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Articles

Philosopher Kings and International Tax: A New Approach to Tax Havens, Tax Flight, and International Tax Cooperation

STEVEN A. DEAN*

INTRODUCTION

Most contemporary tax policy discourse rejects the notion that our tax rules can be understood as the creation of a unitary, economically rational actor. One need only consider the most basic tax rules to be persuaded that a host of factors play a role in producing tax legislation. The growing impact of the alternative minimum tax (AMT),¹ for example, would be impossible to explain as the product of a conscious policy choice by a single individual with the power to enact laws and interested solely in maximizing the nation's welfare (a philosopher king). That is particularly true if welfare is measured in narrow economic terms such as gross domestic product (GDP).² Ignoring the political pressures, institutional dynamics and the simple human flaws³ that contributed to

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1. I.R.C. § 55 (2000).

2. For the sake of consistency, this Article uses the more current concept of gross domestic product (referring to the economic activity that occurs within a nation's borders), even when the older gross national product (referring to the aggregate economic activity generated by a nation's citizens and residents) concept would arguably be more appropriate.

3. In the case of the AMT, excessive optimism turns out to have caused much of the trouble. The AMT was originally introduced as a limited response to the realization that some wealthy Americans paid little or nothing in income taxes. In 1981, Congress indexed the "normal" income tax for inflation, but did not do the same for the AMT (presumably because it was seen as a temporary,

the AMT's rise to prominence would make the AMT as mysterious as Easter Island's moai.

Although the domestic tax policy conversation is largely free of the philosopher king model,⁴ that same philosopher king model of government behavior remains relatively influential in the international tax policy context. The standard explanation for cross-border tax cooperation embraces the most improbable form of the model by assuming that cooperation occurs simply because it is economically efficient and increases the GDPs of both participating nations. For example, the extraordinary success⁵ of bilateral double tax treaties is usually attributed to their positive impact on investment decision-making and ultimately on worldwide economic efficiency. The model assumes that, like a voluntary market exchange between individuals, international tax cooperation produces a normatively desirable result by appealing to the rational self-interest of the participating nations. Unfortunately, international tax policy is not controlled by enlightened philosopher kings devoted to pursuing the national public interest, but by the same governments that produce tax rules like the AMT.

International tax scholars such as Julie Roin have implicitly recognized the failure of the philosopher king model, which assumes that governments will advance the collective national good, to accurately predict how governments and politicians will respond to economically efficient tax policy initiatives.⁶ However, rather than abandoning the

rather than a permanent, measure). That failure is largely responsible for the vast growth in the application of the AMT, which now affects many solidly middle-class taxpayers. LEONARD E. BURMAN ET AL., *The AMT: Out of Control, in TAX POLICY ISSUES AND OPTIONS* 2-3, (Urban-Brookings Tax Policy Center, No. 5, 2002), available at http://www.urban.org/UploadedPDF/a310565_AMT_OutofControl.pdf. Presumably, legislators did not feel it was necessary to index the AMT since the AMT was viewed as a temporary "patch" for flaws in the normal income tax that would be resolved through more fundamental reform.

4. Even the self-serving titles given to domestic tax legislation acknowledge that something other than increases in GDP, or even an undifferentiated desire to increase the public welfare, motivate government action. See, e.g., Working Families Tax Relief Act of 2004, Pub. L. No. 108-311, 118 Stat. 1166 (codified as amended in scattered sections of 26 U.S.C.). Regardless of whether that 2004 legislation was in fact intended primarily to reduce the tax burdens of "working families," the title suggests that politicians recognize that it is in their interests to convey the impression that they are acting on behalf of specific, politically appealing groups. One could articulate a purely utilitarian rationale for cutting the taxes of working families, but few would credit a claim that those tax cuts won out over other tax or spending options strictly because of their positive impact on the collective welfare.

5. "Tax treaties are a very considerable success story for the OECD and its predecessors, the League of Nations, and the OEEC." John F. Avery Jones, *Are Tax Treaties Necessary?*, 53 TAX L. REV. 1, 1 (1999).

6. One such initiative is the effort to harmonize global tax systems. Even though tax harmonization would increase worldwide economic welfare, and would therefore be attractive to a philosopher king, the idea remains popular only with economists. Julie Roin, *Taxation Without Coordination*, 31 J. LEGAL STUD. 61, 78 (2002) ("Though economists have emphasized the need for

philosopher king model completely in favor of a more realistic alternative, the tendency has been to conclude that only those policies providing relatively large collective benefits will succeed.⁷ In effect, domestic political dynamics are treated as a kind of transaction cost or friction that tends to inhibit international tax cooperation. Even when explicitly employing political science concepts to explain the development of the international tax regime, tax scholars have continued to assume that there is a predictable, positive relationship between the collective good and government action, discounting the possibility that internal politics might cause a government to take actions that have no, or even a negative, impact on national welfare.⁸

This Article focuses on one instance in which continued reliance on the philosopher king model has caused a major international tax policy initiative to flounder: the Organisation for Economic Cooperation and Development (OECD) effort⁹ to eliminate tax flight.¹⁰ That effort failed¹¹

international tax base harmonization . . . for over 30 years, there has been little discussion, let alone movement, in that direction in the income tax context.”)

7. For example, Roin concludes that tax “harmonization will not occur whenever its social benefits outweigh its social costs. An additional—and likely quite substantial—margin will be required to overcome the countervailing selfish, but politically powerful, interests that will be arrayed against harmonization.” *Id.* at 94.

8. See, e.g., Diane Ring, *International Tax Relations: Theory and Implications*, 60 *TAX L. REV.* (forthcoming Winter 2007) (manuscript at 64–66, available at <http://ssrn.com/abstract=900406>) (concluding that bilateral double taxation treaties developed pursuant to a “coordination game” in which nations sought to simultaneously increase their respective national welfare by developing a framework for cooperation). Ring does note that domestic politics may be important and encourages future scholarship to acknowledge “the reality that states are not monoliths and may not speak with a single voice or follow a single vision.” *Id.* (manuscript at 71). Presumably, departures from rationality, collective action problems, information asymmetries and agency costs will be just as relevant in this context and just as likely to produce rules that are as suboptimal as the AMT.

9. See *infra* notes 66–79. The OECD has long had a prominent role in international tax matters. See Yariv Brauner, *An International Tax Regime in Crystallization*, 56 *TAX L. REV.* 259, 263 & n.18 (2003). The fact that the OECD is comprised of relatively wealthy countries and most of the nations targeted by the OECD initiative are relatively poor raises questions as to whether another organization, such as the United Nations, would have been more appropriate but the OECD has continued to lead the anti-tax flight effort.

10. Tax flight refers to the practice by individual taxpayers in developed countries (flight jurisdictions) of hiding assets overseas (in tax havens) to avoid income taxes. Tax flight costs the United States more in tax revenues than corporate tax underpayments and tax shelters combined. See *infra* note 27. Tax flight is by no means a new problem. Charles Adams traces the history of tax flight as far back as Roman times. CHARLES ADAMS, *FOR GOOD AND EVIL: THE IMPACT OF TAXES ON THE COURSE OF CIVILIZATION* 406–07 (1993) (“[H]ordes of Roman taxpayers went over to the barbarians to avoid Rome’s ugly tax enslavement. . . . The flight to the havens in the twentieth century is a pattern mankind has been undertaking from time to time since history was first recorded.”). What distinguishes contemporary tax flight is the ease with which modern information technology permits money and investments to cross borders while their owners stay at home.

11. Although early indications suggested that the initiative was a success, it appears that it has had very little practical effect. Compare Brauner, *supra* note 9, at 305 (concluding that “[t]he OECD enjoyed full cooperation from” tax havens), with Maria Flavia Ambrosanio & Maria Serena Caroppo,

because it was designed to conform to the specifications of the strong form of the philosopher king model, in which national governments are assumed to prioritize GDP growth. The OECD approach would have increased the sum of the GDPs of tax havens and of nations losing revenues to tax flight (tax flight jurisdictions). The “winners” in this arrangement, flight jurisdictions, suggested that they would have economically compensated the “losers,” tax havens, by sharing a portion of their GDP increase with tax havens.¹²

Relaxing the central assumption of the philosopher king model would allow international tax policymakers to create more robust policy proposals. Put simply, international tax policies that actually lower the GDPs of some nations, without providing compensation, might be more successful than policies that strive to leave each nation with a higher GDP. It is by no means unreasonable to imagine that a nation might embrace a policy despite the fact that it would reduce that nation’s GDP. If, for example, governments give the well-being of some individuals (law-abiding citizens and residents) priority over the well-being of others (tax cheats), a policy that costs tax cheats more than it provides to everyone else might lower GDP yet still be politically viable. Employing this insight will make it possible to create a solution to the tax flight problem that could work even though the philosopher king model would suggest otherwise.

Applying principles employed in tort law, tax flight jurisdictions could agree to pay tax havens to end the “nuisance” of tax flight.¹³ Such an agreement, referred to in this Article as a tax flight treaty, could succeed even if we assume that it would reduce the collective national

Eliminating Harmful Tax Practices in Tax Havens: Defensive Measures by Major EU Countries and Tax Haven Reforms, 53 CAN. TAX J. 685, 710 (2005) (noting that even those tax havens that “announced programs of reform . . . have not yet put their formal commitments into practice”). That failure may be explained, in part, by the switch from the Clinton administration to the Bush administration that took place after the OECD anti-tax competition initiative was announced, but before its details were fully developed. One could imagine that an administration more supportive of the effort would have devised an approach even more effective than tax flight treaties. Even if that were true, the philosopher king model would be at a loss to explain why. If governments prioritize national welfare and tax flight is harmful for tax flight jurisdictions like the United States, why would a change in administrations affect the anti-tax flight effort? It would suggest that one of those administrations was either not interested in advancing the national welfare or was mistaken about the best way to do so.

12. Alternatively, it is possible that the initiative was designed to serve an expressive, rather than instrumental, purpose. See generally Michael S. Kirsch, *Alternative Sanctions and the Federal Tax Law: Symbols, Shaming, and Social Norm Management as a Substitute for Effective Tax Policy*, 89 IOWA L. REV. 863 (2004) (distinguishing between instrumental legal rules designed to provide direct disincentives to discourage undesirable behavior and expressive legal rules designed to shape behavior indirectly by changing social norms). If that were the case, it might be too soon to declare the OECD’s effort a failure.

13. See *infra* note 178.

well-being (measured either in terms of GDP or more broadly) of participating tax flight jurisdictions. On the one hand, if most residents of a given tax flight jurisdiction have a strong individual preference for preventing tax flight (sufficient to outweigh tax cheats' preference for underpaying their taxes), a GDP decline might not reflect an actual decrease in the nation's welfare. Alternatively, if tax cheats wield relatively little political influence, they could be forced to absorb a welfare decline substantial enough to allow both tax havens and the other residents of flight jurisdictions (i.e., those not engaging in tax flight) to enjoy a welfare increase even without any gains in global wealth.

