

INVITED ARTICLES**Seppo PENTTILÄ*, Jukka KULTALAHTI*****TAX COMPETITION AS A CHALLENGE TO THE
GOVERNANCE OF GLOBAL ECONOMY**

Abstract: The paper analyses the role of tax competition in global economy. How can tax systems respond to the challenge – by international cooperation or by national rules, by tax harmonisation or by tax competition? In this paper we approach the question as a matter of global governance. Tax competition is seen both as a means and as an object of global governance. Our conclusion is that there is no universal answer to the question: competition or harmonisation? Attempts to govern the processes of global economy on a national level may easily lead to tax competition. On the other hand, at least at the supranational level, i.e. at regional or global level, the goals and mechanisms of governance seem to emphasise harmonisation. Nowadays especially the OECD has become an important actor or forum for cooperation in taxation. It has succeeded in many ways in preventing and reducing harmful tax competition. The soft law mechanisms developed by the OECD have often been converted into the hard law mechanisms on national level. The governance activities have been based on both soft law and hard law mechanisms.

Key words: tax competition, tax harmonisation, hard law, soft law, globalisation, governance.

1. INTRODUCTION

This paper concentrates on analysing the increasing role of tax competition due to the globalisation of economy. How do national and international tax systems respond to this challenge? Is the answer in international cooperation

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or in national rules – in tax harmonisation¹ or in tax competition²? Is it possible to answer this question? What are the possible mechanisms of tax competition?

The power to tax is one feature of an independent state. It includes the legislative power, the right to receive the tax revenues and the administrative power. The borders of a state have always been important in taxation.³ Within its own borders a state can exercise its power to tax. Because the borders in taxation are important, states have guarded the borders in taxation effectively so that crossing the border does not enable people to escape taxation. It is even possible and usual that cross-border activities face extra tax burden compared to purely domestic activities. How do such laws, which were developed at a time when cross-border flows of goods, services, persons and capital were much less important than they are today, appear in a globalised world?

We approach the questions of tax competition from the perspective of the governance of globalisation. In this context tax competition may be seen both as a means of governance and as an object of global governance. We start from the more general aspects of governance and then go deeper into the mechanisms and empirical findings of tax competition.

2. GOVERNANCE OF GLOBALISATION

The general idea of global governance is to maximise the benefits and minimise the hazards of globalisation. The governance activities aim at solving or alleviating:

- the problems caused by social polarisation and social/global injustice;
- environmental problems, e.g. global warming and problems with the ozone layer;

¹ Within the EU tax harmonisation consists in the adaptation of each Member State's legislation to a standard which is common to all Member States and which has been set by the EU supranational bodies. However, this is quite a strict definition and tax laws of different countries may harmonise or at least approximate also without standards issued by supranational bodies. Tax systems and tax rates may move closer when countries use foreign tax rules and models as a base when shaping their own legislation. E.g. the dual income tax rate system in the Nordic countries is such an example. Harmonisation may also be a result of tax competition. For more about the concept of tax harmonisation see Steichen (2003, pp. 47–48).

² Tax competition may be defined as improving the relative competitive position of one country *vis-à-vis* other countries by reducing the tax burden on businesses and individuals in order to retain, gain or regain mobile economic activities and the corresponding tax base, whether at the expense of other countries or otherwise. See Kiekebeld (2004, p. 8) and Steichen (2003, pp. 45–46). Often participating in tax competition means lowering of tax rates below those of other jurisdictions or the opening of loopholes in the tax base, e.g. exempting some kind of income from income tax.

³ Borders naturally have many functions. See e.g. Bufon's (2011) analysis about borders producing socio-economic environments of simultaneous potential opportunity or danger, contact or conflict, cooperation or competition, convergence or divergence.

- a shortage of global natural resources (including fossil fuel and water);
- economic inefficiency;
- problems in economic and financial stability;
- problems caused by unbalanced labour markets;
- problems with information society development, the digital divide;
- other problems.

The problem is how to manage with the conflicting benefits of globalisation, with the fact that the benefits and disadvantages of globalisation are unequally distributed. This is also the case in the governance of global economy, where the tax competition seems to be an outstanding phenomenon. The answer to the question: tax competition or tax harmonisation, for instance, depends on the distribution of the benefits and disadvantages of economic globalisation. Whether the question should be approached from the global perspective or from the level of individual state, is also a substantive issue.

The relevant aspects in governance concern who the actors in governance are and what the goals and mechanisms of governance are.

2.1. The Actors in Governance: General Aspects

The governance of globalisation can be carried out by many different actors. There is a need for common principles of governance at the global level but also more detailed governance at the national level. If we understand governance as a broad concept, the actors can be private or public, or actors from the so-called third sector. The governance activities may manifest at global, regional, national or local level. The potential tools of governance vary depending on what kind of power the actor is able to wield.

The institutional features of governance are also connected to the flows in focus. The flows of money, people, goods, environmental hazards or information and others all need different kinds of governance and different actors to implement the governance activities. The actors may also jointly build very complex institutional systems of the governance of globalisation (Rosenau, 2004, p. 73). Thus the concept of governance is highly nuanced and multidimensional.

In the literature there are at least the following types of characterisations of the architecture of global governance (Held and McGrew, 2004, p. 9):

- it is multilayered (suprastate, like the UN; regional, like the EU; transnational civil society, business networks; national, local etc.);
- it is pluralistic (political authority is fragmented);
- it has a variable geometry (infrastructures vary around the globe and from issue to issue);
- the system is structurally complex (composed of diverse agencies and networks with overlapping jurisdictions, differential power resources and competencies);

– national governments are crucial as strategic sites for suturing together the various infrastructures of governance and legitimising regulation.

Thus the institutional system of governance is now highly complex and likely to remain so in the future. It is difficult to describe the whole system of governance. Legal governance can roughly be categorised by two dimensions: (1) *institutional level of governance*: global/international – national and (2) *mechanisms of governance*: ‘hard law’ – ‘soft law’ (according to the legal instruments available to the actor) – see table 1.

Table 1. Some examples of actors of global governance

Mechanism of governance	Institutional level of governance	
	international actors	national actors
‘Hard law’	UN, WTO, WB, IMF... EU, NAFTA IGOs TNCs etc.	states (governments) local communities other authorities (by delegation of legal power) etc.
‘Soft law’	INGOs G8 (org G7 or G20...) OECD TNCs Science (Organisations) etc.	NGOs Third Sector Private Citizens, Science (Organisations) etc.

Legend: UN – United Nations; WTO – World Trade Organisation; WB – World Bank; IMF – International Monetary Fund; EU – European Union; NAFTA – North American Free Trade Agreement; IGO – International Governmental Organisation; OECD – The Organisation for Economic Cooperation and Development; TNC – Transnational Corporation; INGO – International Non-Governmental Organisation; G7 – Governance arrangement between a group of states: USA, Japan, Germany, France, the United Kingdom, Italy, Canada and the European Community (G8 = G7 + Russia; G20 – Group Twenty, arrangement between so-called emerging markets and G7; Formerly the Group of Seven (G7), the G20 was created in 1999 as a forum for national finance ministers of the G7 together with the European Union and the heads of the IMF and World Bank); NGO – National Non-Governmental Organisation.

Source: Kultalahti (2006, p. 78).

