this condemnation comes from the EU and the OECD, which both see (harmful) tax competition as leading to state fiscal crises.¹⁶⁵ The two organizations believe that (harmful) tax competition contributes to the erosion of tax bases, which affects the ability of states to provide essential services.¹⁶⁶ Other organizations such as TJN-Africa also hold this view,¹⁶⁷ and scholars summarize the overall result as mutual harm.¹⁶⁸ Thus, the public poverty school of thought considers tax competition to be bad, harmful, and undesirable because of its inevitable relationship with the race to the bottom and its attendant consequences. However, the taming of the Leviathan school thinks otherwise.

2.3.1.2. The taming of the Leviathan school

In contrast to the public poverty school, the taming of the Leviathan school of thought views tax competition as healthy. This school advocates the idea that governments tend to maximize their budgets, which can be detrimental to the economy. Tax competition, therefore, comes in to curb the untrustworthy states' appetites for excessively high taxes along with preventing tax cartels.¹⁶⁹ Similarly, tax competition puts pressure on each state to behave more efficiently in

¹⁶³ Elkins (n 24) p. 905; Teather, *The Benefits of Tax Competition* (n 3) p. 55; M Littlewood, 'Tax Competition: Harmful to Whom?' (2004) *MichJIntlL* 26(1), p. 413; V P Stefan, 'The Effectiveness of Tax Incentives in Attracting Investment: Evidence from Developing Countries' (2012) *Réflexions et perspectives de la vie économique* LI, p. 130.

¹⁶⁴ Ault (n 55) p. 764; Terra and Wattel (n 152) p. 111; Hoek (n 44) p. 23; Bai (n 158) p. 122; H Gribnau, 'The Integrity of the Tax System after BEPS: A Shared Responsibility' (2017) *ELR* 1, p. 20.

¹⁶⁵ Wishlade (n 26) p. 587.

¹⁶⁶ Elkins (n 24) p. 905.

¹⁶⁷ TJNA & ActionAid, 'Tax Incentives are draining Kenya of needed revenue for essential Public Services' <www.actionaid.org/sites/files/actionaid/brief_-_kenya_report_-_kenya_tax_competition.pdf> accessed on 02/03/2016.

¹⁶⁸ Terra and Wattel (n 152) p. 111; I Lamers, P Mcharo and K Nakajima, 'Tax Base Erosion and Profit Shifting (BEPS) and International Economic Law' (2014) *Trade and Investment Law Clinic Papers*, Graduate Institute Geneva, Centre for Trade and Economic Integration, Geneva, p. 7.

¹⁶⁹ Lampreave (n 72) p. 4; Hoek (n 44) p. 22; Vlcek (n 85) p. 93.

raising and spending taxes.¹⁷⁰ The role of tax competition is, therefore, to counter Leviathan effects by forcing governments to rationalize their public services by balancing the tax burden imposed on taxpayers and the governments' abilities to deliver public services.¹⁷¹

In this sense, reducing government waste and disciplining politicians are among the benefits of tax competition.¹⁷² In this respect, tax competition becomes a tool to tame the Leviathan by imposing budgetary constraints on excessive or wasteful spending.¹⁷³ Tax competition also becomes a check on governments to spend more wisely,¹⁷⁴ as it helps governments to increase their fiscal competitiveness.¹⁷⁵ In short, the school of taming Leviathan sees tax competition as a positive tool to counteract governments' abuses in tax matters. Therefore, tax competition in the lens of this school of thought is good, beneficial, and desirable.

The divergence between these two schools of economic thought adds to other discussions about (harmful) tax competition. Reviewed from a legal perspective, the concerns look different from the economists' concerns.

2.3.2. Normative perspective

The normative perspective of tax competition can be developed in two points: the impact of regional integration on the regulation of tax competition and the existing international standards on the subject.