A highly simplified example¹⁴ can illustrate the point. Suppose a tax flight jurisdiction currently loses \$10 per year in tax revenues to tax flight. Although that \$10 in taxes goes unpaid, the nation does not lose \$10 of wealth. If we assume tax cheats keep \$7 of the \$10, taking the offshore expenses of tax flight into account, the flight jurisdiction is only \$3 poorer. If it could pay a tax haven \$5 per year for information that would permit the flight jurisdiction to collect \$10, doing so would reduce the flight jurisdiction's economic wealth, narrowly defined, by \$2. A philosopher king focused purely on the nation's GDP would reject such a deal even though, excluding tax cheats (who would suffer a \$7 wealth decrease), the nation would be \$5 better off if it agreed to pay for the information.¹⁵

This Article begins the process of developing a better model of how and why nations respond to international tax policy proposals. That improved model will facilitate the development of policies that would be more effective than the OECD's anti-tax haven initiative. It does so by assuming that international tax law shares some of the characteristics of other regimes such as international trade and international human rights law. To analyze existing and proposed tax rules it draws on work by the international law scholar Oona Hathaway¹⁶ that, in turn, builds on the insights of legal and political scholars such as Harold Koh, Robert O. Keohane and Anne Marie Slaughter regarding the relationship between

14. The example ignores the possibility that effectively combating tax flight will increase voluntary compliance, and thereby further increase tax revenues, by reassuring ordinary taxpayers that others are paying their fair share of taxes. It also ignores the possibility that the existence of other tax avoidance techniques could prevent the flight jurisdiction from collecting the full \$10 of tax even with complete cooperation from the tax haven.

15. A similar calculus is implicated whenever a government decides how much it should spend to enforce its tax laws. The key difference in this context is that paying a tax haven for information is likely to produce even fewer benefits for the jurisdiction attempting to enforce its tax laws than, for example, paying the salaries of additional revenue agents.

16. See generally Oona A. Hathaway, *Between Power and Principle: An Integrated Theory of International Law*, 72 U. CHI. L. REV. 469 (2005).

domestic politics and international law. Hathaway works to create a comprehensive framework, her “integrated theory,” that categorizes the many factors that bear on a government’s decision to first commit to and, no less important, to actually comply with international agreements such as the OECD’s cooperation commitments¹⁷ and bilateral double tax treaties.¹⁸

Hathaway’s model offers a means of distinguishing among policies based on their likely real-world impact.¹⁹ It identifies four forces that determine the efficacy of international agreements: (i) domestic collateral consequences, (ii) transnational collateral consequences, (iii) domestic legal enforcement, and (iv) transnational legal enforcement.²⁰ Applying the integrated theory to bilateral tax treaties and to cooperation commitments reveals why one succeeded while the other failed, even though they cannot be meaningfully distinguished on pure efficiency grounds.²¹

Part I of this Article explains what the philosopher king model is and why it is inadequate. Part II provides an illustration of the inadequacy of the philosopher king model. It describes the failure of the GDP-enhancing potential of the OECD’s cooperation commitments to cause tax havens to comply with those commitments. Part III develops an alternative account of the success of the bilateral double tax treaties that are the backbone of the international tax regime. That account sets aside the philosopher king model and attempts to explain the success of those tax treaties in terms of their impact on international relationships and on the concentrated economic benefits they provide to a relatively limited group of taxpayers. It offers a solution to the puzzle at the heart of the “tax treaty myth”²²—why tax treaties have enjoyed so much success despite their limited contribution to economic efficiency—by exploring the international and sub-state political implications of the double tax treaty.

Finally, Part IV proposes a new solution to the problem of tax flight, the tax flight treaty, that relies on a market-based strategy²³ designed to

17. The OECD initiative relied on formal commitments made by tax havens to cooperate with the OECD to end tax flight. See *infra* text accompanying notes 75–78.

18. Hathaway, *supra* note 16, at 492–93 & tbl.1.

19. Hathaway’s theory does not address the normative desirability of a particular policy. It merely predicts when a nation will adopt and support a given policy proposal. In other words, Hathaway’s theory does not offer a means of identifying normatively desirable policies. Instead it offers a way of identifying potentially useful tools. For instance, the integrated theory will not reveal whether torture is bad, but will predict whether a particular type of treaty will actually reduce the incidence of torture.

20. *Id.*

21. *Id.* at 492–511.

22. See *infra* note 132.

23. Taking a market approach highlights one of the most puzzling aspects of the debate over tax

appeal²⁴ to modern governments rather than philosopher kings. Those tax flight treaties would allow tax flight jurisdictions and tax havens to share more substantial economic benefits than the net gains in GDP that would be produced by eliminating tax flight. Part IV then applies the integrated theory to compare the likely efficacy of tax flight treaties to that of the OECD's approach and the other leading proposed solution²⁵ to the problem of tax flight.

The tax flight treaty would challenge the traditional assumption that gains in global wealth, as opposed to, for example, changes in the allocation of global wealth, are the key to the success of international tax cooperation.²⁶ Tax flight treaties would be effective because of, rather than despite, the fact that tax flight jurisdictions' governments are not principally concerned with increasing their GDPs or even the collective well-being of their nations. Tax flight treaties would allow both tax havens and tax flight jurisdictions (excluding tax cheats) to "win" at the expense of tax cheats, by collecting and sharing a portion of the billions of dollars²⁷ lost to tax flight each year.

havens and tax flight: the fact that being a tax haven is considered to be vastly profitable yet precarious. Tax havens are thought to be able to extract enormous sums from tax cheats, *see infra* text accompanying notes 97–101, but are simultaneously presumed to face stiff competition from would-be tax havens, so that any deal with an existing tax haven would have virtually no effect on tax flight. As a logical matter, both cannot be true. If being a tax haven were immensely profitable, other nations would enter the "market" for tax flight. On the other hand, if the barriers to entering that market were low, being a tax haven could not be especially lucrative.

24. The proposal assumes that the OECD's goal of eliminating tax flight is normatively justifiable.

25. See Reuven S. Avi-Yonah, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 HARV. L. REV. 1573, 1654, 1667–70 (2000) (proposing the creation of a withholding tax regime by developed nations to combat tax flight).

26. The tax flight treaty represents a fundamentally different approach to the problem of international tax cooperation than efficiency-driven cooperation. Efficiency-driven cooperation works by making everyone better off (either directly or indirectly by providing compensation). The tax flight treaty would make tax havens and, in a sense, flight jurisdictions better off by redistributing wealth away from tax cheats. The difference mirrors the differences among the definitions of the word "cooperate" provided in the AMERICAN HERITAGE COLLEGE DICTIONARY (3d edition, 1997): "1. To work or act together toward a common end or purpose. 2. To acquiesce willingly; be compliant: *asked the child to cooperate and go to bed.* 3. To form an association for common, usually economic, benefit: *When buyers cooperate, they can make large wholesale purchases at a discount.*" The third definition, unlike the first (and arguably the second), represents an instance in which not everyone wins. Instead, there are winners *because* there is a loser.

27. Official estimates suggest that the global tax gap (taxes due but unpaid) associated with tax flight could easily exceed \$100 billion annually. See Joseph Guttentag & Reuven Avi-Yonah, *Closing the International Tax Gap*, in BRIDGING THE TAX GAP: ADDRESSING THE CRISIS IN FEDERAL TAX ADMINISTRATION 101 (Max B. Sawicky ed., 2005) (citing estimates from \$40 billion to \$70 billion per year for the United States alone and settling on a middle-of-the-road estimate of \$50 billion per year). The estimated \$50 billion per year in U.S. federal revenue losses is higher than each of the \$9 billion dollars lost each year to earned income tax credit overclaims, the \$30 billion lost each year to corporate underreporting and the \$10–\$15 billion in revenues lost to tax shelters. Max B. Sawicky, *Do*

I. THE TAX LAW'S PHILOSOPHER KING

A. WHAT IS THE PHILOSOPHER KING MODEL?

Even to a casual observer, it is obvious that most domestic tax legislation is not the handiwork of a rational individual dedicated to furthering the collective well-being of the nation. In theory, “[i]n our democratic society, we the people have organized a national government to protect our safety and security, to maintain our liberty, and to promote the well-being of our citizens and residents.”²⁸ Unfortunately, that pure public interest theory of legislation has proven difficult to reconcile with what we know of the tax legislative process. For good or ill, the prevailing view holds that, when it comes to taxes, the interests of the few regularly win out over concerns of the many,²⁹ often to the detriment of the nation’s collective welfare.³⁰

In the domestic tax policy context, the notion that a public interest theory of legislation cannot adequately explain the nation’s tax rules is almost taken for granted. For example, whether or not reducing capital gains taxes boosts economic growth, few would dispute that the preferential tax treatment investment income receives in part reflects the political influence of taxpayers paying a large amount of capital gains taxes.³¹ As a result, there is no more than a loose correlation between a tax rule’s normative desirability and its political viability. More than a decade ago, the debate had shifted from whether specific groups or individuals exercise a disproportionate amount of control over the

It Yourself Tax Cuts: The Crisis in U.S. Tax Enforcement, in BRIDGING THE TAX GAP, *supra*, at 4–6. The \$50 billion figure was calculated by estimating how much taxable income is earned by assets held by U.S. persons in offshore accounts and multiplying that figure by a representative tax rate. If a significant number of those U.S. persons would find alternative ways of avoiding tax, such as purchasing tax shelters, eliminating tax flight might have a much smaller revenue impact. On the other hand, if tax flight depresses voluntary tax compliance by individuals and businesses that have no offshore assets, eliminating tax flight could generate additional revenue not accounted for in those estimates.

28. Michael J. Graetz, *Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 26 BROOK. J. INT’L L. 1357, 1371 (2001).

29. See Edward A. Zelinsky, *James Madison and Public Choice at Gucci Gulch: A Procedural Defense of Tax Expenditures and Tax Institutions*, 102 YALE L.J. 1165, 1190 (“Both the benign explanation for the Tax Reform Act of 1986 and the less charitable account of that legislation share the premise of an essentially degenerate political process, largely controlled by self-seeking interest groups serviced by willing political entrepreneurs.”).

30. It is worth asking why the tax legislative process seems so different from, say, the environmental regulation process or the design of building codes. One possible answer is that the tax laws have a unique capacity to provide large cash benefits to a variety of interest groups and, as a result, suffers disproportionately from the impact of special interests.

31. The same can be said of the effort to repeal the estate tax. See, e.g., Dan Mitchell, *Maybe the Heirs Aren’t Apparent*, N.Y. TIMES, Apr. 29, 2006, at C5 (noting report linking the current effort to repeal the estate tax with lobbying campaign by eighteen extremely wealthy families).

political process to details such as the identity of those politically influential actors.³²

The contrast with the consensus view of international tax rules is stark. Bilateral double tax treaties, the central element of the international tax regime, are presumed to exist primarily because they provide an economically efficient result. “The states can be seen as actors pursuing an activity (taxation) and the international regime (in place of a supranational government) regulates that activity so that it can take place more efficiently (e.g., reduced administrative burdens on parties, information sharing, or increased efficiency of cross-border investment).”³³ The same governments that the conventional wisdom might view as essentially indifferent to the public interest when they produce domestic tax legislation³⁴ tend to be viewed as if they were helmed by philosopher kings, unswervingly devoted to the collective national good, when they devise international tax regimes.