The institutional system of global governance is in a state of flux. Rorden Wilkinson (2006, pp. 2–5) has pointed out several trends in the structures of global politics, actors, processes and mechanisms of governance. Concerning the actors there is a trend from state to non-state actors, from bilateral to multi-lateral relations and towards the idea of using networks of actors to solve global problems. There is also a need to respect human rights and develop democratic

systems of governance. These trends are relevant if we look at the issue from a more general level of governance activities. From the taxation point of view the most important actors – in the field of hard law – are national states, local communities or other authorities having taxation competence. The actors use taxation – not only for fiscal purposes but also as a means of governance, where the tax competition is an essential instrument. International hard law actors consist mostly of national governments (tax treaties) and regional authorities like the EU. In this case taxation may be seen as an object of governance. It is often a question of tax harmonisation.

Due to the legalistic nature of taxation, soft law does not have a very important role in it, at least not on the national level. The soft law actors focus on defining tax policy, international standards and models. This is primarily done through international cooperation, carried out e.g. by the G8, G7, G20 and international organisations like the OECD and WTO. Because taxation is pronouncedly national, legislators and national authorities are the most important ones. In federal states local governments may also be of importance. It is well known that some but not all the Swiss cantons have a very good climate from the perspective of tax planning. However, in the field of taxation international cooperation is also needed. The role of the OECD is central in matters of international taxation. Nowadays the OECD can be classified as global actor. At least in Europe, but also more widely, the EU is important as a regional actor. The premise is that the role of the OECD is seen mainly at the level of soft law whereas the role of the EU is seen in both hard law and soft law. Such governance activities are also in a state of flux.

2.2. The Goals of Governance

In the global information society and economy there is a need to strengthen the positive aspects of globalisation and to weaken the negative ones. The best deals are those where all the parties win (the ‘win-win’ situation).⁴ The problem is that the benefits and disadvantages of globalisation are often unequally distributed. Hence the need for governance varies from place to place and from time to time. It is difficult or even impossible to construct a universal model of governance. Sometimes we only have to strengthen our capability to adapt to the global changes.

Held and McGrew (2005) have analysed the new globalisation policy which they call a *cosmopolitan social democracy*. In addition to economic efficiency

⁴ This refers to the idea of ‘Pareto theory’ (‘Pareto optimum’). In the field of tax harmonisation or tax competition this means that these taxation activities are only justified if they improve the actor’s situation without deteriorating that of any others. See e.g. Steichen (2003, pp. 78–79) and the source mentioned there.

they emphasise such values as the rule of law, political and international equality, democracy, social justice and global solidarity, transparency in political and administrative processes etc. These values should also be implemented in the distribution of natural resources and human security. Held and McGrew call for communality both on the local level and on the global level, and also on all the intermediate levels. They speak for the governance of world trade by publicly controlling the money and commercial flows of the world, by producing global public services and by compelling the stakeholders to commit to directing the big companies (Held and McGrew, 2005, pp. 141–142).

Recently attention has also been paid to the paradigm change of globalisation. The idea is that the globalisation process is now accruing at a much finer level of disaggregation. As Richard Baldwin (2006) puts it,

[...] due to radical reductions in international communication and coordination costs, [...] firms can offshore many tasks that were previously considered non-traded. This means that international competition – which used to be primarily between firms and sectors in different nations – now occurs between individual workers performing similar tasks in different nations.

The other new feature is that globalisation will seem quite unpredictable. Since individual tasks can be offshored, globalisation may help some workers in a given firm while harming others. Baldwin suggests that this all calls for flexibility, the ability to adapt rapidly to new circumstances and an education policy which concentrates on learning how to learn, instead of learning particular sets of skills (Baldwin, 2006, especially pp. 5, 24–30 and 45–46).⁵

The governance of globalisation is of course a matter of political will. If values like the rule of law, democracy, transparency of activities, social justice, human rights and economic efficiency are deemed important, they should appear both in the content and measures of governance as well as in the institutional structures of the governance of globalisation. In the field of taxation this means a ‘good tax system’ built on democratic decisions and social/global justice – and at the same time guaranteeing economic efficiency. The last two or three conditions (justice and economic efficiency) depend strongly on the standpoint we are looking from, global or national. A so-called ‘good tax system’ has many definitions. Usually the national tax system is characterised by features like economic efficiency, social justice, clarity, flexibility and international compatibility (Hjerpe *et al.*, 2003, pp. 25–31).

Is there a need for tax competition and/or tax harmonisation? If we take tax competition as a means of a national state to govern global economy by ensuring the national competitiveness, what are the pros and cons of it? Schön (2003, pp. 5–6) emphasises three aspects as pros of tax competition: downward

⁵ Giuseppe Burgio also paid attention to this idea in the meeting of globalisation researchers in Rome 5th October 2006.

pressure on tax burden, fiscal discipline and proper balance of tax level and public goods. Steichen (2003, p. 73) states that tax competition should be welcomed because it is the perfect tool for making public services leaner and more efficient. At the other end of the scale are the risks of harmful or unfair⁶ competition and the so-called ‘race to the bottom’. There is also a possibility that tax competition undermines the constitutional foundations of a tax system, i.e. the institutional power of the parliament as a tax legislator. It may also challenge the material principle of equity which requires a non-discriminatory approach as to the different sources of income without respect for the economic mobility of the tax base (see Schön, 2003, p. 14 and the reports referred to there). Steichen (2003, pp. 60–62) thinks, however, that the race to the bottom will never happen and he prefers tax competition to tax harmonisation (see also Schön, 2003, p. 30). The pros of tax harmonisation are also many: reduction of compliance costs, transparency for the taxpayer, tax neutrality and equity of taxation and redistributive effects of taxation (Schön, 2003, p. 5). On the other hand tax harmonisation also has many undesirable features, such as its character as a ‘tax cartel’ or the possibility that, ultimately, everybody may turn out to be a loser from tax harmonisation (Steichen, 2003, pp. 60, 83–84). Steichen (2003, pp. 43 and 119) also thinks that, at least in the EU, tax harmonisation is possible only in the field of indirect taxes, but an ‘impossible task’ in the field of income taxes. However, there has been at least some progress in tax harmonisation, including income taxation and currently there are fairly ambitious efforts in this field namely the proposal for the Common Consolidated Corporate Tax Base (CCCTB).

Taxes are the main source of income of most welfare states and taxation is also used as a tool of economic policy. It is understandable that states are reluctant to restrict their sovereignty in taxation. On the other hand states endeavour to remove barriers to international trade, and to foster capital flows and mobility of persons but at the same time they want to retain their sovereignty in taxation and tax the cross-border activities maybe even more severely. How to strike a balance between these objectives? It means to develop a system that does not constitute an undue impediment to cross-border activities while protecting the revenue of the state (see Vann, 2002, p. 720). So, how to govern globalisation in tax matters?

If we set these findings against the background of general goals of global governance and the good tax system, tax harmonisation seems to promote their social and global justice aspects fairly well. Of course justice is also heavily dependent on other circumstances. On the other hand, tax competition tends to contribute to

⁶ It has been pointed out that the distinction between ‘fair’ and ‘unfair’ competition is not possible from the legal point of view. It is a definition of the political level see Schön (2003, pp. 18–19).

the efficiency of the national economy – and perhaps also the global economy. This is the case if the ‘race to the bottom’ does not take place. Thus there may not be any universal answer to the question: tax harmonisation or tax competition? We need some empirical findings to understand better the benefits and disadvantages of these two tendencies of taxation.

2.3. The Mechanisms of Governance

Governance may be carried out by governments and international cooperation, it may happen at the global, regional, national or local level and it may be based on legal regulation or different kinds of practices or conventions. The mechanism of governance can also be arranged hierarchically or horizontally, the governance activities may be described as ‘top down’ or ‘bottom up’ etc.