2.3.2.1. Impact of regional integration

The relationship between tax competition and regional integration is two-fold. First, due to the nature of tax competition, unilateral regulation does not bring many benefits. Therefore, this phenomenon has been mainly regulated through bilateral or multilateral measures. Second, regional integrations facilitate tax harmonization, which, in one way or another, impacts tax

¹⁷⁰ Lampreave, *ibid.*; Semeta (n 3) p. 3; Terra and Wattel (n 152) p. 111; Teather, *The Benefits of Tax Competition* (n 3) p. 35; Ault (n 55) p. 764; Sobotková (n 4) p. 344; Harris and Olivier (n 158) p. 107; Cassee (n 149) p. 243.

¹⁷¹ Pinto, *Tax competition* (n 2) p. 8.

¹⁷² Lampreave (n 72) p. 14; Deák (n 104) p. 25.

¹⁷³ Englisch and Yevgenyeva (n 2) p. 624; T Madiès and J J Dethier, 'Fiscal Competition in Developing Countries: A Survey of the Theoretical and Empirical Literature' (2010) *The World Bank Development Economics Dpt Policy Research WP 5311*, p. 6 <<http://documents.worldbank.org/curated/en/660651468148759194/pdf/WPS5311.pdf>> accessed 20/04/2020.

¹⁷⁴ Sobotková (n 4) p. 346; Teather, *The Benefits of Tax Competition* (n 3) p. 13; Ault (n 55) p. 764.

¹⁷⁵ Pinto, *EU and OECD* (n 4) pp. 386-87.

competition. The next paragraphs address both aspects, starting with the regional regulatory framework.

Notwithstanding the effectiveness of unilateral measures counteracting tax competition, global and regional approaches offer more benefits. This is due to the global nature of (harmful) tax competition, which, therefore, requires global and regional level solutions.¹⁷⁶ Regional solutions might be the preferred ones compared to global ones. This is because in most cases, the regional members have an almost similar situation and their interests are not very different, which is not the case with a global approach.

Moreover, the nexus between tax competition and regional integration elaborates on harmonization, which is an intrinsic element in the process of regional integration. Depending on the main objective of each regional integration, the harmonization of policies, laws, and practices greatly impacts the success or failure of the integration. In the case of regional integrations whose objectives are economically oriented, tax harmonization represents a non-negotiable pillar for rapid integration success.

Thus, it can be rightly argued that tax harmonization, in one way or another, slows down tax competition between the community member states. Actually, tax harmonization seeks compatibility by pulling closer the elements that were initially different through a reduction of the differences towards a common standard. Even if approximation doesn't amount to equality, it is at least the opposite of tax competition, which by its nature seeks rivalry, fighting for superiority among the usual peers, which escalates and increases the differences.

It is, therefore, through these lenses that the impact of tax competition on regional integration can be seen. Two types of influences can be established. One, tax harmonization and regional integration influence each other. Second, regional integration and tax competition influence each other. Consequently, there is a triangular influence between tax harmonization, regional integration, and tax competition. Besides, some standards exist internationally in regulating tax competition.

2.3.2.2. Development of international standards

At the international level, one should note an absence of an international legal order in terms of tax competition. The same applies to the area of international tax law, which remains, so far,

¹⁷⁶ Wróblewska (n 6) p. 21; Ayi-Yonah, Bridging the north/south divide (n 38) p. 383; OECD 2000 progress report (n 134) p. 22.

largely determined by the state's individual sovereignty save for bilateral and multilateral tax treaties.

Attempting to close the gaps, the EU and the OECD have developed some standards to counteract harmful tax competition. The details of these standards are developed in chapter four of this book. In summary, the focus of the two organizations has been on the elements that can distinguish good tax competition from bad tax competition, which is the focus of the next section.

2.4. In search of the boundaries between good and bad tax competition

The distinction between good and bad tax competition dominates discussions on tax competition. One main issue in the discussion is the dividing line between the two. In other words, where bad tax competition stops being bad and becomes good. This question is based on the legal reasoning that not every tax competition is harmful, i.e. tax competition may be good and beneficial as it may be bad and harmful.¹⁷⁷ In attempting to find the boundaries between the two, this section first emphasizes the need to distinguish bad tax competition from good tax competition. It then takes up what can be part of the boundaries, and concludes explaining the main concerns of lawyers in tax competition.