1. The Strong Form of the Philosopher King Model

A philosopher king plays a role equivalent to the hypothetical prisoner in the best-known game theory model: the prisoners’ dilemma.³⁵ Like the prisoners, each of whom must decide whether cooperating with the police or remaining silent will minimize his jail time, philosopher kings have a clear goal and a clear choice. For each philosopher king the goal is maximizing the collective good of his nation and the choice is whether to cooperate with other philosopher kings to resolve international tax conflicts such as double taxation and tax flight. As a result, a pair of nations will cooperate when cooperation would increase the collective welfare of each nation.³⁶

The strong form of the philosopher king model equates a nation’s collective well-being with its GDP and predicts that a government will

32. See, e.g., Daniel Shaviro, *Beyond Public Choice and Public Interest: A Study of the Legislative Process as Illustrated by Tax Legislation in the 1980s*, 139 U. PA. L. REV. 1, 104 (1990) (arguing that viewing legislators purely as a conduit for the interests of others is inappropriate because “members of Congress in enacting legislation both have considerable leeway and are subject to significant constraints apart from interest group influence”).

33. Ring, *supra* note 8 (manuscript at 67) (offering economic efficiency as a key reason for the success of bilateral double tax treaties).

34. See *supra* note 29.

35. See Daniel Shaviro, *Why Worldwide Welfare as a Normative Standard in U.S. Tax Policy?*, TAX L. REV. (forthcoming) (manuscript at 5, available at <http://ssrn.com/abstract=966256>) (describing the frequency with which the model is employed in legal scholarship).

36. Nations need an incentive to cooperate because, as is generally true in international law, there is no central authority with the power to compel observance of international norms or rules. As a result, a nation is typically bound by international law only if it chooses to be. Customary international law represents the primary exception to that rule. See RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW OF THE UNITED STATES § 102(2) (1987) (providing that “[c]ustomary international law results from a general and consistent practice of states followed by them from a sense of legal obligation”).

act to increase the nation's economic growth.³⁷ Few, if any, scholars would defend the strong form of the model as descriptively accurate. Nevertheless, as a normative matter, tax policies that maximize a nation's economic growth will often be desirable. It is even possible that the best long-term strategy for increasing national GDP is to target a higher global GDP.³⁸ However, as a description of real-world government behavior, the strong form of the philosopher king model does not seem particularly useful.

2. *The Weak Form of the Philosopher King Model*

In part, the limitations of the strong form of the philosopher king model stem from the nature of the GDP concept which, because it only measures market activity, may not provide a particularly accurate measure of a nation's welfare or of changes in welfare. For example, a decrease in liberty³⁹ or increased levels of pollution might reduce a nation's collective well-being even if it has no effect on GDP.

The weak form of the philosopher king model avoids that problem by taking a much broader view of national welfare. In place of the assumption that government actions can be explained by a desire to boost GDP or other narrow measures of economic activity, it offers a more plausible alternative. Rather than focusing exclusively on GDP, for example, a government might seek to strike a balance between GDP growth and preserving liberty.

Thoughtful scholars are likely to find the weak form of the philosopher king model more appealing than the strong form. Although the weak form of the model rejects GDP as a measure of collective welfare, it still is essentially a national public interest theory of international tax cooperation. Like the strong form, it accepts the notion that normatively desirable government action can be explained purely by reference to aggregate welfare. Even if what could be charitably described as political inertia might require a relatively large collective gain to spur a jurisdiction into action, it assumes that a government will generally act when the social benefits of cooperation exceed the social costs of doing so.⁴⁰

37. "[W]e assume that governments maximize national income. In our bilateral context, a country's national income is the sum of the home-controlled production and net tax revenue." Richard Chisik & Ronald B. Davies, *Asymmetric FDI and Tax-Treaty Bargaining: Theory and Evidence*, 88 J. PUB. ECON. 1119, 1123 (2004).

38. See generally, Shaviro, *supra* note 35 (manuscript at 34) (concluding that the apparent tension between worldwide economic welfare and national economic welfare is illusory, because over the long term they are the same).

39. See Graetz, *supra* note 28, at 1371.

40. See *supra* note 7.

B. WHAT IS WRONG WITH THE PHILOSOPHER KING MODEL?

The persistence of the philosopher king model in the international tax policy context, especially when the public interest theory of legislation has fallen so far out of favor in the domestic tax context, is surprising. Still, that does not explain why the philosopher king model is ill-suited to the task of explaining the evolution of the existing international tax regime. All models make simplifying assumptions. Is it not possible that the philosopher king model's assumptions are less problematic when applied to international tax issues? Perhaps the fact that the executive, rather than the legislative, branch has primary authority over the foreign policy process (and the nation's treaty-making apparatus)⁴¹ makes U.S. international tax cooperation a more straightforward exercise than producing domestic tax legislation.

Such a conclusion would cut against the grain of recent scholarship observing that the flaws of the philosopher king model are just as relevant in the context of international tax law as they are with respect to domestic tax legislation.⁴² For example, scholars have noted that the strong form of the model, and its assumption that a limited measure of national well-being such as GDP, could be used to adequately explain a nation's international tax policy choices is unrealistic.⁴³ Although the weak form does a better job of incorporating the broad range of factors that affect welfare, it produces a different measurement problem.

Whereas the strong form offers a high level of precision⁴⁴ but may or may not provide an accurate account of a nation's welfare, the weak form does just the reverse. It may be correct to say that a government attempts to please the greatest number of its citizens to the greatest degree (taking into account their varied, and perhaps irrational,⁴⁵ preferences), but it is difficult to understand how a government might actually go about measuring or predicting changes in welfare defined in such broad terms.

41. See U.S. CONST. art. 2, § 2 ("The President . . . shall have power, by and with the advice and consent of the Senate, to make treaties, provided two thirds of the Senators present concur . . .").

42. See, e.g., Shaviro, *supra* note 35 (manuscript at 16-17) (noting many "departures from the simple prisoner's dilemma" such as "interest group politics" and "ideological divisions" in the international tax policy context).

43. For instance, scholars have noted that it is unrealistic to assume that nations act solely on the basis of economic efficiency, especially worldwide economic efficiency. See, e.g., Graetz, *supra* note 28, at 1407 (noting that national interests such as "[f]oreign policy concerns have long played an important role in U.S. international tax policy").

44. The Commerce Department publishes quarterly measures of GDP and GDP growth, with GDP growth specified to a tenth of a percent. See Bureau of Econ. Analysis, National Economic Accounts, <http://bea.gov/National/Index.htm> (last visited Apr. 1, 2007).

45. See Edward J. McCaffery & Jonathan Baron, *Thinking About Tax*, 12 PSYCHOL. PUB. POL'Y & L. 106, 106 (2006) (noting "wide range of heuristics and biases, or cognitive errors" people make when thinking about tax laws that can result in "tax and public finance systems that are psychologically pleasing but economically costly").

It would be difficult to raise normative objections to a government pursuing such a strategy, but what government (other than one under the control of a philosopher king) would be up to the task of implementing it?⁴⁶

Beyond questions of accuracy or precision in measuring aggregate welfare, both forms of the philosopher king model suffer from a more fundamental weakness. Put bluntly, it may not be reasonable to assume that the political actors who pull the levers of government in fact are trying to maximize aggregate national welfare.⁴⁷ If such an assumption is treated with skepticism in the domestic tax policy context, that same skepticism may be appropriate when trying to understand why a nation might enter into a bilateral double tax treaty or refuse to cooperate in the fight against tax flight.

Obviously, rejecting the philosopher king model only makes sense if a more useful alternative exists. One possible alternative is Hathaway's integrated theory.⁴⁸ The integrated theory offers a means of opening the "black box of domestic politics"⁴⁹ in order to explain intergovernmental cooperation. The integrated theory provides an approach that takes the sub-state political dynamics that international tax scholars have already begun to acknowledge⁵⁰ into account without reducing the domestic political process to a kind of "public choice toll charge."⁵¹ Hathaway's integrated theory could not only produce a more satisfying account of the development of existing international tax law like the bilateral double tax treaty, but also could guide the development of solutions to today's important tax policy challenges.

Part II offers an example of why continued reliance on the philosopher king model, particularly in its strong form, is harmful. It first explains what tax flight is and then describes the approach the OECD took in combating it. The failure of the OECD's recent high-profile initiative to achieve its goal of limiting tax flight offers a dramatic

46. This already difficult task could be further complicated by asking how a government should determine the appropriate time horizon for measuring well-being. The current debate over questions of "intergenerational equity" highlights the need to balance current and future interests as well as the broad array of current interests in making any such calculation. See Neil H. Buchanan, *Social Security, Generational Justice, and Long-Term Deficits*, 58 TAX L. REV. 275, 281-83 (2005).

47. See, e.g., Shaviro, *supra* note 32, at 8 (observing that legislators may use legislation as a "means of symbolic communication with members of the general public, of causing them to like a politician without the inconvenience (and possible political inconsequence) of actually having to benefit them tangibly").

48. See Hathaway, *supra* note 16.

49. *Id.* at 484 (referring to the "black box of domestic politics" that liberal institutionalists have only recently begun to open).

50. See *supra* note 8.

51. See Roin, *supra* note 6, at 94.

illustration of the limits of the philosopher king model. The OECD's anti-tax flight instrument, the cooperation commitment, promised precisely the sort of simultaneous GDP gains that would prove irresistible to philosopher kings. Flight jurisdictions within the OECD would experience efficiency and concomitant GDP gains larger than the GDP losses cooperation commitments would impose on tax havens. Those gains would allow flight jurisdictions to compensate tax havens for the expenditures and economic losses incurred in connection with their efforts to discourage tax flight. The negligible impact of the OECD's cooperation commitments⁵² on tax flight highlights the importance of developing a model of how and why nations respond to international tax policy proposals that is richer than the dominant philosopher king model.

II. TAX FLIGHT

Beginning in the late 1990s, the OECD sought to reduce tax flight by articulating a universal code of conduct that it then attempted to persuade tax havens to observe. In its 1998 report, *Harmful Tax Competition: An Emerging Global Issue*, the OECD identified the factors that set tax havens apart from other countries.⁵³ The OECD then urged tax havens to enter into formal "cooperation commitments" reflecting their intention to combat tax flight by modernizing their substantive and administrative tax policies. This Part explores the reasons the OECD's initiative has enjoyed so little success and concludes that the philosopher king model bears at least some of the responsibility.

A. GLOBALIZATION, TAX HAVENS AND TAX FLIGHT

Part II.A explains what makes a jurisdiction a tax haven and describes the dynamic that produces tax flight. In doing so, it accepts the anti-tax flight goals of the OECD initiative even though they rest on important, and potentially problematic, assumptions.⁵⁴ The OECD assumes, for instance, that tax flight has a negative, rather than beneficial, impact on global welfare.⁵⁵ Implicit in that assumption is the

52. See *supra* note 11.

53. ORG. FOR ECON. CO-OPERATION AND DEV., *HARMFUL TAX COMPETITION: AN EMERGING GLOBAL ISSUE* ¶ 52, at 22-23 (1998), available at <http://www.oecd.org/dataoecd/33/0/1904176.pdf> [hereinafter 1998 OECD REPORT]. The OECD's list of factors is similar to older lists, including one previously contained in the I.R.S.'s *Internal Revenue Manual* that listed low or no tax rates; bank secrecy; relative importance of banking to the haven's economy; availability of modern communication facilities; lack of currency controls; and self-promotion as an offshore financial center as typical characteristics of tax havens. See MICHAEL W. E. GLAUTIER & FREDERICK W. BASSINGER, *A REFERENCE GUIDE TO INTERNATIONAL TAXATION* 232-34 (1987).