What is then the role of law in the governance of globalisation? It is naturally important to try to maximise the benefits and minimise the disadvantages of globalisation. Obviously, not all the problems can be resolved by legal regulation, but it may be possible to keep the problems from becoming critical. For example, common rules are needed to prevent the emergence of unreasonable and unjust divides (e.g. the digital divide, the informational divide; see Pöysti, 2002, p. 36) and polarisations in the information society and global economy (see e.g. WSIS, 2003a, b). The problem with legal governance is that in many cases the law is lagging behind. Legal regulation is often reactions to things that have already happened, ‘beating the fire out’, rather than guiding the development in the right direction. Yet it is possible to strengthen a healthy global information society and global economy by legal regulation. This can be done with common legal rules and rational allocation of resources.

The categorisation of the actors in global governance already demonstrated that there are many kinds of legal means available. The mechanisms vary, of course, depending on the actor or the level of governance. It is also worth keeping in mind that there are many other mechanisms than the legal ones, e.g. direct/indirect economic and financial governance. ‘Money makes the world go around’. The mass media also influence people’s behaviour on the market, as do cultural, political, imaginary and security issues.

We now concentrate on the legal measures, which also are many and varied. The institutional categorisation made above is based on two categories: legally binding mechanisms (‘hard law’) and non-binding or indirect mechanisms (‘soft law’). We could also use the concepts of ‘formal’ and ‘informal’ regulation. Such a dichotomy is not, of course, analytical and detailed enough to describe the legal mechanisms available. We now attempt to analyse the mechanisms in greater detail (see table 2).

Table 2. Some examples of the legal mechanisms of global governance

Mechanism of governance	Institutional level of governance	
	global, international or regional actors	national actors
'Hard law'	Human rights (UN, Council of Europe...) International tax laws and treaties (custom duties etc.) Air safety laws (ICAO) Shipping laws (IMO) Intellectual property rights (WTO, WIPO) etc.	rule of law constitutional rights, fundamental rights other national laws (e.g. tax laws)
'Soft law'	international standards (OECD) food standards (FAO) motor vehicle standards (ECE) market governance (by TNCs) etc.	part of the legal principles (rule of law and good governance principles...) social capital national standards private contracts/agreements etc.

Legend: ICAO – International Civil Aviation Organisation; IMO – International Maritime Organisation; WTO – World Trade Organisation; WIPO – World Intellectual Property Organisation; OECD – The Organisation for Economic Cooperation and Development; FAO – Food and Agriculture Organisation; ECE – Economic Commission of Europe; TNC – Transnational Corporation.

Source: Kultalahti (2009, p. 286).

It is obvious that there is no way to construct a comprehensive instrument of global governance. However, we can learn from our experiences of international relations (e.g. the regulation of the UN), building up regional governance systems (e.g. EU law) and even national government. It is possible to intervene in flows of globalisation and guide them in the right direction by using the existing legal mechanisms, by learning from them and by developing new mechanisms. For example, international human rights regulation and the national fundamental rights laws are used to guarantee private autonomy for every individual, autonomy which both public authorities and private citizens are forbidden to violate. These legal rules have programmatic future effects and they also ensure a minimum level of rights for every individual. The principle is that these rights should be the basis for the governance of globalisation. The national legal regulation aims in the same direction by strengthening democracy and the rule of law. Many international and national regulations concerning some specific fields direct different kinds of economic and welfare flows, and try to safeguard the rights of individuals.

The roles of international and national standards, self-regulations, principles and conventions are often important, even when they are non-binding in nature. Some social and cultural factors also have at least indirect regulatory effects on

the flows of people and capital. From the point of view of legal validity the mechanisms of international law can be categorised as follows (figures 1 and 2).⁷

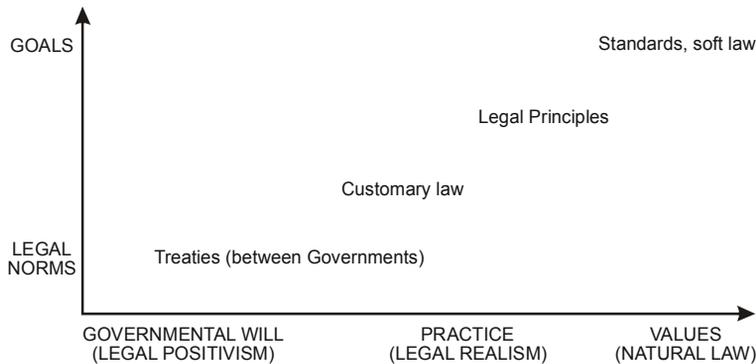


Fig. 1. International sources of law
Source: Rosas (1993)

Langet *et al.* (2006, p. 276) have pointed out that ‘there exists a lack of clarity in the international system as to which type of rules should govern particular situations and conflicts’. For example, it is possible to use either formal rules (here ‘hard law’) or informal rules (here ‘soft law’), but neither of these types of rules (formal/informal) should be preferred to the other, because both are subject to dispute and can lead to abuse (Lang *et al.*, 2006). Therefore both are needed!



Fig. 2. International soft law documents (some examples)
Source: Rosas (1993)

⁷ See also Rosas (1993, pp. 68–71), where the international sources of human rights are categorised in this way. Figure 1 concerns both ‘hard law’ and ‘soft law’ documents, figure 2 concerns only ‘soft law’ documents.

Legal principles are also very important mechanisms of global governance. The principle of *Pacta sunt servanda* ('agreement must be abided by') is very important both on the international and national level. The role of the principle depends, of course, on how strongly binding the governments and other actors consider them to be.

It is worth noting that the regulatory effect depends on how binding the legal mechanisms are considered to be. This interdependence is not necessarily linear, however. For example, a certain 'gentleman's agreement' may not be legally binding but at the same time it may have a very strong factual effect on some flows of globalisation. In developing the legal governance mechanisms we have to pay attention to this kind of phenomenon. At the same time we have to take care of the coherence and parallelism of the legal governance mechanisms.⁸

The nature of globalisation as a network development constitutes a problem for governance. The change of global activities into horizontal networks may undermine the governance mechanisms based on vertical interrelations. On the other hand, many of the hierarchical political/legal mechanisms are still efficient. At the level of international law the problem is the lack of implementation apparatus and legal sanctions. These problems can also be seen in the implementation of declarations of common intent.

This brief overview of the general mechanisms of global governance shows that there is a complexity and variety of legal mechanisms to be used also in the field of taxation. Tax harmonisation and tax competition may be carried out by hard law and soft law mechanisms. Hard law consists mostly of international tax law (tax treaties, avoiding double taxation etc.) and national tax law. They are used both in tax harmonisation and in tax competition. Soft law mechanisms are also numerous: model tax conventions, standards, statements of NGOs and experts etc. which are often used in the field of tax harmonisation. Tax competition usually takes place on national level (by national legislators), but it aims at strengthening the comparative competitiveness of a national economy on the global market. The idea is to attract economic production factors to the country, and to prevent the economic resources from leaving the country. It is important to note that tax competition – and partly also tax harmonisation – contains only one constellation of mechanisms in this field of governance activity. There are also many other attracting factors, like public services, infrastructure, education, income transfers etc. An exclusive focus on taxes may be misleading. In a global environment governments compete by means of the pattern of both revenue and expenditure (Steichen, 2003, pp. 77–78). The competition therefore occurs on much a broader level, as a competition of systems (see e.g. Penttilä, 2006, p. 596 and the report referred to there). In this respect the coherence of policies has to be taken care of.