2.4.1. Why distinguish 'bad' from 'good' tax competition?

From a legal perspective, not every tax competition is bad.¹⁷⁸ Equally, not every tax competition is good. Tax competition can be good, beneficial, and desirable, and thus worthy of promotion as it can be bad, i.e. harmful, and thus, undesirable.¹⁷⁹ Good tax competition also exists along with bad tax competition. In this sense, harmful tax practices are unacceptable, and generally discouraged. In contrast, tax competition *per se* is generally perceived unproblematic. Hence, the need to distinguish bad i.e. harmful tax competition from good i.e. harmless tax competition arises. On the one hand, that need is justified by the consequences associated with each. On the other hand, discussions on the desirability or non-desirability of tax competition are prompted by their increasing practices.¹⁸⁰

¹⁷⁷ Patterson and Serrano (n 91) p. v.

¹⁷⁸ Pastukhov (n 14) p. 163; Lampreave (n 72) p. 8; Avi-Yonah, TC and Fiscal Crisis (n 40) p. 1610; M Rushton, 'Interprovincial Tax Competition and Tax Reform in Saskatchewan' (2000) *CTJ/RFC* 48(2), p. 386; K Dirix, 'Harmful Tax Competition: Six Belgian Tax Incentives under the Microscope' (2013) *EC T.Rev.* 5, p. 233.

¹⁷⁹ Pinto, Tax competition (n 2) p. 1 and 297; Gaffney (n 85) p. 46; M Schaper, 'Tax Law', in J Hage, A Waltermann and B Akkermans (eds), *Introduction to Law* (2nd edn, Springer 2017), p. 274.

¹⁸⁰ Sobotková (n 4) p. 344.

In this sense, good tax competition is acceptable, desirable, and is acknowledged in legal scholarship.¹⁸¹ The EU and OECD standards also confirmed the desirable acceptance. Indeed, both organizations accept the potential positive effects of good tax competition. This refers to the 1998 OECD Report on harmful tax competition, which acknowledged the existence of good tax competition and points out that it includes all tax measures that a sovereign state can take without breaching internationally accepted standards.¹⁸² Not only the OECD, but also the EU recognizes the existence of good tax competition.

This recognition is reflected in the preamble of the 1997 EU Code of Conduct on business taxation which acknowledges the positive effects of fair competition and the need to strengthen the EU's competitiveness, while at the same time pointing out the negative effects of harmful tax competition.¹⁸³ In this sense, it was not the EU's intention to end all tax competition.¹⁸⁴ Rather, it emphasized the need to promote good tax competition within the Union.¹⁸⁵ For example, the Explanatory Memorandum on the 2011 CCCTB Proposal of the European Commission states:

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 [...] allows the Member States to consider both their market competitiveness and budgetary needs in fixing their tax rates.¹⁸⁶

Moreover, Member States' fiscal sovereignty is recognized by EU law, which in principle, establishes tax competition as the norm.¹⁸⁷ These examples prove the need to retain and support good tax competition, based on the benefits it brings.

The benefits of good tax competition are two-fold: good for the country and good for taxpayers. As far as the country is concerned, good tax competition is necessary to enhance the

¹⁸¹ I Roxan, 'Limits to Globalization: Some Implications for Taxation, Tax Policy, and the Developing World' (2002) LSE WP 3, p. 21 <[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 07/05/2019.

¹⁸² OECD 1998 Report (n 11) p. 15; Pinto, EU and OECD (n 4) p. 390.

¹⁸³ EU Code of Conduct (n 136) C 2/3; Genschel, Kemmerling and Seils (n 140) p. 596; Drezgić (n 50) 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 Univ. 2011), p. 169.

¹⁸⁴ A Haupt and W Peters, 'Restricting Preferential Tax Regimes to Avoid Harmful Tax Competition' (2005) *Reg.Sci.Ur.Econ.* 35, p. 494.