54. Even though these assumptions are suspect, it is useful to evaluate the OECD's initiative on its terms. Rather than challenging the normative wisdom of the OECD's anti-tax flight objectives, this Article merely attempts to find a more effective means of achieving them.

55. In other words, the OECD initiative assumes that preserving the current tax status quo by

view that the income taxes prevalent in OECD member nations represent appropriate, efficient tax regimes and are worth preserving.⁵⁶ Another questionable OECD assumption is that information exchange of the type the United States engages in with nations like France and Germany would be sufficient to end tax flight.⁵⁷

In theory, tax laws are crafted to satisfy the revenue demands of a given jurisdiction in a manner that is fair, efficient and easy to administer. In reality, practical considerations produce tax systems that fall far short of the theoretical ideal. Those practical considerations do not often include the need to coordinate those tax laws with the laws of other jurisdictions.⁵⁸ At the national level, fundamental tax decisions, such as whether to choose an income or a consumption tax, are made without meaningful attention to their potentially harmful extraterritorial effects. Efforts to reconcile the inevitable conflicts that result from this approach usually take the form of targeted statutory regimes⁵⁹ and individually negotiated bilateral tax treaties.

1. *What is Tax Flight?*

Over the course of the twentieth century, although the design of tax laws has remained an inward-looking process, the enforcement of a nation's tax laws has not. Globalization, reflected in the growing mobility of taxpayers and their capital, has made the ability of nations to monitor the foreign activities of their taxpayers increasingly important. While the political pressures that influence the creation of tax laws are principally domestic, the ability of taxpayers to relocate themselves, their activities, or their assets to other jurisdictions, creates a critical external threat to the integrity of a nation's tax regime. If a nation's ability to monitor

eliminating tax competition is preferable to taking tax competition as a given and engaging in more fundamental tax reform.

56. This assumption is less likely to be valid if tax flight is a problem that is specific to income taxes. If it is, by replacing their income taxes with consumption taxes, OECD members could eliminate tax flight and the inefficiencies associated with tax flight. The relevant question is whether hiding money in offshore tax havens would have less of an impact on a taxpayer's liability under, for example, a national sales tax than under the current system.

57. Even data gathered and exchanged among developed nations that impose income taxes are often unhelpful. The limits of information exchange are evident in the United States' experience. See, e.g., Mark Everson, *Everson Explains U.S. I.R.S.'s Use of Foreign-Source Income Data*, WORLDWIDE TAX DAILY, June 16, 2006, (explaining limits of existing information exchange programs caused by "deficiencies" in the data received such as the lack of taxpayer identification numbers).

58. Nations may design their tax regime to capitalize on features of other nations' tax systems, but they do not ordinarily concern themselves with the negative effects their own choices might have on others. See, e.g., Graetz, *supra* note 28, at 1376 ("[O]ur foreign tax credit rules . . . stimulate other nations to adopt taxes on income, whether or not their own notions of fairness or of the appropriate trade-off between fairness and efficiency call for income taxation at all.").

59. E.g., I.R.C. § 901 (2000) (allowing U.S. taxpayers to credit foreign taxes paid against their U.S. tax liability).

compliance by its taxpayers ends at its borders, taxpayers can effectively, albeit illegally, exempt themselves from taxation by their home jurisdiction by moving their activities or assets to another jurisdiction. The ability of a significant number of taxpayers to shield income from their home jurisdiction's tax simply by opening bank accounts in another jurisdiction would represent an important vulnerability in a nation's tax collection system.

For example, assume one country, Flight Jurisdiction, imposes a tax on the interest income earned by its citizens (even if earned abroad) and that a Flight Jurisdiction citizen deposits cash in a bank account in a second country, Haven, and then makes investments in a variety of jurisdictions through that account. Also assume that the Flight Jurisdiction taxpayer does not report the interest earned through the Haven account to Flight Jurisdiction's tax authorities. If Flight Jurisdiction's tax authorities have no capacity to gather information about the Haven account or the investments, Flight Jurisdiction's tax on the interest earned in Haven is likely to go uncollected. With the power to collect information about accounts in Haven, Flight Jurisdiction would be more likely to be aware of the unreported income and would be in a position to collect the tax.

2. *Discouraging Tax Flight*

Of course, Flight Jurisdiction's enforcement failure only becomes problematic when a taxpayer is able to escape the reach of Flight Jurisdiction's tax authorities into a Haven that does not impose a comparable income tax. The absence of that income tax is critical for two reasons. First, if Haven could be relied on to impose a tax on the interest income comparable to the tax that Flight Jurisdiction would have collected, there would be no tax incentive for the Flight Jurisdiction citizen to become a Haven taxpayer. If Haven does not impose that tax, and is otherwise an appealing locale,⁶⁰ Flight Jurisdiction citizens can lower their tax burden by availing themselves of Haven's tax regime.

The second reason the absence of an income tax in Haven is problematic for Flight Jurisdiction is not a matter of substantive tax obligations, but of tax administration. Without an income tax in place, Haven has no reason to maintain the comprehensive, and burdensome, system of information reporting that allows tax authorities to monitor

60. The most important attribute would be political stability. A taxpayer presumably would not be willing to avoid tax on income at the risk of losing that income to war or expropriation. Other non-tax considerations include: geographic location; communications; language; currency and exchange control; legal system; relative development of financial and professional services; and entry and operating costs. See GLAUTIER & BASSINGER, *supra* note 53, at 241.

compliance with income taxes.⁶¹ Without such a system, even if it were willing, Haven would be incapable of providing Flight Jurisdiction with more than piecemeal information about income earned by Flight Jurisdiction citizens through accounts in Haven.⁶²

In today's tax environment, Haven's inability to provide that information, although more subtle than the fact that Haven effectively imposes a 0% tax on income, is the more troublesome problem. For example, the U.S. income tax would reach the interest income earned in Haven by a U.S. citizen whether it is earned directly by that U.S. citizen⁶³ or indirectly through a foreign corporation owned by the U.S. citizen.⁶⁴ However, without information about the interest income, the United States (filling the role of Flight Jurisdiction in the above illustration) would not be able to impose any tax on the interest income. As a result, individuals and entities that in theory owe U.S. taxes on Haven income are able to hide that income from U.S. tax authorities.

3. *Identifying Tax Havens*

As the preceding discussion suggests, in this context being a tax haven is principally a matter of lacking, rather than possessing, specific attributes.⁶⁵ That is reflected in the test proposed by the OECD for identifying tax havens. It isolates four attributes that a tax haven lacks: a comprehensive income tax, effective information exchange, transparency, and requirements regarding substantive activities.⁶⁶

61. All modern income taxes primarily rely on a system of self-assessment that operates on the principle of "trust but verify." Taxpayers report their income on a voluntary basis, and tax authorities use information gathered from employers, participants in transactions and financial institutions to verify that information.

62. That piecemeal information may be sufficient to investigate and prosecute individual tax cheats, but is not the sort of comprehensive information that Flight Jurisdiction could use to actually calculate and assess taxes with respect to uncooperative taxpayers.

63. *Cook v. Tait*, 265 U.S. 47, 56 (1924).

64. See I.R.C. § 951(a) (requiring certain shareholders of "controlled foreign corporations" to pay tax on passive income earned by that corporation even if the shareholders receive no dividends from the corporation).

65. A tax flight haven is not the only type of tax haven. For example, Ireland is considered a tax haven because of the relatively low taxes it imposes on corporate income. Its tax haven status has nothing to do with information reporting failures.

66.

The necessary starting point to identify a tax haven is to ask (a) whether a jurisdiction imposes no or only nominal taxes (generally or in special circumstances) and offers itself, or is perceived to offer itself, as a place to be used by non-residents to escape tax in their country of residence. Other key factors which can confirm the existence of a tax haven . . . are: (b) laws or administrative practices which prevent the effective exchange of relevant information with other governments on taxpayers benefiting from the low or no tax jurisdiction; (c) lack of transparency and (d) the absence of a requirement that the activity be substantial, since it would suggest that a jurisdiction may be attempting to attract investment or transactions that are purely tax driven (transactions may be booked there without the requirement of adding value so that there is little real activity, *i.e.* these jurisdictions are essentially 'booking centres').

Applying those four factors to Haven would clearly mark it as a tax haven. The first two apply because Haven imposes no income tax and, as a result, does not maintain a system of income tax information reporting. Haven also would presumably satisfy the final two factors by virtue of having satisfied the first two.⁶⁷ Because even jurisdictions that are extremely unlikely to actually attract tax flight, such as a nation in the midst of a civil war,⁶⁸ could meet those objective criteria, the OECD further specified that a tax haven must also offer itself, or be “perceived to offer itself, as a place to be used by non-residents to escape tax in their country of residence.”⁶⁹

The OECD’s 1998 report contained two key recommendations with respect to tax havens and tax flight. First, it recommended “that countries that do not have rules concerning reporting of international transactions and foreign operations of resident taxpayers consider adopting such rules and that countries exchange information obtained under these rules.”⁷⁰ The report also proposed the creation of a “list of jurisdictions constituting tax havens” to pave the way for a “co-ordinated response to the problem of harmful tax competition” from tax havens.⁷¹

Several years after the release of that initial report, the OECD published its list of tax havens.⁷² That list included most, but not all, of the jurisdictions that satisfied the OECD’s tax haven criteria. The nations that met the criteria but were not listed⁷³ had, to the OECD’s satisfaction,

1998 OECD REPORT, *supra* note 53, ¶ 52, at 22.

67. The lack of information exchange goes hand in hand with a lack of transparency. *See, e.g.*, ORG. FOR ECON. CO-OPERATION AND DEV., THE OECD’S PROJECT ON HARMFUL TAX PRACTICES: THE 2001 PROGRESS REPORT ¶ 28, at 10 (2001), available at <http://www.oecd.org/dataoecd/60/28/2664438.pdf> [hereinafter 2001 OECD REPORT] (“In applying the transparency and exchange of information criteria many factors are relevant, including a relaxed regulatory framework, which reduces transparency and makes it less likely that the information needed for effective exchange of information will be available.”). However, it is possible for a nation to be “transparent” by allowing access to information upon request even without having a comprehensive, automatic system of information exchange in place. It is not clear how a potential tax haven could avoid meeting the fourth criteria. What would it mean to not impose an income tax yet require “substantive activities” to avoid being subject to that nonexistent tax? The OECD eventually revisited this factor and reframed it as a question of “whether there were factors that discouraged substantial domestic activities.” *Id.* ¶ 27, at 10.

68. Somehow, Liberia made it on the OECD’s list of tax havens despite being in the midst of a “brutal 14-year civil war” that would deter most potential tax cheats. *See* U.S. Department of State, Background Note: Liberia, <http://www.state.gov/r/pa/ei/bgn/6618.htm> (last visited Apr. 1, 2007).