⁸ At the meeting of globalisation researchers in Rome 6th October 2006 Graziano Battistella paid attention to the need for coherence of policies e.g. in the governance of migration.

One central mechanism in balancing of taxation and globalisation consists of bilateral treaties. The OECD has offered the states a model by which to retain their national tax laws but at the same time facilitate free movement. This is done on a reciprocal basis restricting their fiscal jurisdiction through tax treaties. The OECD has also guided how some internationally acknowledged principles intended to protect the tax base against improper tax planning, especially the arm's length principle, are applied. In transfer pricing documentation requirements the guidance is in many states transformed into tax law and thus the guidance has achieved the status of hard law. The OECD also has a central role in cooperation which aims to protect the tax revenues of national states in a globalised world. This is done e.g. by effective exchange of information for tax purposes.

The EU is to establish an internal market. The TFEU (Treaty on the Functioning of the European Union) includes fundamental freedoms such as free movement of workers, freedom of establishment, freedom to provide services and free movement of capital. These are also applied to taxation, although there have been difficulties in striking a balance between them and the old traditions of taxation of cross-border activities. To a certain extent fundamental freedoms accelerate tax competition in Europe. It noteworthy that the fundamental freedoms can – at least to a certain extent – also be used to avoid the taxation of a Member State.⁹ However, purely artificial arrangements are not protected by EU law.

Of course the EU imposes limits on tax competition by harmonising taxation. This has happened in value added taxation. In income taxation there is only little harmonisation and its aim is mainly to abolish the tax obstacles to cross-border activities. However, the TFEU includes state aid provisions which are also of significance in taxation. They, as hard law, considerably restrict the scope for using various tax incentives in Member States and thus also impose limits on tax competition. The EU is also of importance in ensuring the effectiveness of taxation e.g. by the exchange of information. The Savings Directive is an example of this.

In the next section we illustrate harmonisation and competition mechanisms by referring to some examples and empirical findings of present legal mechanisms used.

3. EXAMPLES OF TAX COMPETITION AND TAX HARMONISATION

As a whole, although taxation is essentially national, quite a lot of work has been done – other than tax competition – in this field, which aims to facilitate free movement by removing the tax obstacles to cross-border activities, but at the same time

⁹ In C-196/04, *Cadbury Schweppes*, p. 49, the ECJ states as follows: 'it is settled case-law that any advantage resulting from the low taxation to which a subsidiary established in a Member State other than the one in which the parent company was incorporated is subject cannot by itself authorise that Member State to offset that advantage by less favourable tax treatment of the parent company'.

the aim is to govern the movement and thus protect the tax revenues of the state. Next present some examples of this kind of mechanisms but also tax competition mechanisms. The latter are mainly national. We will now approach the question by analysing goals, mechanisms and actors on global, regional and national levels.

3.1. Global Level

3.1.1. Tax Treaties

It is natural that states have demonstrated a tendency to extend the powers of taxation in general as widely as possible. Most countries tax the income on the basis of both the residence status of the taxpayer and the source of income. E.g. Finland taxes residents on their worldwide income and non-residents on income received from Finnish sources. This causes international juridical double taxation. The income of a Finnish resident may also be taxed in the source country and the income of a non-resident may also be taxed in the country of residence. Foreign source income is thus taxed twice: once by the country of source and again by the country of residence.¹⁰ This inevitably causes double taxation. Its harmful effects on the exchange of goods and services and movements of capital, technology and persons are well known. There are two mechanisms which are used to alleviate or to abolish such double taxation. Firstly, most countries have domestic legislation which will partly or wholly abolish international double taxation. Secondly, countries have mostly made bilateral tax treaties with each other in order to abolish double taxation. It is clear that the objective of tax treaties, broadly stated, is to facilitate cross-border activities (trade, investments and mobility of persons) by eliminating the tax impediments to these cross-border flows (see Arnold and McIntyre, 2002, p. 105). Thus tax treaties are a good example of how countries can cooperate in the field of taxation to promote globalisation but also at the same time to govern globalisation. They are also a very widely used method; there are more than 3,600 bilateral tax treaties (see OECD, 2011a, p. 12).

In income tax treaties the treaty countries divide the right to tax certain income and if both countries levy tax, the treaty includes paragraphs on how the double taxation can be avoided. Tax treaties are based on reciprocity. This is one remarkable difference, if we compare tax treaties with tax competition. Despite this, tax treaties are at least to a certain extent also an instrument in tax competition. If a country has a wide tax treaty network, the country is assessed positively in tax

¹⁰ Such situations are called residence-source conflicts. It is the most common case of international double taxation. Another quite common conflict is that of residence-residence. This is the case when two or more countries regard the same taxpayer as tax resident in their country (see Rohatgi, 2005, p. 17).

planning.¹¹ A country with a wide treaty network may be seen as a good country in which to locate or in which to invest. This is because tax treaties will usually reduce withholding taxes of the source country or they may abolish them altogether. For example, for finance and holding companies it is important that the taxes they have to pay on interest, dividend or royalty inflows or outflows are modest.¹² Thus a country on participating in international cooperation may concurrently also have tax competition aspects in mind.

Although tax systems are designed by national legislators and tax treaties are a part of the national tax system the treaty law (tax treaties) is globally quite uniform (or well harmonised). This is due the system of Model Tax Treaties. There are two influential model tax treaties: (1) the OECD Model Tax Convention on Income and Capital and (2) the UN Model Double Taxation Convention between Developed and Developing Countries. The main difference between these two models is that the UN Model Treaty imposes fewer restrictions on the tax jurisdiction of the source country (Arnold and McIntyre, 2002, p. 109).

It is clear that the nature of Model Tax Conventions is soft law. The OECD or UN member countries may decide independently whether to conclude tax treaties and with whom they will do so.

The member countries may also deviate from the Model in their tax treaties. Nearly all OECD member countries have also made reservations on some provisions of the Model. At least the OECD Model indicates cooperation but at the same time adhering to the sovereignty of the Member States to their power to tax. However, this kind of purely juridical characterisation downgrades inequitably the influence of the OECD Model Tax Convention.

The OECD Model Tax Convention has a long history. The first version was published in 1963. Since then several revisions have been made. The success of the OECD Model Treaty has been incredible. First, OECD member countries have largely conformed to the Model Convention when concluding or revising bilateral tax treaties. Second, the impact of the Model Convention has extended far beyond the OECD area. It has been used as a basic document of reference in negotiations between member and non-member countries and even between non-member countries (see OECD, 2010, p. 10). One can say that virtually all existing bilateral tax treaties on income and capital are based on the OECD Model (Arnold and McIntyre, 2002, p. 109). Of course every treaty is independent and may include deviations from the OECD model but as a whole or at least

¹¹ E.g. the Netherlands has a wide treaty network.

¹² See Finnerty *et al.* (2007, p. 86), where they outline the key requirements for a holding company jurisdiction. They write: 'Ideally the holding company location would not tax dividends, capital gains, interest or royalty income. There would be no withholding tax on dividends, interest or royalty outflows and the holding company location would provide access to EC Directives and/or a strong network of double tax treaties, thereby eliminating or reducing withholding taxes on dividend, interest and royalty inflows?'

the mainlines of tax treaties are similar. Actually OECD member countries have only a weak obligation to adapt their tax treaty policy to the Model Convention and non-member countries have no obligation at all. However, from the point of view of countries which are negotiating tax treaties the influence of the OECD Model Convention is more than the influence of soft law and is approaching the influence of hard law.