¹⁸⁵ EU Com., Explanatory Memorandum to a Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM (2011) 121/4 2011/0058 (CNS) {SEC(2011) 315} {SEC(2011) 316}, p. 4.

¹⁸⁶ *Ibid.*

¹⁸⁷ Pinto, Tax competition (n 2) p. 52, 78, 300 and 302.

country's competitiveness. The need to build a competitive tax system is important to compensate for some disadvantageous factors. It is also important to adjust and complete the country's economic and social comparative advantages.

In terms of general taxpayers, good tax competition is helpful because it reduces the tax burden. In fact, taxation is a part of the cost of doing business, and lowering its level is obviously beneficial to businesses.¹⁸⁸ This mitigation plays an important role in increasing the profitability of taxpayers. Other benefits of good tax competition include encouraging investment,¹⁸⁹ promoting the design of investment-friendly tax systems,¹⁹⁰ and increasing efficiency.¹⁹¹

In contrast, bad tax competition is generally condemned. Most often, the richest countries believe that (harmful) tax competition is bad and must be stamped out.¹⁹² The academic community has also supported efforts to combat bad tax competition.¹⁹³ This is because tax competition is seen as a threat,¹⁹⁴ along with some other disadvantages associated with it, such as erosion of the tax base, which ends up creating an unbearable situation.¹⁹⁵ Other consequences of bad tax competition include 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 diminution of global welfare.¹⁹⁶

Consequently, bad tax competition is labeled unfair and harmful, which has led to the formulation of measures to eliminate it. This again emphasizes the need to distinguish bad tax competition from good tax competition as the attention should be on what to eliminate and what to preserve. This is a serious matter because a wrong choice would lead to a detrimental

¹⁸⁸ *Id.*, p. 8.

¹⁸⁹ Boulogne (n 89) p. 3.

¹⁹⁰ EU Com., *A Fair and Efficient Corporate Tax System in the European Union: 5 Key Areas for Action*, Communication from the Commission to the European Parliament and the Council, COM(2015) 302 final {SWD(2015) 121 final}, 17/06/2015, p. 5; A F Abbott and D R Burton, 'Apple, State Aids, Tax Competition, and the Rule of Law' (2017) *Backgrounder* 3204, p. 2.

¹⁹¹ Sobotková (n 4) p. 343.

¹⁹² Teather, *Harmful Tax Competition?* (n 111) p. 58.

¹⁹³ Elkins (n 24) p. 914.

¹⁹⁴ Morriss and Moberg (n 3) p. 57; J Hey, 'Tax Competition in Europe: The German Perspective' (EATLP Conference, Lausanne, 2002), p. 6 <www.eatlp.org/uploads/Members/Germany02.pdf> accessed 13/08/2019.

¹⁹⁵ Sobotková (n 4) p. 343.

¹⁹⁶ OECD 1998 Report (n 11) p. 16; K van Raad, *Materials on International & EU Tax Law* (13th edn, International Tax Center 2013), p. 1309; A W Oguttu, 'Tax Base Erosion and Profit Shifting in Africa: Africa's Response to the OECD BEPS Action Plan' 2016 ICTD WP 54, p. 9 <https://opendocs.ids.ac.uk/opendocs/bitstream/handle/20.500.12413/12802/ICTD_WP54.pdf> accessed 24 October 2019.

effect: either retention of a practice that is deemed to be part of bad tax competition or the elimination of an aspect of good tax competition.

It is therefore necessary to establish a clear understanding of the practices that form bad tax competition and the practices that form good tax competition. To this end, some benchmarks have been developed by the EU and the OECD. These are explained in details in chapter four of this book, and chapters six and seven are largely based on them to assess the Rwandan situation and formulate the proposals respectively.

In summary, tax competition becomes problematic when it goes beyond good tax competition and becomes bad tax competition. This happens when it moves from pure tax competition to harmful tax competition. The puzzling and open question, then remains the point at which one distinguishes harmless tax competition from harmful tax competition.