69. 1998 OECD REPORT, *supra* note 53, ¶ 52, at 22.

70. *Id.* at 43–44.

71. *Id.* ¶ 139, at 52–53.

72. ORG. FOR ECON. CO-OPERATION AND DEV., TOWARDS GLOBAL TAX CO-OPERATION: REPORT TO THE 2000 MINISTERIAL COUNCIL MEETING AND RECOMMENDATIONS BY THE COMMITTEE ON FISCAL AFFAIRS: PROGRESS IN IDENTIFYING AND ELIMINATING HARMFUL TAX PRACTICES 17 (2000), available at <http://www.oecd.org/dataoecd/9/61/2090192.pdf> [hereinafter 2000 OECD REPORT].

73. Those jurisdictions were Bermuda, Cayman Islands, Cyprus, Malta, Mauritius, and San Marino. 2001 OECD REPORT, *supra* note 67, ¶ 17, at 6–7.

already “made a public political commitment at the highest level (an ‘advance commitment’) to eliminate their harmful tax practices and to comply with the principles of the 1998 Report.”⁷⁴ The listed nations were urged to make a similar “public political commitment”⁷⁵ to cooperate with the OECD. That formal cooperation commitment would allow a listed jurisdiction to “avoid inclusion on the List of Uncooperative Tax Havens” to be issued in 2001.⁷⁶ Pursuant to those cooperation commitments, the cooperative tax havens became obligated to cease being tax havens by the end of 2005⁷⁷ by developing their capacity to collect and exchange the information required by flight jurisdictions to enforce their income taxes.⁷⁸ The OECD’s list of uncooperative tax havens, naming seven nations, was ultimately published in 2002.⁷⁹

B. ECONOMIC EFFICIENCY AND TAX FLIGHT

The most obvious effect of tax flight, the decrease in revenues caused by erosion of the tax bases of flight jurisdictions,⁸⁰ is not the most economically harmful. As a practical matter, the lost revenue could, for example, easily be made up with higher rates. The economic distortions produced by those higher rates, along with the time, effort and money taxpayers devote to achieving tax flight, are much more important. Accordingly, the OECD cited economic efficiency as one of the principal justifications for its anti-tax haven initiative:

Globalisation has . . . had the negative effects of opening up new ways by which companies and individuals can minimise and avoid taxes and in which countries can exploit these new opportunities by developing tax policies aimed primarily at diverting financial and other geographically mobile capital. These actions induce potential distortions in the patterns of trade and investment and reduce global welfare.⁸¹

Tax flight, by definition, occurs when an individual or entity opens accounts or creates entities that, putting aside tax considerations, would not exist. Those accounts or entities would not otherwise exist because

74. 2000 OECD REPORT, *supra* note 72, ¶ 17, at 16.

75. *Id.* ¶ 21, at 19.

76. *Id.*

77. *Id.* ¶ 30, at 22.

78. “[T]he Committee has decided that commitments will be sought only with respect to the transparency and effective exchange of information criteria to determine which jurisdictions are considered as uncooperative tax havens.” 2001 OECD REPORT, *supra* note 67, ¶ 28, at 10.

79. JEFFREY OWENS, THE OECD WORK ON TAX HAVENS BOX 1, at 2 (2002), available at http://www.law.wayne.edu/mcintyre/text/Treaty_class/oecd_work_on_tax_havens.pdf.

80. See 1998 OECD REPORT, *supra* note 53, ¶ 23, at 14.

81. *Id.* While the quoted language identifies its concern as global welfare rather than global GDP, its references to diversions of capital and distortions of trade and investment clearly indicate that the OECD’s primary concern was with GDPs rather than broader measures of worldwide welfare.

the costs of creating, for instance, a bank account in a haven jurisdiction would be significantly greater than opening a comparable account closer to home. In other words, flight jurisdiction residents make decisions that, "absent tax considerations, would be very stupid."⁸² Those tax-driven choices, along with the higher tax rates and increased government borrowing tax flight necessitates, produce economic distortions that reduce the GDPs of flight jurisdictions.

For the OECD, the economic efficiency implications of tax flight provided both a normative rationale for their anti-tax haven initiative and a key reason the OECD believed the initiative would succeed. Eliminating tax flight would reduce economic inefficiency and boost GDPs within the OECD. That increase in welfare would allow flight jurisdictions to compensate tax havens for their welfare losses while remaining better off than they were. That economic efficiency has turned out to be insufficient to make cooperation commitments a success. Instead, the OECD initiative and the cooperation commitments the OECD sought from tax havens provoked an intense confrontation between tax havens and flight jurisdictions. The fact that the OECD initiative produced neither cooperation nor indifference but a hostile confrontation suggests that the philosopher king model does a very poor job of identifying the concerns that prompt governments to behave as they do.

C. THE POLITICS OF TAX FLIGHT

The negative impact of tax flight on global economic welfare is difficult to dispute.⁸³ Given that, what explains the failure of the OECD's

82. Tom Herman, *A Special Summary and Forecast of Federal and State Tax Developments*, WALL ST. J., Feb. 10, 1999, at A1. The same principle applies to tax shelters and international tax arbitrage. Michael Graetz has defined a tax shelter as "[a] deal done by very smart people that, absent tax considerations, would be very stupid." *Id.* International tax arbitrage occurs in situations in which all of the relevant jurisdictions have broadly similar tax systems. Even when two countries impose income taxes, if the details of the rules each jurisdiction applies to a person, entity or transaction are inconsistent, those inconsistencies can create significant gaps taxpayers can exploit to reduce their taxes. Those gaps can produce large amounts of potential revenue losses but are often so esoteric that few have either the inclination or knowledge to understand them. See H. David Rosenbloom, *International Tax Arbitrage and the "International Tax System"*, 53 TAX L. REV. 137, 142 (2000) (defining international tax arbitrage as "taking advantage of differences among country tax systems, usually differences in addressing a common tax question" and noting that "[w]hat is debt in Norway may be equity for us").

83. See Joel Slemrod & John D. Wilson, *Tax Competition with Parasitic Tax Havens* (Nat'l Bureau of Econ. Research, Working Paper No. 12225, 2006), available at http://gemini.econ.umd.edu/cgi-bin/conference/download.cgi?db_name=MIE2006&paper_id=97 (employing a model to predict that eliminating tax flight would increase welfare). Of course, difficult does not mean impossible. Some argue that tax flight keeps taxes, particularly taxes on capital, low and that those low tax rates are important to the efficiency and health of the global economy. See *supra* notes 54-56 and accompanying text.

cooperation commitments? The simplest answer is politics. Whatever benefits the development of the information infrastructure sought by the OECD might have had, the leaders and residents of tax havens made a decision not to deploy the resources necessary to create it.⁸⁴ At the same time, flight jurisdictions did themselves a disservice by failing to distinguish between money laundering and tax flight.

It is not surprising that tax havens would respond to the OECD's initiative with indifference or even skepticism.⁸⁵ However, what doomed the initiative was that skepticism blossomed into a conflict that had all the earmarks of a schoolyard brawl.⁸⁶ Flight jurisdictions essentially labeled tax havens cheaters⁸⁷ and havens denounced the OECD as bullies.⁸⁸ Philosopher kings, rationally working towards a solution that would provide net welfare benefits for each nation, were nowhere in sight.

84. Although tax havens' critics find it difficult to believe, the biggest obstacle to information exchange is not bank secrecy laws, *see infra* text accompanying notes 97–99, but the small public sectors of the non-European tax havens. To get a rough sense of the difference in size between the government of a typical tax haven and a typical flight jurisdiction one could compare the GDP of Greece, a mid-sized OECD nation (\$232.5 billion), to that of St. Lucia, a mid-sized tax haven (\$825 million). *See* U.S. Cent. Intelligence Agency, *The World Factbook: Field Listing—GDP*, <https://www.cia.gov/cia/publications/factbook/fields/2195.html> (last visited Apr. 1, 2007) (providing GDP data). Because tax havens are hundreds of times smaller than tax flight jurisdictions, it would not be unreasonable to conclude that their governments are also much smaller than those of tax flight jurisdictions. That conclusion is supported by the observation that tax havens tend to have governments that are slightly smaller as a percentage of GDP than nations that are not tax havens. Dhammika Dharmapala & James R. Hines Jr., *Which Countries Become Tax Havens?* 33 *tbl.2* (Nat'l Bureau of Econ. Research, Working Paper No. 12802, 2006) available at <http://ssrn.com/abstract=952721> (showing mean tax haven government expenditures of 26.77% of GDP as compared to a mean of 27.80% for all other nations).

85. One could easily draw a parallel between cooperation commitments and tax sparing provisions. Tax sparing provisions allow developed countries to subsidize investments in developing countries by permitting investors to treat unpaid taxes as paid for purposes of calculating foreign tax credits. Allison D. Christians, *Tax Treaties for Investment and Aid to Sub-Saharan Africa: A Case Study*, 71 *BROOK. L. REV.* 639, 692–93 (2005). Tax sparing provisions, like cooperation commitments, would have benefited one group of countries at the expense of the nation adopting tax sparing provisions, with a positive overall impact on global welfare. Some developed countries chose to adopt tax sparing provisions while others, including the United States, declined. *See id.* at 694.

86. *See* Alexander Townsend, Jr., Comment, *The Global Schoolyard Bully: The Organisation for Economic Co-Operation and Development's Coercive Efforts to Control Tax Competition*, 25 *FORDHAM INT'L L.J.* 215, 216 (2001) (comparing the OECD's effort to stifle tax competition to anticompetitive private sector behavior of Microsoft, AT&T and ALCOA).

87. *See, e.g.*, Michael Littlewood, *Tax Competition: Harmful to Whom?*, 26 *MICH. J. INT'L L.* 411, 439 (2004) (“There are good reasons for regarding tax havens as objectionable. In particular, they are commonly parasitical. They do not seek to attract real investment. Rather, they make themselves available as a means by which people and firms can escape the taxes they might otherwise have to pay in other countries.”); Julie Roin, *Competition and Evasion: Another Perspective on International Tax Competition*, 89 *GEO. L.J.* 543, 599 (2001) (referring to tax havens “‘poach[ing]’ on the tax bases of other countries”).

88. *See* Townsend, *supra* note 86.

It is not difficult to understand that tax havens are likely to be less concerned with the harmful effects of tax flight than flight jurisdictions are. The passion that tax flight elicits from both sides is harder to explain.⁸⁹ Part II.A.3.C attempts to make sense of the responses of tax havens and flight jurisdictions. It observes that flight jurisdictions inappropriately conflated tax flight with money laundering⁹⁰ while tax havens viewed the OECD's initiative as an assault on their sovereignty. As a result, flight jurisdictions and other critics of tax havens exhibited an unwarranted level of hostility towards tax havens while tax havens took an obstinate pride in being tax havens. The resulting polarization, with both flight jurisdictions and tax havens convinced that their irreconcilable positions were not merely justifiable but just, doomed the OECD's anti-tax haven initiative. It also makes it difficult to think of either tax havens or tax flight jurisdictions in philosopher king terms.

1. Tax Flight, Organized Crime and Money Laundering

While other high profile international tax issues such as international tax arbitrage have generated a significant amount of discussion in recent years,⁹¹ tax havens and tax flight are more likely to provoke anger than to produce debate. To understand the source of that hostility, it is helpful to recall the context in which tax havens first captured the public's attention.