There is still one remarkable feature in the OECD Model Convention. It includes commentaries on the provisions of the convention. These commentaries are a widely accepted guide to the interpretation and application of the provisions of existing bilateral treaties. Therefore the interpretation of tax treaties is quite uniform although each country has its own and different traditions concerning the interpretation of national tax laws. One can say that when the treaty is applied the influence of the commentaries in interpretation is more powerful than that of soft law, although commentaries can be categorised as soft law in jurisprudence.

As stated above, the main purpose of tax treaties is to eliminate double taxation. In this way tax treaties abolish tax obstacles to cross-border flows of goods, investments, capital and persons. Making these tax treaties promote globalisation and without them the world would be less globalised than it is today.

Double taxation is not the only problem of international taxation although it is a central issue for the taxpayer. Another important problem in international taxation and in the globalised environment is the international tax avoidance. Nowadays prevention of fiscal evasion is also a purpose of tax treaties (see Rohatgi, 2005, p. 25). This can also be seen in the titles of many tax treaties,¹³ and in certain articles of treaties. Treaties based on the OECD Model include limited anti-avoidance measures such as comprehensive taxation for residents (art. 4) and restriction on tax concessions on dividend, interest and royalty income only to beneficial owners (art. 10, 11 and 12). In this sense article 26 is very important. It contains the provision for the exchange of tax information between tax authorities. A recent addition in the OECD Model Convention is the new Article on mutual assistance in the collection of taxes (art. 27). These anti-avoidance features of tax treaties became more and more important as soon as cross-borders flows have increased and globalisation advanced. Because tax treaties normally include such anti-avoidance features, some countries or tax havens have not been willing to conclude tax treaties with other countries. On the other hand, a country with high tax rates may be willing to conclude a tax treaty with a low tax country if the information exchange article is included in the treaty. These anti-avoidance features of tax treaties especially show that they can be used also to govern globalisation. Because tax treaties are quite well harmonised law, this limited governance also has the same feature.

¹³ See e.g. Convention between the Government of the Republic of Finland and the Government of the United Kingdom of Great Britain and Northern Ireland for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital.

3.1.2. OECD Transfer Pricing Guidelines and Transfer Pricing Documentation

The role of multinational enterprises in world trade has increased dramatically over the last 20 years. It has been estimated that 60% of world trade consists of trade within multinational corporate groups. Therefore transfer pricing issues are of the utmost importance today. Transfer prices are the prices at which an enterprise transfers physical goods and intangible property or provides services to associated enterprises (OECD Guidelines, 2010, p. 13) For example, if A Ltd manufactures goods in country A and sells them to its foreign subsidiary B Ltd, located in country B, the price at which that sale takes place is a transfer price. Because A Ltd is taxed on its profits in country A and B Ltd in country B, the transfer price affects how the total profit and taxes of the company group are divided between countries A and B. If the tax rate in country B is lower than in country A, it may, from the tax planning point of view, be profitable to set the transfer price as low as possible. Unless prevented from doing so, multinational enterprises engaged in cross-border transactions could avoid the income taxes of a country through their manipulation of transfer prices.

Each country wants to ensure that its legitimate rights over the tax revenues due from the activities of the multinational enterprises in its tax jurisdiction are protected. Therefore domestic tax laws usually include provisions for transfer pricing. It is an international custom that an appropriate transfer price of cross-border activities is set according to the so-called arm's length standard. This standard is met if the prices with associated enterprises are set so that the prices are the same as the prices used in comparable dealings with unrelated parties. This means that the transfer price should be 'market price'.

In order to protect their tax revenues countries have adopted the same standard in assessing transfer prices. However, the arm's length standard provides only little guidance as to how transfer prices should be established in concrete situations. The aim is in principle quite clear, but how to achieve it is very unclear. The companies and the tax authorities of different states may not be unanimous regarding the arm's length price. It is notable that different countries often have opposite interests in transfer pricing disputes and there is not only dispute between a taxpayer and a tax administration but also between tax administrations. In order to avoid the possible conflicts and international double taxation, the OECD has drawn up Transfer Pricing Guidelines for multinational enterprises and tax administrations. The Guidelines analyse the methods for evaluating whether the conditions of commercial and financial relations within a multinational enterprise meet the arm's length standard. Additionally the Guidelines discuss the practical application of those methods.

The Guidelines are targeted to tax administrations and multinational enterprises. They are to be categorised as soft law. Of course there may also be legal provisions including the main principles of the Guidelines. Even though the

Guidelines are not binding on the tax authorities they are very widely followed (see Helminen, 2009, p. 123).¹⁴ Certain states¹⁵ have their own transfer pricing guidelines. They largely follow the OECD Guidelines but may differ in details.

The OECD Transfer Pricing Guidelines include also a section which provides general guidance for tax administrations to take into account in developing rules and/or procedures on documentation to be obtained from taxpayers in connection with a transfer pricing inquiry. They also provide guidance to assist taxpayers in identifying documentation that would be most helpful in showing that their controlled transactions satisfy the arm's length principle. It is obvious that the documentation guidance of OECD is soft law, but it has become extensively hard law because in the last ten years many countries have added transfer pricing documentation requirements to their domestic legislation. These documentation requirements are usually quite well in line with the OECD Guidelines.

The EU Council on 27th June 2006 adopted a Code of Conduct on transfer pricing documentation for associated enterprises in the European Union (EUTPD). The EU Code is based on the OECD Guidelines. The purpose of the EU Code of Conduct is to standardise the documentation that multinational enterprises must provide to tax authorities on their pricing of cross-border intra-group transactions. The EU Code is a political commitment, but the documentation made according to this Code should be accepted in Member States. Thus the Code may be categorised to be above the normal soft law though it is not strictly speaking hard law. The EU Code is an example of how global soft law or governance by an international actor (the OECD) is channelled through a regional actor (the EU) to national level and the binding force of the soft law at the same time increases.

3.1.3. The Harmful Tax Competition Project and Exchange of Information

It has been said that harmful tax competition means competition for the location of profits rather than fair competition for the location of economic activity (see Timms, 2009, p. 3). Harmful tax competition is not a healthy aspect of a global economy, since it may result in investments and other decisions made solely on a tax basis and not on a commercial basis. Such distortions cause ineffectiveness from the global point of view and also in the light of economic growth. Such distortions caused by national tax laws should be abolished. The question is by whom and by which mechanisms this abolition is feasible because tax laws are national and states have sovereignty in fiscal matters. The OECD has offered countries a forum where they can cooperate in this field.

It is evident that globalisation has added the need for the international exchange of information in tax matters. Most countries have adopted the taxation of

¹⁴ See also HE (107/2006 vp, p. 5), where it is stated that the commitment with the OECD Transfer Pricing Guidelines is worldwide.

¹⁵ E.g. the United States and Germany.

worldwide income of residents. In order to be effective the tax system thus needs to be able to receive information from foreign jurisdictions. Otherwise the taxpayers could evade the tax of their state of residence by neglecting to report foreign income. The OECD has done a lot work in this field.

In 1998 the OECD report: *Harmful Tax Competition: An Emerging Global Issue* was published. The 1998 report contains recommendations to counter harmful tax practices. As part of the 1998 report, the OECD Council adopted Guidelines for Dealing with Harmful Preferential Regimes in Member Countries. Under these Guidelines the harmful features of preferential regimes in member countries must be removed within 5 years. In 2000, the OECD identified 47 preferential tax regimes in member countries as potentially harmful on the basis of the criteria contained in the 1998 Report and the guidance developed by the OECD Fiscal Committee on the application of these criteria (see OECD, 2006, p. 3). In 2004 it was reported that 18 of these regimes has been abolished, 14 had been amended to remove their potentially harmful features and 13 were found not to be harmful after further analyses. In 2006 it was concluded that there was only one regime which was harmful.¹⁶ The OECD's project concerning the harmful tax practices in member countries had been successful.