2.4.2. What is good and what is bad tax competition?

Since the 1990s until today, tax competition has been one of the hotly debated topics in international tax law. Considering countries' motives to engage in tax competition and its effects, these discussions are not expected to end soon. This skepticism is supported by some challenging and provocative ideas about tax competition. One example is the distinction between harmless and harmful tax competition, which has always been highly contentious,¹⁹⁷ difficult,¹⁹⁸ thorny,¹⁹⁹ and even impossible.²⁰⁰ The difficulties are also fuelled by several factors, including the nature of tax competition itself.²⁰¹ This is because all countries engage in tax competition in one way or another, with some using more sophisticated and less transparent mechanisms than others.²⁰²

Moreover, it seems difficult, even impossible, to come up with a general definition of good or bad tax competition. This is mainly because such a distinction depends largely on normative perspectives. Nevertheless, this does not preclude the possibility of having a modest, workable concept of harmful tax competition. Of course, this cannot cover all harmful tax

¹⁹⁷ Ault (n 55) p. 765.

¹⁹⁸ Lampreave (n 72) p. 3; de Almeida and Pereira (n 62) p. 64; L Cerioni, 'Harmful Tax Competition Revisited: Why not a Purely Legal Perspective under EC Law?' (2005) *Euro.Tax.*, p. 267; W Schön, 'Tax Competition in Europe: The National Perspective' (2002) *Euro.Tax.* 42(12), p. 492.

¹⁹⁹ Pinto, Tax competition (n 2) p. 8.

²⁰⁰ Petersen (n 150) p. 25.

²⁰¹ S J C Hemels, 'Fairness and Taxation in a Globalized World' (2015), p. 17 <<http://dx.doi.org/10.2139/ssrn.2570750>> accessed 29/07/2019.

²⁰² A Christians, 'BEPS and the New International Tax Order' (2017) *BYUL.Rev.* 2016(6), p. 1630.

competition to everyone's satisfaction. In this respect, the normative criteria of the EU and OECD, as described in chapter four, are at the heart of international standards.

In their efforts to distinguish good from bad tax competition, the EU and the OECD have elaborated on the components of harmful tax practices and the criteria for determining whether a regime is harmful or not. Nevertheless, the established criteria change their weight from time to time. On this matter, the substantial economic requirement is a good example. This criterion was initially established among the criteria for assessing tax havens.²⁰³ However, it was dropped in 2001 because there were difficulties in determining exactly what substantial meant.²⁰⁴ Its use was resumed in 2015, driven by the BEPS project.²⁰⁵ Similarly, transparency and EoI gained momentum from time to time.²⁰⁶ In 2016, the Council of the EU also accepted fair taxation and anti-BEPS implementation as part of the criteria to establish the lists of non-cooperative jurisdictions.²⁰⁷

Notwithstanding that, tax competition is acceptable if it is an expression of a country's fiscal sovereignty to attract new and genuine investment.²⁰⁸ Here, the key element is attracting genuine investment. In this respect, favorable tax measures targeting manufacturing, asset investment²⁰⁹ and the like are generally not harmful.

Favorable tax measures that apply to all and do not target foreigners, also generally qualify as not harmful.²¹⁰ This argument is consistent with the fact that there is nothing wrong with building a national competitive tax system as long as it has a general application.²¹¹ In this

²⁰³ OECD 1998 Report (n 11) p. 22.

²⁰⁴ Pinto, Tax competition (n 2) p. 226; OECD 2001 progress report (n 81) p. 10; Ambrosiano and Caroppo (n 53) p. 690; Seeruthun-Kowalczyk (n 183) p. 202.

²⁰⁵ OECD (2015), *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, OECD Publishing <<http://dx.doi.org/10.1787/9789264218970-en>> accessed 21/05/2019; OECD (2019), *Harmful Tax Practices – 2018 Progress Report on Preferential Regimes: Inclusive Framework on BEPS Action 5*, OECD Publishing, p. 38.