In the 1960s, tax havens attracted the interest of flight jurisdictions, including the United States, not merely because they were being used to hide income, but also because of who was using tax havens to hide income. The United States responded with efforts like Operation Tradewinds. "[T]he IRS organized Operation Tradewinds in the late 1960s. The main targets were reputed mobsters such as Meyer Lansky"⁹² The involvement of prominent organized crime figures

89. International tax arbitrage, by contrast, is frequently perceived as relatively benign and not a cause for concern by nations other than the nation whose revenues it affects. See, e.g., Ring, *supra* note 8 (manuscript at 82–83) (suggesting that “the United States has no legitimate interest in whether and how much tax is paid to a foreign country”).

90. See, e.g., Roin, *supra* note 87, at 597 (“It is one thing to argue that a country should be able to use the tools at its disposal—tools that impose costs on the local population—to attract investment and tax revenues. It is another to attract investment (or *launder* the profits generated by investment elsewhere) by using tools that impose costs only on outsiders (including outside governments).” (emphasis added)). Money laundering refers to efforts to obscure links between cash and the criminal activity that generated it. Hiding profits from legal investments actually transforms “clean” money into “dirty” money—the very opposite of laundering.

91. See, e.g., Diane M. Ring, *One Nation Among Many: Policy Implications of Cross-Border Tax Arbitrage*, 44 B.C. L. REV. 79 (2002); Rosenbloom, *supra* note 82.

92. Tom Nicholson & Anthony Marro, *Probing the Tax Havens*, NEWSWEEK, June 28, 1976, at 50. After it learned that “certain organized crime figures were using foreign trust accounts . . . as part of attempts to evade U.S. taxation,” an I.R.S. office in Florida “commenced an information gathering project named ‘Operation Tradewinds,’ later named ‘Operation Haven.’” *Operations of the IRS*

acted as a catalyst for the creation of an aggressive anti-tax haven effort.

As a quintessential flight jurisdiction, the United States found itself struggling with an inability to catch and prosecute suspected tax cheats. U.S. citizens, some famous and others less so, opened accounts in a nearby tax haven, the Bahamas, in order to shield unreported income from U.S. tax authorities. The Bahamas, of course, imposed no taxes on income. Just as important, because it imposed no income tax it also had no system in place to gather the information on the activities of U.S. taxpayers necessary for the United States to impose its income tax. For U.S. authorities, the ability to punish U.S. citizens hiding money in the Bahamas became a matter of straightforward detective work.⁹³

Tax havens' reputations as jurisdictions in which organized crime figures hide their ill-gotten gains from authorities are, particularly as an historical matter, well deserved. However, as the OECD learned, the politics of tax flight is more complicated than the politics of money laundering.⁹⁴ In part, that is because not all of the assets hidden in tax havens are the proceeds of criminal enterprises.

(*Operation Tradewinds, Project Haven, and Narcotics Traffickers Tax Program*): *Oversight Hearings Before the H. Comm. on Government Operations*, 94th Cong. 122 (1975) (statement of Donald C. Alexander, I.R.S. Commissioner). The methods used to collect information included the infamous "briefcase incident," *id.*, at the center of a landmark Supreme Court Fourth Amendment case. *See United States v. Payner*, 447 U.S. 727 (1980).

93. Operation Tradewinds turned out to be a particularly colorful example of such an investigation. *See Payner*, 447 U.S. at 729–30 (describing the details of Operation Tradewinds). As the result of evidence obtained through a clandestine search of a briefcase while its owner was entertained by a private investigator, Jack Payner was convicted of tax evasion. *Id.* at 728–30. Unfortunately for Mr. Payner, although the search was found to be "flagrantly illegal," Mr. Payner's conviction was upheld. *Id.* at 729, 735.

94.

The OECD initiative against harmful tax practices . . . has undertaken to follow the [1989 Financial Action Task Force anti-money laundering] model of the blacklist in its approach to tax avoidance and evasion. However, avoidance and evasion do not bear the same stigma of criminality than [sic] money laundering and the OECD has met more resistance to its own set of blacklists and measures than it expected.

Marika Toumi, *Anti-Avoidance and Harmful Tax Competition: From Unilateral to Multilateral Strategies*, in *THE INTERNATIONAL TAX SYSTEM* 83, 87 (Andrew Lymer & John Hasseldine eds., 2002). One reason that the politics of tax flight are so complicated is that even within tax flight jurisdictions, tax flight implicates one of the most fiercely contested tax policy debates. For some conservatives, tax flight is viewed as essential to healthy "tax competition." *See, e.g.*, Daniel J. Mitchell, *A Tax Competition Primer: Why Tax Harmonization and Information Exchange Undermine America's Competitive Advantage in the Global Economy*, HERITAGE FOUNDATION, July 20, 2001, <http://author.heritage.org/Research/Taxes/BG1460.cfm> ("Tax competition promotes responsible tax policies. . . . Without competition, politicians can act like monopolists, free to impose excessive tax rates without fear of consequences."). That tax competition among jurisdictions, it is argued, is desirable because it limits governments' capacity to impose high taxes. *Id.* Because tax flight tends to involve highly mobile capital, tax competition creates disproportionate pressure on tax flight jurisdictions to lower taxes on income earned from capital. *Id.* If low taxes on capital income are appropriate, then fighting tax flight should not be a high priority.

Tax flight, as opposed to laundering income from drug smuggling or other illegal activities, is purely about taxes.⁹⁵ In other words, money laundering exists independent of tax rules and tax obligations, so that even in a world without income taxes, Meyer Lansky would still have a reason to hide his ill-gotten gains. Even thoughtful commentators sometimes muddy the distinction and lump tax flight together with money laundering.⁹⁶

Criticism of the impediments that bank secrecy poses for non-tax criminal investigations of organized crime figures often blends together with support of “proposals for the exchange of tax information”⁹⁷ intended to facilitate wholesale tax collection. By the same token, tax cheats are treated as though they were indistinguishable from gangsters. As a result, “restrictions on intergovernmental information exchanges”⁹⁸ are viewed as inherently corrupt and corrupting:

[B]ank secrecy laws and tax haven entities encourage corrupt administration and corrupt administrators. Most money laundering schemes require the cooperation of bank officials, customs officials, tax officials, business professionals, lawyers, and the like. Most are aware of the shady nature of their dealings, and ask for appropriate economic rewards. Further, some take advantage of the perilous legal position of their contacts to extort additional rewards; thieves cannot complain about the theft of ill-gotten gains. They may, however, resort to various forms of extra-legal sanctions which add to a general climate of lawlessness. Additionally, many of the corrupt administrators and politicians take advantage of the secrecy provisions to hide their own malfeasance.⁹⁹

Whether or not this is a fair characterization of the effects of money laundering, it seems unlikely to be true of tax flight. Although cheating on one's taxes is often a crime,¹⁰⁰ it is not the legal or moral equivalent of narcotics trafficking. While they may be dishonorable, it is difficult to picture many tax cheats resorting to extra-legal sanctions when they could either relocate their assets to another tax haven or, if pressed, simply stop cheating on their taxes. The failure to recognize the distinction between tax evasion and money laundering has made the anti-tax flight effort far more fraught than necessary.¹⁰¹

95. See Guttentag & Avi-Yonah, *supra* note 27, at 99 (distinguishing between “laundering funds earned in criminal activities” and “evading federal income taxes on funds earned legally”).

96. See *supra* note 90.

97. Roin, *supra* note 87, at 597.

98. *Id.*

99. *Id.* at 598–99 (citations omitted) (rejecting arguments that the failure to exchange tax information is justified on sovereignty grounds).

100. See I.R.C. § 7201 (2000) (making it a felony to “willfully . . . evade or defeat” federal taxes).

101. Treating tax flight as a moral, rather than economic, issue makes the possibility of using economic incentives to discourage tax flight seem both inappropriate, see *infra* text accompanying note

The OECD mistakenly assumed that tax flight was no different than money laundering as a political matter. It concluded that its anti-tax haven initiative would receive the same reception that an earlier anti-money laundering effort had received.¹⁰² To put it mildly, the OECD failed to appreciate how different the response to its anti-tax flight proposals would be.

2. *The Tax Haven Perspective*

Some of the reasons tax havens responded petulantly to the initiative are obvious. Particularly given the total amounts of tax revenues at stake, from the tax havens' perspective, the OECD's initiative had little to recommend it.¹⁰³ In addition, offshore finance, at least some of which is driven by tax flight, is a major industry for many tax havens. One can only imagine how the OECD would respond to tax havens if their situations were reversed.¹⁰⁴

Other causes might be less apparent to those unfamiliar with the history and politics of the jurisdictions the OECD identified as tax havens. Looking at those jurisdictions as a group reveals important

199, and likely to be ineffective. If we assume that tax cheats cannot balk if lawyers charge too high a price for their services because of their dubious moral status, tax havens will derive all of the benefit of tax flight and tax cheats will derive no part of the benefit. Even if that were true of money launderers, there is no reason to believe that tax flight is generally anything other than an economically motivated act. If tax havens "charge" tax evaders too high a price, they will either pay their taxes or find some other way of cheating. The conclusion that a typical tax cheat would employ extra-legal sanctions to avenge over-billing, rather than merely responding to economic incentives, seems odd.

102. See Toumi, *supra* note 94.

103. The total U.S. foreign aid budget is smaller than the \$50 billion in tax revenue lost to tax flight. See Press Release, Elizabeth Kelleher, Dep't of State, \$21 Billion in U.S. Foreign Aid Voted by House Subcommittee (May 19, 2006), <http://usinfo.state.gov/gi/Archive/2006/May/22-781014.html>. The only benefit a particularly cooperative haven might hope to receive would be an incremental increase in foreign aid. See, e.g., 2000 OECD REPORT, *supra* note 72, ¶ 26, at 20 (proposing that "bilateral assistance programmes can be re-targeted" for the benefit of cooperating tax havens); Roin, *supra* note 87, at 602 n.196 (suggesting the possibility of additional foreign aid for repentant tax havens). Even the most pro-tax haven proposals only suggest that flight jurisdictions help tax havens collect taxes from their own residents. See Marshall J. Langer, *The Outrageous History of Caribbean Tax Treaties with OECD Member States*, 26 TAX NOTES INT'L 1205, 1217 (2002). Langer correctly observes that tax havens have "[t]hus far been offered little or nothing." *Id.* His proposal would remedy that by coupling (i) "revenue sharing" modeled on the European Union savings directive approach that would entitle a tax haven to taxes paid by its residents with (ii) bilateral double tax treaties to reduce "confiscatory withholding taxes." *Id.*

104. Imagine that ten years from now, the United States has managed to replace its income tax with a national sales tax and that tax havens all enacted income taxes. Would the United States be willing to reconstitute the information reporting regime that it eliminated along with its income tax (the elimination of which produced much of the "simplification" generated by the elimination of the income tax) so that it could provide that information to the former havens (now flight jurisdictions)? In considering the answer to that question keep in mind that "[t]he United States, which has long taken the lead in attempts to encourage intergovernmental information exchanges, itself operates as a tax haven for foreigners because it exempts their portfolio interest income from source tax in such a way as to make residence taxation impossible." Roin, *supra* note 87, at 601 n.188.

differences between them and the OECD members. In comparison to OECD member nations, the tax havens that were the focus of the OECD's criticism are small countries.¹⁰⁵ In addition, many are either newly or only partly independent.¹⁰⁶ As a result, they tend to be extremely, and perhaps excessively, sensitive to perceived affronts to their sovereignty. That supporters of the initiative included former (and in some cases current¹⁰⁷) colonial rulers¹⁰⁸ of the nations targeted by the initiative reinforced a perception that the OECD effort represented an attempt by powerful nations to exert control over weaker nations. One official called the OECD initiative "the worst form of bullying by big, strong and powerful nations that the world has witnessed since the 19th Century."¹⁰⁹

It is not surprising that tax havens would perceive the OECD initiative as a threat to their sovereignty. For some tax havens, almost any issue can become a sovereignty issue. Even for tax havens that are formally independent nations, ties to the former metropolises play a role in important political debates that in other nations would be entirely domestic matters.¹¹⁰ Because of their small size and their proximity to much larger neighbors, nominal sovereignty has not always meant freedom from the influence of more powerful nations.