In its report *Towards Global Tax Cooperation* (2000) the OECD published a list of 35 jurisdictions which were found to meet the tax haven criteria of the 1998 Report (see OECD, 2000, p. 17). However, many of these had indicated an interest in the possibility of cooperating with the OECD by committing to the elimination of harmful tax practices. Therefore it was decided to prepare a list of uncooperative tax havens. If a tax haven did not make a commitment to eliminate harmful tax practices it would automatically be included in the list. In 2001 the tax haven work was modified. According to the new definitions a jurisdiction was not be considered uncooperative if it committed by 28th February 2002 to transparency and effective exchange of information for tax purposes (see OECD, 2001, p. 11). Seven jurisdictions did not make commitments to transparency and exchange of information at that time and were identified in April 2002 by the OECD's Committee on Fiscal Affairs as uncooperative tax havens. By the end of 2007 four of these made commitments and were removed from the list. In May 2009, the Committee on Fiscal Affairs decided to remove all three remaining jurisdictions (Andorra, Liechtenstein and Monaco) from the list of uncooperative tax havens in the light of their commitments to implement the OECD standards of transparency and effective exchange of information and the timetable they set for the implementation. As a result, no jurisdiction is currently listed as an uncooperative tax haven by the Committee on Fiscal Affairs.

¹⁶ That was the Luxembourg 1929 holding company regime. Since the publication of the 2006 Progress Report, the Luxembourg 1929 holding company regime has been abolished by legislation enacted on 29th December 2006, with transitional rules for certain existing beneficiaries up to 31st December 2010.

Although the aims of the OECD's project on harmful tax practices have been achieved, the work continues and non-OECD countries are also cooperating with the OECD in tax matters. The cooperation takes place within the Global Forum on Transparency and Exchange of Information for Tax Purposes. The Global Forum now (at the beginning of August 2011) includes 101 member jurisdictions. Membership includes all G20 members, all OECD countries and all major financial centres. The Global Forum ensures that all its members fully implement the standard on the exchange of information for tax purposes they have committed to implement. Member jurisdictions, but, if needed, non-member jurisdictions will be assessed on their ability to effectively exchange information. The internationally agreed standard on the transparency and exchange of information is primarily reflected in the OECD 2002 Model Agreement on Exchange of Information in Tax matters and in article 26 of the OECD's Model Tax Convention. Neither the Global Forum nor the OECD has the power to impose sanctions on countries that do not implement the standards. However, there is strong international pressure to implement standards. It is possible that individual countries will decide what actions they consider necessary to ensure the effective enforcement of their tax laws. The G20 has provided a list of potential countermeasures against non-cooperative jurisdictions based upon an analyses provided by the OECD.

It is clear that the Global Forum has successfully expanded the network of international agreements allowing for effective exchange of information (see OECD, 2011b, p. 9 and the Annex IX). Because exchange of information is an important tool in fighting non-compliance with the tax laws in an increasingly borderless world the success in this field is notable from the point of view governance of globalisation. Of course, even today a country may be one with low or zero income tax, but because of the exchange of information residents of other countries are not safe if they are trying to use the low tax country to evade their tax liabilities in their home countries.

3.2. Regional Level (EU Level)

3.2.1. Introduction

The EU is an example of a regional actor in governance. The actions taken in the EU exert influence within the EU and its Member States. The EU law is mainly implemented in Member States by the authorities of the Member States. Thus the EU and its Member States are intertwined with each other as actors of governance. In some areas of taxation the EU has succeeded in also including non-member states to cooperate so that it is possible to say that in these areas the EU, the Member States and also the cooperating non-member states are actors in governance. The Savings Directive, which we consider later, is such an example.

Tax directives may be only adopted on the basis of unanimity in the EU Council. In other words, all Member States must agree on measures adopted in the field of taxation. It is clear that Member States perceive fiscal harmonisation, especially in the field of direct taxation, as an infringement of their fiscal sovereignty. Therefore direct taxation directives have only limited scope. One can say that it is quite difficult to govern taxation and also tax competition by using EU-level hard law, i.e. directives, as a mechanism of governance. However, there has been some success (e.g. the Savings Directive and the directive concerning mutual assistance by the competent authorities of the Member States in the field of direct taxation) and just now there is an ambitious Commission proposal (the CCCTB directive). Another new proposal from the European Commission is the Proposal for a Council Directive on a common system of financial transaction tax.¹⁷ However, directives are not the only source of EU tax law. The articles of the TFEU are also applied to taxation. In the light of governance the TFEU includes an important hard law mechanism in the articles concerning state aid.

Soft law as a tool to govern harmful tax competition is also used in the EU. On 1st December 1997 the Council of Economics and Finance Ministers (ECOFIN) adopted the Code of Conduct for business taxation. The Code is not a legally binding instrument but it clearly does have political force. By adopting this Code, the Member States have undertaken to roll back existing tax measures that constitute harmful tax competition and refrain from introducing any such measures in the future ('standstill'). It is to be noted that this soft law tool has been used combined with hard law, i.e. with state aid provisions of the TFEU. The Commission has used the state aid procedure to pressurise the Member States in the rollback process of existing harmful tax measures of the Code of Conduct (see Bárbara, 2011, p. 273).

3.2.2. State Aid

The TFEU 107–109 articles include state aid provisions. According to the TFEU 107 (1) save as otherwise provided in the Treaties, any aid granted by a Member State or through state resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, insofar as it affects trade between Member States, be incompatible with the internal market.

It is clear that tax provisions may also constitute forbidden state aid. Such state aid may be provided by decreasing the undertaking's tax burden in various ways. Firstly, a reduction in the tax base (such as special deductions), secondly, a total

¹⁷ The tax would be levied on all transactions on financial instruments between financial institutions when at least one party to the transaction is located in the EU. The exchange of shares and bonds would be taxed at a rate of 0.1% and derivative contracts, at a rate of 0.01%. See COM (2011) 594 final. The Commission has also explored ways to introduce a financial transaction tax at global level.

or partial reduction in the amount of tax (such as exemption) or thirdly, deferment, cancellation or even special rescheduling of tax debt. It is evident that special tax incentives may be forbidden state aid. There are also many cases where a special provision in the tax legislation of a member country has proven to be forbidden state aid. In that case the taxpayer may have to reimburse the aid received under the forbidden provision.

The state aid provisions of the TFEU restrict tax competition in the EU. The provisions are hard law provisions aimed at the legislators of Member States. They are also hard law from the taxpayers' point of view because they may have to pay back the forbidden aid. Therefore e.g. in tax planning, it is very important to know that the tax incentives to be used are not forbidden state aid.

3.2.3. The Savings Directive

In the EU there are quite many directives which are focused on specific income tax areas. Usually they seek to remove tax obstacles to cross-border activities. E.g. the aim of the Merger Directive is to avoid the imposition of tax in connection with mergers, divisions and with other cross-border transactions to which the Directive is applied. The Parent-Subsidiary Directive deals with the elimination of economic double taxation arising within a group of companies from cross-border distributions of profits. EU income tax directives thereby facilitate free movement and also globalisation, at least within the EU.