²⁰⁶ P Baker (2004), 'The World-Wide Response to the Harmful Tax Competition Campaigns', *GITC Review*, 3(2), p. 5; A P Dourado, 'The Global Anti-Base Erosion Proposal (GloBE) in Pillar II', (2020) *Intertax* 48(2) p. 153; OECD 2001 Progress Report (n 81) p. 4.

²⁰⁷ CEU, Outcome of proceedings on criteria and process leading to the establishment of the EU list of non-cooperative jurisdictions for tax purposes, 14166/16, FISC 187 ECOFIN 1014, 8/11/2016, pp. 4-7.

²⁰⁸ Rixen (n 80) p. 72; Pinto, EU and OECD (n 4) p. 390.

²⁰⁹ OECD 1998 Report (n 11) p. 8; Carlson (n 74) p. 165; Samuels and Kolb (n 63) p. 234; Pinto, EU and OECD, *ibid.*

²¹⁰ Elkins (n 24) p. 947.

²¹¹ R Szudoczky and J L van de Streek, 'Revisiting the Dutch Interest Box under the EU State Aid Rules and the Code of Conduct: When a 'Disparity' is Selective and Harmful' (2010) *Intertax* 38(5), p. 275; M Nouwen and P J Wattel, 'Tax Competition and the Code of Conduct for Business Taxation' in P J Wattel, O Marres, and H Vermeulen (eds), *European Tax Law* (7th edn, Wolters Kluwer 2019), p. 933.

view, there is harmless tax competition if the country reduces the tax burden on both residents and non-residents.²¹² This is in contrast to the situation of ring-fencing, which is an essential element determining harmful tax practices. Coupled with this, tax competition that boosts a country's economy and benefits all taxpayers is good. Moreover, tax competition that does little harm to other countries but brings significant benefits to the host country is also justified.²¹³ In contrast, tax competition that attracts tax bases at the expense of other countries, i.e. that poaches other countries' tax bases is spontaneously bad.²¹⁴ Similarly, tax competition becomes harmful when '*states merely damage each other's budgets, without creation of economic activity being at issue, but rather for artificial cross-border shifts of activities, and causing a tax loss for the whole*'.²¹⁵

To be more specific, from a legal perspective, there is no stand-alone element that distinguishes good tax competition from bad tax competition. One possible reference is the standards developed by the EU and the OECD. A tax practice becomes bad because it violates the EU and OECD standards. Without these standards, there would be no way to qualify a tax regime as part of bad or good tax competition. Even so, the idea behind setting standards for harmful tax competition stems from the effects of tax competition. Thus, if tax competition decreases another state's tax revenues, it looks *prima facie* bad. But if there is no such effect, i.e. a decrease of tax revenues, tax competition is harmless and falls within the general framework of other competitions that countries engage in all the time.

With this understanding, the decrease of other states' tax revenues is at the heart of the driving force for regulating tax competition. Thus, tax competition is good as long as it does not poach other states' tax bases. In other words, tax competition is part of state sovereignty, which includes the freedom of each state to design its own tax system in consideration of its primary interest aimed at satisfying the public needs. The diversity of countries, naturally and politico-economically, leads to an understanding that countries are not alike. Consequently, no one should force a country to have a tax system that is similar to another country's tax system. This freedom to design a competitive tax system remains good as long as it only affects the internal affairs of the designing country. However, when the effects escalate beyond the

²¹² Lampreave (n 72) p. 6; Webb (n 75) p. 801; Biswas (n 143) p. 121.

²¹³ Lampreave (n 72) p. 8.

²¹⁴ OECD 1998 Report (n 11) p. 16; Oguttu, International tax competition (n 82) p. 294; Pinto, Tax competition (n 2) p. 1.

²¹⁵ OECD BEPS Action 5 (n 205) p. 21; Gribnau, Integrity of Tax System (n 164) p. 12.

designing country and negatively affect other countries that played no role in designing the underlying system, tax competition becomes bad.