Often, those sovereignty objections mask a much more complex reality. Resistance to the OECD's anti-tax haven initiative strikes a political chord in tax havens by appealing to the pride of tax havens' residents despite the fact that it is far from correct to suggest that

105. See *supra* note 84.

106. Barbados, for example, achieved independence from the United Kingdom in 1966, while the Bahamas and Belize did so in 1973 and 1981, respectively. CIA, *The World Factbook*, Bahamas, <https://www.cia.gov/cia/publications/factbook/geos/bf.html> (last visited Apr. 1, 2007); CIA, *The World Factbook*, Barbados, <https://www.cia.gov/cia/publications/factbook/geos/bb.html> (last visited Apr. 1, 2007); CIA, *The World Factbook*, Belize, <https://www.cia.gov/cia/publications/factbook/geos/bh.html> (last visited Apr. 1, 2007).

107. For example, the Cayman Islands are currently a U.K. colony. CIA, *The World Factbook*, Cayman Islands, <https://www.cia.gov/cia/publications/factbook/geos/cj.html> (last visited Apr. 1, 2007).

108. See *supra* note 106.

109. Vaughn E. James, *Twenty-First Century Pirates of the Caribbean: How the Organization for Economic Cooperation and Development Robbed Fourteen Caricom Countries of their Tax and Economic Policy Sovereignty*, 34 U. MIAMI INTER-AM. L. REV. 1, 30 (2002) (quoting Ronald M. Sanders, Chief Foreign Affairs Representative with Ministerial Rank of Antigua and Barbuda, The OECD's "Harmful Tax Competition" Scheme: The Implications for Antigua and Barbuda, Address to the Luncheon Meeting of the Antigua and Barbuda Chamber of Commerce and Industry (Mar. 27, 2001), http://www.antigua-barbuda.com/business_politics/harmful_tax_competition.asp).

110. The already volatile debate over capital punishment in the Caribbean countries that are members of the British Commonwealth, including tax havens like the Bahamas, became entangled in questions of sovereignty when the Privy Council, serving as the highest appellate court, overturned death sentences imposed by local courts. See Joanna Harrington, *The Challenge to the Mandatory Death Penalty in the Commonwealth Caribbean*, 98 AM. J. INT'L L. 126, 126 (2004).

becoming a tax haven represented, or that remaining one represents, an expression of sovereign will. As both an historical and a practical matter, precisely the opposite is likely to be true.¹¹¹ The often antiquated tax regimes of tax havens that make tax flight possible (and information exchange impossible) reflect a relatively weak public sector¹¹² more than the ruthlessly efficient government-sponsored enterprise that tax havens' critics seem to envision.¹¹³ In many cases, the current tax regimes of tax havens are holdovers from the colonial era. In others, the tax systems are pared-down copies of another country's laws. Despite that, for the small and relatively weak tax havens, the opportunity to defy the will of an organization as powerful as the OECD has an appeal that is almost entirely independent of the merits of the overblown claims on which that defiance rests.

Although the impulse to view every issue in terms of sovereignty presumably also would have posed a problem for the anti-money laundering initiative on which the OECD's effort to combat tax flight was modeled,¹¹⁴ there is an important difference between them. Unlike money laundering, which is often a product of drug trafficking or worse, tax flight and tax evasion are ultimately no more than a matter of dollars and cents. It is easier to take pride in being a tax haven than in helping gangsters escape punishment.

It is important to understand how the OECD and tax havens came to have such different perceptions of the nature of the tax flight problem. Because tax havens have long been used by dangerous criminals to shield their activities from view, flight jurisdictions tend to lump tax flight together with money laundering. For tax havens, the notion that they would be asked to dedicate significant amounts of resources to help their wealthier and more powerful neighbors collect taxes and balance their

111. To the extent that tax havens' tax laws were not in fact the product of a local, democratic political process, it is difficult to see how they could be viewed as a badge of sovereignty. Those tax havens that retain tax systems introduced by their colonizers have not affirmatively chosen a tax system at all. Those that rely on a copy of another country's tax system have chosen a regime designed to satisfy another country's needs. Both approaches reflect the limits of tax havens' sovereign authority at least as much as they evidence the authority itself. One could discount the colonial origins of tax havens' tax systems, treating the choice to retain those taxes as a ratification. However, such a conclusion would only be justified if retaining those nineteenth century taxes in place of a comprehensive income tax represented a choice between two plausible alternatives. In light of their small size and relative lack of administrative capacity, there has never been any realistic possibility that tax havens would replace the colonial-era taxes with income taxes comparable to those of the much larger and more sophisticated OECD member countries.

112. See *supra* note 84.

113. See, e.g., Roin, *supra* note 87, at 602 n.196 (suggesting that tax haven governments are "training people how to launder money").

114. See Toumi, *supra* note 94.

books was perceived as, to say the least, provocative.¹¹⁵ Predictably, the small and often only recently or partially independent tax havens, many economically dependent on offshore finance, were not eager to join the OECD's efforts to combat tax flight.

D. THE FAILURE OF COOPERATION COMMITMENTS

The failure of cooperation commitments offers an opportunity to test the utility of the philosopher king model. It appears that the OECD designed its approach to secure cooperation from both tax flight jurisdictions and tax havens by harnessing the gains in global wealth that eliminating tax flight was expected to produce. Because cooperation commitments did not have a meaningful impact on tax flight, one of two things must be true. Either (i) the strong form of the philosopher king model fails to accurately describe the behavior of the relevant governments, or (ii) the model is sound but the net gains from cooperation were not enough to overcome the political inertia inhibiting cooperation. If the latter were true, one would have to conclude that intergovernmental cooperation is unlikely to ever eliminate tax flight. Cooperation commitments would represent the framework for a deal that is simply not worth the candle.

The alternative is that the philosopher king model is flawed. It is possible, for example, that the governments of tax havens and flight jurisdictions were never truly interested in bargaining over potential welfare gains that preventing tax flight would produce.¹¹⁶ Perhaps the governments of the nations involved were instead motivated by a desire to make "the general public . . . like [them] without the inconvenience (and possible political inconsequence) of having to benefit them tangibly"¹¹⁷ by taking politically expedient positions against cheating on the one hand and bullying on the other. If that were true, the failure of cooperation commitments would indicate very little about the possible welfare effects of eliminating tax flight.

Although such a scenario paints an unflattering portrait of both the governments of tax havens and flight jurisdictions, it actually would be good news. Because it suggests that governments are not necessarily intent on providing welfare gains to their respective nations, it may still be possible for intergovernmental cooperation to prevent tax flight. For example, if there were a way that the governments of tax flight

115. The extent to which tax havens found themselves demonized as parasites and poachers for not collecting income taxes or income tax information from nonresidents was undoubtedly unhelpful. See *supra* note 87.

116. Presumably, those gains amounted to less than the \$50 billion per year in tax revenues lost to tax flight.

117. Shaviro, *supra* note 32, at 8.

jurisdictions could persuade the general public to support an approach that did not benefit them tangibly, tax flight jurisdictions could be willing to pay tax havens more than 100% of the net GDP gains they would enjoy with the end of tax flight. Cooperation would still boost global GDP and the GDPs of tax havens, but the GDPs of flight jurisdictions would fall. It is certainly not what the strong form of the philosopher king model would suggest, but if the interests of political actors are not directly tied to national welfare (here measured in GDP terms), it may be possible for such a deal to be struck.

Looked at in a different way, the puzzle posed by the failure of cooperation commitments is that economic efficiency (and its promise of GDP gains for each participating nation) has not been enough to support cooperation between tax havens and tax flight jurisdictions even though that efficiency is widely viewed as the foundation on which the modern international tax regime was built.¹¹⁸ Part III begins the process of resolving that puzzle by examining the conventional account of the success of the double tax treaty. That success is generally credited to the impact of the bilateral double tax treaty on worldwide economic efficiency and its positive GDP effects for each treaty partner, a view that supports the strong form of the philosopher king model. The contrast of the double tax treaty's success against the failure of the OECD's cooperation commitments offers an opportunity to determine whether Hathaway's integrated theory is more helpful than the philosopher king model. If the integrated theory can explain the differing fortunes of bilateral double tax treaties and cooperation commitments, the integrated theory could guide the creation of an effective solution to the tax flight problem.

III. THE LESSONS OF THE DOUBLE TAX TREATY

The study of international tax is the study of conflicts. The fight over tax flight is unique among international tax conflicts primarily because it represents a struggle over tax systems (e.g., the sophisticated U.S. income tax versus a tax system with no income tax at all) that have so little in common. Most international tax conflicts arise between tax systems that are very similar.¹¹⁹ Even nations with much in common can find

118. Part IV applies Hathaway's integrated theory to this puzzle and concludes that economic efficiency only influenced tax havens via transnational collateral consequences. While those transnational collateral consequences were sufficient to cause tax havens to make cooperation commitments, those commitments have had little effect on tax flight. This is just what Hathaway predicts: "[C]ollateral consequences . . . can lead states to commit to treaties in order to obtain various material and nonmaterial benefits, but those same incentives do not always conduce to compliance." Hathaway, *supra* note 16, at 509.

119. See Brauner, *supra* note 9, at 290 ("In spite of some differences, most of the components of the current international tax regime are highly harmonized . . .").

themselves at odds over tax disputes that can be traced to subtle differences in their approach to taxing international income.¹²⁰ Those disputes prove the truth of the observation that “[d]espite many common features in our trading partners’ tax systems, the multitude of factors that produce tax law, including social policy, administrative constraints, and political compromise render conflicting rules a likely possibility.”¹²¹

Inter-jurisdictional conflicts create both opportunities and risks for taxpayers.¹²² International tax arbitrage and tax flight offer two examples of the ways in which taxpayers can benefit from conflicting rules. Double taxation has long been the principal danger for taxpayers. Double taxation occurs when two jurisdictions employ rules that cause both of them to impose a tax on the same economic income or activity. Even if both jurisdictions design their tax with the same objective in mind, such as fairness, failing to consider the other jurisdiction’s tax could cause the policy goals of both jurisdictions to be frustrated. In other words, the two tax burdens may together have an effect on taxpayers that neither jurisdiction foresaw.