The Savings Directive differs from all other direct tax directives insofar as it does not seek to remove tax obstacles to cross-border activities. It seeks to ensure effective taxation of savings income and to protect national revenue from attempted tax evasion and fraud by EU nationals. This is pursued by obligatory and automatic exchange of information between the competent authorities of the Member States. When a paying agent established in one Member State makes an interest payment to an individual resident in another Member State the paying agent is obliged to report to the competent authority of its own Member State the payment and the detailed information of the beneficiary owner of the interest income. The competent authority of the paying agent, in turn, is obliged to forward the information gathered to the competent authority of the beneficiary owner's Member State of residence.

Some Member States considered that the information exchange system violated their system of banking secrecy. These states (Austria, Belgium and Luxembourg) were granted the concession of a transitional withholding tax regime.¹⁸ Instead of requiring paying agents established on their territory to exchange information, under the same circumstances and condition a withholding tax is carried levied. As of 1st July 2011 the withholding tax rate is 35%, which is quite high. Because

¹⁸ Belgium applies the exchange of information system as of 2010.

the tax rate is high it is less attractive for a beneficiary owner of the interest payment not to declare the income in his state of residence. If he declares the income, the withholding tax is wholly credited in the state of residence. Thus it is possible to receive a cash payment from the residence state if the tax rate there is less than 35% and if the income is declared. The Member State using the withholding system is obliged to pass 75% of the withholding tax to the beneficial owner's Member State.

The Savings Directive's coming into force was made subject to the concurrent application of measures equal those contained in the Directive by all dependent or associated territories of Member States and equivalent measures by five key European third countries (Switzerland, Liechtenstein, San Marino, Monaco and Andorra). Many of these jurisdictions are known as low tax areas. The EU concluded the agreements with these five countries and each Member State concluded a treaty with dependent and associated territories. After these treaties the directive entered into force on 1st July 2005.

From the point of view of the governance of globalisation the Savings Directive is an important example. It applies to income from interest which in a globalised world often escapes taxation. The taxation on interest income is also an area where countries have diverse opinions. It is quite often claimed that effective taxation of interest income exiles the capital to other countries where it is not taxed. To avoid this it was important for the EU to succeed in expanding the territorial scope of the Directive to some non-EU key jurisdictions. Of course, the information exchange system of the Directive is important, likewise the mechanism by which the information exchange system and the considerations of the bank secrecy of some Member States could be balanced.

3.2.4. Common Consolidated Corporate Tax Base (CCCTB)

Groups of companies doing business in many or all EU Member States face compliance and double taxation problems. They have to deal in principle with 27 different tax base determination systems and their administrative requirements. Cross-border activity within the EU is therefore facing administrative burdens and high tax compliance costs. This is in contrast with the single market. To avoid such problems the European Commission on 16th March 2011 proposed a directive for a common system for calculating the tax base of businesses operating in the EU: the Common Consolidated Corporate Tax Base (CCCTB).¹⁹

The CCCTB is a system of common rules for computing the tax base of companies which are tax resident in the EU and of EU-located branches of third-country companies. Specifically, the common fiscal framework provides for rules

¹⁹ COM (2011) 121 final, Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB).

to compute each company's (or branch's) individual tax results, the consolidation of those results, when there are other group members, and the apportionment of the consolidated tax base to each eligible Member State. The CCCTB would mean that the tax base would be harmonised.

Under the CCCTB, groups of companies would have to apply a single set of tax rules across the Union and deal with only one tax administration (one-stop-shop). A company that opts for the CCCTB ceases to be subject to the national corporate tax arrangements in respect of all matters regulated by the common rules. A company which does not qualify or does not opt for the system provided by the CCCTB Directive remains subject to the national corporate tax rules. These national rules may be more advantageous or more burdensome than the CCCTB rules. The CCCTB would mean fewer opportunities for tax planning by companies using transfer pricing or mismatches in Member State tax systems. However, the central tax planning question would be to opt or not to opt for the CCCTB.

The introduction of the CCCTB would harmonise the corporate tax bases of the companies to which the system is applicable. This would abolish tax base competition of the companies which have opted for the system. However, the system would be optional and there would also be the national system. It is obvious that there would be tax base competition between national systems and between national systems and the CCCTB. Of course the competition would be more complex than today, because there is a new challenger, i.e. the CCCTB, on the market.

The CCCTB would not harmonise tax rates. The taxable income of the group is divided to each member country and the tax due depends on the tax rate of that country. Thus there might be tax rate competition. As a whole tax competition would be more transparent than today because the tax base would be harmonised.

Currently, it is impossible to predict what will happen regarding the proposal of the Commission. One can assume that not all EU countries are willing to introduce the CCCTB system. It is possible that the system will be introduced in some Member States if there are enough such countries. The system includes tax consolidation. This means that the losses incurred in one member country may be deducted from the profits made in another member country. Many countries seem to doubt this kind of cross-border loss deduction. Therefore one alternative may also be a more limited system, a system without consolidation. This system would be CCTB. Such a system would also be one step ahead in tax harmonisation.

3.3. National Level

Globalisation causes pressure to change the national structure of taxation because international tax competition focuses on different tax bases differently. It is obvious that corporations and their profits are sensitive to tax changes and at the same

time also sensitive to tax competition. An enterprise may quite easily transfer at least some of its functions to another country. If the functions are transferred the future profits of this function are taxed in the destination country and the country of origin loses its tax revenues. It depends on the line of business how easily it or its functions can be transferred. It is to be noted that in the enterprise there are nearly always some functions which can be shifted although the main function, e.g. manufacturing, will remain in the home country. E.g. holding, financing, marketing, research and development activities and intellectual property right (patents, trademarks, know-how) are quite movable and also sensitive to taxes. The location of such functions and property will often have a material impact on the allocation of taxable income and the tax burden of a multinational enterprise. Therefore corporate tax rates are very important from the national point of view and they are also a key element in international tax competition.

The average corporate tax rate in 2000 of the OECD countries was 33.6% and in 2009 it was 26.3%. The drop is remarkable and indicates the pressure of tax competition. In small OECD countries corporate tax rates are lower than in big countries. The finance crises of 2008/2009 stopped the fall of corporate tax rates but there are signs that this stop was temporary. The UK Government in March 2011 published a radical plan to get the UK economy growing. One element in this plan is to create the most competitive tax system in the G20. This is to be achieved *inter alia* by cutting the corporate tax rate; the corporate tax rate will fall to 23% in 2014. After this e.g. the Netherlands and Finland have announced that they will also cut their corporate tax rates.²⁰

Although corporate tax rates have dropped there has not been a dramatic change in the ratio of corporate tax and gross domestic product. One reason for this has been the fact that at the same time the corporate tax base has been broadened. However, at the moment such broadening seems to be difficult and the trend seems to be to the opposite direction. Countries seem to compete by offering a narrowing tax base by which certain transactions are exempt from tax or are taxed more leniently than other income. One example of this is the participation exemption system. Under this system, the alienation of shares is tax-exempt in corporate taxation if certain requirements are met. Such a system has traditionally been included in the Netherlands tax system. Therefore the Netherlands has been a country where multinational company groups have located their holding companies which own the subsidiaries of the group. As a countermeasure, other countries have also included similar tax exemptions in their legislations. This also happened in Finland in 2004 although the official tax policy in Finland has been to retain the broad tax base of corporate taxation. The tax base erosion of corporate tax seems to be continuing. Many countries have special incentives for research

²⁰ There is often also domestic pressure to cut the corporate tax rate. The cut is mainly argued for by the claim that the drop will have a positive influence on economic growth.

and development (R&D) activities. As noted, before the location of intellectual property of a multinational company group may have notable influence of the tax burden of the group. Intellectual property is also easy to transfer from one country to another. Therefore there are countries which have special tax regimes for this kind of income. The outcome of this kind of 'patent box' provisions is that the income from intellectual property will be very low taxed income.