In summary, without undermining the dynamisms of tax competition as a concept, the real problem with tax competition is the unfair erosion of other countries' tax bases. Thus, good tax competition refers to a country using its sovereign rights to design a tax system that is competitive to attract and retain genuine investment or tax base without breaching regional and/or international rules and regulations on fair sharing of the international tax base. In contrast, bad tax competition refers to the abuse of a country's sovereign rights to set strategic policies that erode the tax base of other countries while protecting its own tax base, in violation of rules and regulations set at the regional and/or international level on fair sharing of the international tax base.

To change the subject a bit, lawyers are interested in and attentive to discussions about (harmful) tax competition. This gives rise to determine the specific concern of lawyers in tax competition, which is the subject of the next sub-section.

2.4.3. What is the main concern of lawyers in tax competition?

The concern of lawyers in the study of harmful tax competition relates to taxing rights. In fact, the concern of lawyers is quite different from the concern of economists. The economists' concern relates to competition for movement, i.e. the attraction of productive investment along with the race to zero, i.e. the eventual fall to zero.²¹⁶ In contrast, the legal reasoning behind the lawyers' concern is that countries are perfectly entitled under existing international norms to choose their own tax rates, even if 'choosing' can sometimes amount to 'following'. Thus, in studying tax competition, lawyers seek to determine the fair sharing, i.e. an equitable allocation of taxing rights.

In general, in studying tax competition, lawyers refer to the OECD developments on harmful tax competition,²¹⁷ coupled with the EU developments on the same subject. In short, the issue is about competition to '*have income reported in a particular country*' and the problem arises when this occurs without an associated movement of production.²¹⁸ In other words, the concern of lawyers is whether the sharing of taxing rights is fair or unfair. However, given the

²¹⁶ Calich (n 30) p. 60.

²¹⁷ Id., pp. 41-42.

²¹⁸ R Griffith and A Klemm, 'What Has Been the Tax Competition Experience of the Last 20 Years' (2004) The Institute for Fiscal Studies WP04/05, p. 4.

complexity of the concept of fairness, the concern of lawyers in tax competition matters can be simplified as a matter of standards and concepts that can draw the line between acceptable and unacceptable practices in the sharing of taxing rights. In other words, the main concern is the determination of permissible versus prohibited tax competition, two aspects that each relate in one way or another to harmless tax competition as opposed to harmful tax competition.

Conclusion of chapter two

This chapter provided a panoramic view of tax competition. It began with an understanding of the main features of tax competition. In this context, it discussed the definitions of tax competition and harmful tax competition. Then, it presented two rival views on the origin of tax competition. One view sees tax competition as a natural phenomenon based on its long existence, while the other view sees tax competition as a human creation, dominated mainly by a process of retaliation. This was followed by a detailed account of the impact of globalization on increasing tax competition.

This provided a basis for moving into one of the fundamental parts of the chapter, namely the principles and practice of tax competition. The focus was on the rivalries between the two main accepted principles, namely state tax sovereignty and freedom of competition. The interactions and mutual influence of the two were also highlighted. This was followed by a discussion of the global practices of tax competition.

Considering the interactions with other disciplines in the study of tax competition such as economics, public finance, and politics, two important schools of economic thought were highlighted. Here, emphasis was placed on the race to public poverty school of thought and the taming of the Leviathan school of thought. This preceded the highlights of the normative perspectives of tax competition. This was considered through the role of regional integration on tax competition and the development of international standards on the subject. Then, the focus was on finding the boundaries between bad and good tax competition. This point focused on the need to search for the boundaries, and what these boundaries are, before taking a look at the main concern of lawyers in tax competition.

It is worth noting that the discussions on the principles underlying the field of tax competition are endless. The same applies to tax competition, the scope of which is large. This suggests that the issues pertaining to the subject of the present chapter can never be exhausted. Nevertheless, the key elements, including the principles, practices, and theories that underlie

the field of tax competition, have been fairly dealt with. This was done without a focus on any particular jurisdiction. The next chapter focuses on Rwandan law.