Reduction of corporate tax rates and narrowing the tax base are general measures within corporate taxation used in tax competition. There are also other kinds of competition measures, e.g. special taxes for certain industries. The tonnage tax is an example of these.

The shipping industry is very international and operates under tough international competition. It is easy to register a ship under a foreign flag and operate the ship by foreign company, maybe by a company organised in a low tax jurisdiction. There are many reasons why countries find it important that there is enough tonnage owned by resident companies and registered under the national flag of the country. Because of the nature of the industry and of the importance of the industry for countries, the shipping industry is very vulnerable to tax competition and also vulnerable to subsidies given by states.

The tonnage tax is a special tax regime for the shipping industry allowing shipping companies to elect to have their taxable income from shipping activities determined at fixed rates by reference to the tonnage of their ships, rather than by reference to real business profits. The tax may be very small compared to the real income of the company. Actually the tonnage tax is state aid to the shipping industry. In the EU such selective state aids are forbidden, but the European Commission has approved the tonnage taxes of Member States if certain conditions are met.

The tonnage tax system is very common in Europe. As first it was included in tax law in Greece. In the mid-1990s this model began to spread to other countries. Today it is used in Greece, the Netherlands, Norway, Germany, the UK, Denmark, Spain, Ireland, Finland, Belgium, France, Italy, Poland and Latvia. Because the tonnage tax is so widespread the competitive advantage within Europe of having this tax has at least partly disappeared. Of course, it is a disadvantage *not* to have tonnage tax.

Although tonnage taxes in different countries have similar features and they are intended to cut the tax burden of the shipping industry, there are still differences between national regimes. These differences may be crucial. The history of the Finnish tonnage tax is an example of these. The act was passed in 2002. However, it included some disadvantageous provisions compared to regimes in other countries and it also included some risks for the company if it opted for the system. Therefore by the end of 2009 only one fairly small company had elected to be taxed according this system. The share of the Finnish imports and exports handled under Finnish flag registered ships was constantly declining. The Finnish companies had registered more and more ships under the flags of Sweden,

Estonia, the Netherlands, Germany, the UK and the Bahamas. Thus the Finnish participation in tax competition had been quite unsuccessful. In order to stop the process the law has been reformed, but at the moment the European Commission has not yet approved the new provisions.

The tonnage tax is an example of a tax where the ‘race to the bottom’ in tax competition nearly came true. However, there are also opposite examples. A certain line of business may be seen as a new source of tax revenue. As such we mention the bank tax. The financial crisis of 2008 attracted interest in additional taxation for the financial sector. There have been discussions and plans by the G20, IMF (2010), in the European Union (see COM, 2010) as well as on national level to introduce a bank levy or bank tax and also discussions on introducing a financial transaction tax. Some countries have decided to adopt a bank tax or are at least actively considering introducing such measures. The UK, France, Germany, the Netherlands and Sweden are such countries. According to the programme of the new Finnish government, a bank tax will be adopted in Finland. The idea of a bank tax is that the financial sector should participate more in the costs of stabilising the financial system. The tax is based on the balance sheet of financial institutions and the revenue collected is used to set up a fund for future interventions or they are used as budget finance like other taxes. When adopting a bank tax it is obvious that countries will use the models adopted in other countries as one basis for their own solutions.²¹

The global financial crisis of 2008 required many governments to provide extensive support for their financial sectors. Bank taxes are to be seen as a reaction of this. To begin with the focus of bank taxes was to recover the direct fiscal costs of the recent crisis but later the focus has shifted to reducing and addressing the costs of future financial failures and crises. Bank taxes and the global discussion of such taxes is also a sign to the financial sector. Because the financial sector will bear the costs of the crisis by paying extra taxes this will probably reduce the probability of future crises. Besides corporate taxation, there are also other areas in income taxation which are sensitive to tax competition. The capital income taxation of individuals is one such area. However, there is one notable feature which restricts the influence. The capital income taxation of individuals is usually based on residence and therefore the foreign capital income is also taxed in the country of residence. In order to be effective the tax authorities must have sufficient information on the foreign income. Therefore the treaties on the exchange of information on tax matters are important. However, the effectiveness of capital income taxation in a globalised world is a problem, because there are tax planning opportunities, especially at international level.

²¹ The Dutch Government in July 2011 announced its plans to introduce a bank tax in 2012. It also announced that the tax would be broadly based on the UK bank tax and the levies in place in France and Germany.

Today these tax planning opportunities are easier to handle and may also be less costly than before.

The labour force is not as movable as capital and also not so sensitive to tax. The mobility of highly skilled persons is greater than the average. It seems that countries want to be attractive to these well salaried individuals and there is also tax competition in this field. Many countries have systems for foreign skilled persons which mitigate the tax burden of such immigrants compared to the burden residents of that state.

4. CONCLUSIONS

Tax competition and tax harmonisation are real challenges to the governance of global economy. It is also possible to approach the goals, actors and mechanisms of governance from different angles. Our analyses focused on different levels and different mechanisms of governance. Our conclusion is that there is no universal answer to the question: competition or harmonisation? The main reason for this is the fact that the benefits and disadvantages of globalisation, and also of the governance activities, are unequally distributed. Thus the attempts to govern the processes of global economy on national level may easily lead to tax competition. On the other hand, there are also examples indicating another kind of attitude. Many countries have included CFC rules in their tax legislation. These are intended to protect the tax base allowing the state to tax the income of a foreign company situated in a low tax jurisdiction if that company is wholly or partly owned by the residents of that state. Therefore channelling the income of a resident into this kind of foreign company does not have the tax advantages which the owner of the company has pursued. Globalisation makes it easy to use foreign companies situated maybe in low tax jurisdictions to escape the tax in the home country but CFC legislations are intended to block at least certain abusive practices. The USA was the first state to include CFC rules in its legislation and was later followed by Germany and some other big countries. Nowadays CFC rules are quite usual in national legislations. CFC rules illustrate how ideas and models of anti-abuse legislation may circulate from one country to another if the model is successful. One requirement for this kind of development may be that the model is first introduced in big countries like the USA, Germany, the UK and France.

Bank tax is possibly another example of tightening tax legislation from national level aimed at governing globalisation or its consequences. Compared to CFC legislation, bank tax is a new phenomenon and it seems to be spreading faster than CFC legislation. Maybe this is also a consequence of globalisation. New tax ideas from other countries will be adopted more quickly than before.

On the other hand at the supranational level, i.e. at regional or global level, the goals and mechanisms of governance seem to emphasise harmonisation and the prevention of harmful tax competition and tax avoidance. The problem in this field has been that in tax matters there has not been any forum for cooperation. Nowadays the OECD has filled the gap and has become an important actor or forum for cooperation in taxation. It has succeeded in many ways in preventing and reducing harmful tax competition. The soft law mechanisms developed by the OECD have been converted into the hard law mechanisms on national level. The tax treaty network is an old example of this and the exchange information agreements a new one.

At the regional level (EU) the governance activities have been based on both soft law and hard law mechanisms. However, the hard law mechanisms are difficult to use because the Member States are not inclined to abandon their taxation sovereignty. On the EU level it is also possible to use combined activities consisting of soft law mechanisms and hard law mechanisms. An example of this is the combination of the Code of Conduct for business taxation and the state aid rules of the TFEU.

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