Unlike tax flight, double taxation appears to have proven remarkably amenable to an international law solution. That solution, the bilateral double tax treaty, provides what has long been presumed to be a very successful example of the GDP-driven cooperation the strong form of the philosopher king model envisions. Those treaties are believed to be successful because they permit pairs of nations to improve the flow of capital across their borders, permitting investors to make more efficient decisions and increasing the GDPs of both treaty partners.¹²³

This Part argues that bilateral double tax treaties have proven more potent than the traditional explanation for their success can explain. It begins by considering weaknesses in the conventional account of the double tax treaty’s extraordinary success. That account overstates the efficiency impact of bilateral double tax treaties by discounting the effects of foreign tax credits. It also understates other factors that make bilateral double tax treaties attractive to governments.

120. See Rosenbloom, *supra* note 82, at 141–48.

121. Ring, *supra* note 91, at 81.

122. Those inconsistencies matter because taxpayers (and their capital) can cross borders with relative ease. In a sense, those tax conflicts are analogous to those that could be produced by the choice of driving on the left or right side of the street. There may be slight advantages to driving on a given side (say, if right-handed drivers drive more safely on the right side of the street). But so long as left-driving and right-driving vehicles find it more difficult to move from one jurisdiction to another than it is for capital to move around the globe, there will be relatively few accidents triggered by the differences among jurisdictions. Because taxpayers face little difficulty in moving assets around the globe, there is a significantly greater likelihood the equivalent of a left-driving car will find its way into a right-driving jurisdiction.

123. See *infra* text accompanying note 138.

Part III.D proposes an alternative explanation for the success of tax treaties that relies on the concepts employed by the integrated theory of international law. That alternative account focuses on the opportunities for legal enforcement and the powerful domestic collateral consequences that bilateral tax treaties create but that the philosopher king model ignores. The integrated theory provides an explanation for the contrast between the success of double tax treaties on the one hand and the failure of the OECD's cooperation commitments on the other that the philosopher king cannot.

A. DOUBLE TAXATION AND BILATERAL DOUBLE TAX TREATIES

This Subpart describes the two primary techniques used to eliminate double taxation. Double tax treaties are only one of a number of tools the United States and other jurisdictions use to reduce the risk that multiple jurisdictions will attempt to impose multiple taxes on the same income.¹²⁴ Although many other methods of mitigating the efficiency effects of double taxation are theoretically possible,¹²⁵ and although foreign tax credits had tamed the threat of double taxation as a practical matter decades before tax treaties began to proliferate, bilateral double tax treaties have become a ubiquitous feature of the international tax landscape.¹²⁶

The first affirmative step the United States took to reduce the burden of double taxation was not the double tax treaty, but the predecessor of today's foreign tax credit.¹²⁷ The credit allows U.S.

124. Statutory exclusions are one alternative to bilateral double tax treaties and foreign tax credits. See, e.g., I.R.C. §§ 893, 911 (2000) (providing for preferential exclusion treatment of income earned by employees of foreign governments and international organizations and of certain foreign income earned by U.S. citizens and residents, respectively).

125. For example, direct subsidies or penalties could be designed to encourage cross-border investment by countering the disincentive effects of double taxation.

126. The importance of double tax treaties in eliminating double taxation has long been overstated. In a sense, it is fortunate that double tax treaties are not essential to eliminating double taxation because double taxation is not a problem that is unique to the international context. Negotiating the relationship among different, potentially conflicting regimes drives some of the most important intra-jurisdictional tax policy debates. As a result, it is not surprising that the non-treaty techniques used to minimize conflicts between competing jurisdictions' tax regimes find analogues in the domestic context. The earned income tax credit, for example, has an effect that can be compared to the effect of the foreign tax credit. See I.R.C. § 32. Both work to soften the blow of having two taxes apply to the same income. In the case of the earned income tax credit, the two taxes are the social security payroll tax and the income tax. See Anne L. Alstott, *The Earned Income Tax Credit and the Limitations of Tax-Based Welfare Reform*, 108 HARV. L. REV. 533, 534 (1995) ("For many years, the EITC was a relatively small program, viewed principally as a means of offsetting the adverse distributional and incentive effects of federal income and payroll taxes on low-income workers.").

127. See generally Michael J. Graetz & Michael M. O'Hear, *The "Original Intent" of U.S. International Taxation*, 46 DUKE L.J. 1021, 1043-54 (describing the circumstances of the foreign tax credit's creation).

taxpayers earning income abroad to avoid being taxed on that income by both the United States and the foreign jurisdiction. The credit is necessary because the United States asserts taxing jurisdiction over the worldwide income of citizens and residents.¹²⁸ As a result, without the existence of the credit, a U.S. citizen or corporation earning foreign income and paying foreign tax on that income would also be subject to U.S. income tax on that non-U.S. income. The foreign tax credit allows U.S. citizens and residents to credit their foreign taxes paid on income generated outside the United States against their U.S. tax obligations.¹²⁹

A simple example illustrates the tax consequences of a foreign tax credit. Assume a U.S. taxpayer operates a business that derives a portion of its income in a foreign country that imposes an income tax. If the business earns \$100 in the foreign jurisdiction, that \$100 would, in absence of some corrective measure, be subject to tax in both the foreign jurisdiction and in the United States.¹³⁰ If a foreign tax credit is available (and the tax rates in both jurisdictions are similar), the U.S. tax will generally be reduced by one dollar for every dollar of foreign income taxes paid.

In terms of eliminating double taxation, bilateral double tax treaties produce essentially the same results as the foreign tax credit: one jurisdiction cedes taxing authority to another. However, important differences exist between the two methods. The most fundamental is that, rather than merely ceding the right to tax to any and all other jurisdictions, double tax treaties allow pairs of nations to openly negotiate for taxing rights.¹³¹ Another difference is the way in which they allocate tax revenues between jurisdictions.¹³²

128. *Cook v. Tait*, 265 U.S. 47, 56 (1924).

129. The foreign tax credit begins with a relatively simple premise and refines the application of that premise with a host of caveats and limitations. At its most basic level, the foreign tax credit allows U.S. taxpayers to reduce their U.S. tax obligations for every dollar of foreign tax paid. The amount of the credit is then limited in a number of ways. First, the taxes for which a credit is available must be an income, and not a sales or value added, tax. To ensure that the credit does not eliminate U.S. taxes on the taxpayer's U.S. source income, the amount of the credit is also adjusted to reflect the fraction of the taxpayer's income that is foreign (as a proportion of the taxpayer's worldwide income). See I.R.C. §§ 901-904 (2004).

130. Even without the foreign tax credit, the foreign taxes would be deductible for U.S. tax purposes. That deduction would ameliorate but not eliminate the problem of double taxation because, in contrast to the foreign tax credit, a deduction would not provide a dollar-for-dollar reduction in U.S. taxes.

131. See, e.g., Tsilly Dagan, *The Tax Treaties Myth*, 32 N.Y.U. J. INT'L L. & POL. 939, 980 (2000).

132. Although they both mitigate the risk of double taxation, the foreign tax credit works by eliminating the residence jurisdiction's tax while the treaty eliminates the source jurisdiction's tax. As a result, tax treaties produce a more favorable result for capital exporters, nations that send more capital overseas than they import, while foreign tax credits produce a more favorable result for capital importers. Dagan asserts that this difference is what explains the existence of tax treaties. She suggests that relatively wealthy capital exporting nations use tax treaties to gain an advantage over poorer,

Double tax treaties operate by limiting the circumstances in which, or the extent to which, one jurisdiction's taxes will apply to "qualified residents" of the other jurisdiction. They do not affirmatively impose taxes or create an alternative joint tax regime. They merely coordinate the operative provisions of each treaty partner's tax rules, offering a sort of ex post legislative history that explains how the two jurisdictions' rules should be harmonized.¹³³ Only by reading a tax treaty in conjunction with each nation's substantive rules is it possible to determine how much a taxpayer owes to each jurisdiction.

In the above example, a tax treaty might prevent the imposition of two taxes on the \$100 of income by limiting the ability of the foreign jurisdiction to impose any tax at all. If the business' presence in the foreign jurisdiction were modest, it might not have a "permanent establishment" in that jurisdiction. Pursuant to the terms of a double tax treaty, the foreign jurisdiction may have agreed only to tax foreign businesses that meet the permanent establishment threshold.

From a taxpayer's point of view, the key difference between bilateral double tax treaties and foreign tax credits is neither the fact that one mechanism is international law while the other is domestic nor the identity of the tax authority that receives their tax payments. Simply put, tax treaties provide taxpayers with a more favorable bottom line result than foreign tax credits do. That is because foreign tax credits do not ordinarily¹³⁴ apply unless duplicative income taxes actually would be imposed in the absence of the credit. As a result, foreign tax credits only ensure that a taxpayer will not be required to pay more than one tax. By contrast, tax treaties allow for double-dipping. In other words, in the not unlikely event that the U.S. taxpayer is eligible for favorable tax

capital importing nations by shifting tax revenues from source countries (where investments are made) to residence countries. *Id.* at 941. The obvious response to Dagan's thesis is that, while it offers a reason for wealthy nations to enter into tax treaties, it raises questions as to why poor countries would ever voluntarily enter into tax treaties. "Developing countries . . . have never been forced, nor have they claimed to have been forced, into concluding a bilateral treaty with a developed country. In fact, in many cases the developing countries wish to conclude treaties with the developed countries, which often reject their overture." Brauner, *supra* note 9, at 308.

133. For example, a typical double tax treaty will contain an article governing the taxation of interest. In the absence of a treaty, interest paid by a resident of one jurisdiction to a resident of another could be subject to tax in both. A modern tax treaty might cap the amount of tax imposed by the jurisdiction in which the interest is earned at a relatively low rate, such as 10%. See, e.g., A Revised Protocol Amending the 1980 Tax Convention With Canada, U.S.-Can., Art. 6, Apr. 24, 1995, S. Treaty Doc. No. 104-4 (1995) (reducing the applicable rate from 15% to 10%). The treaty would permit the taxpayer's residence jurisdiction to impose its normal rate of tax on the interest income. In addition, the treaty rate is only a ceiling. The source jurisdiction's domestic law may further reduce or even eliminate its tax.

134. The practice of allowing foreign tax credits in a residence country when a source country tax has not in fact been paid is referred to as tax sparing. See Christians, *supra* note 85.

treatment in the United States (e.g., accelerated depreciation), the taxpayer could see the size of his allowable foreign tax credit fall,¹³⁵ but the treaty-based exclusion will be the same even if no U.S. tax is paid.¹³⁶

B. DOUBLE TAX TREATIES AND THE STRONG FORM OF THE PHILOSOPHER KING MODEL

Tax treaties play a central role in the international tax regime. In the abstract, it is easy to see why. They allow pairs of nations to reduce the risk of inter-jurisdictional conflicts in much the same manner, and for the same reasons, that a single jurisdiction might remedy a purely internal statutory conflict.¹³⁷ To the extent they eliminate conflicts by preventing double taxation, they increase economic efficiency and boost GDPs by preventing anomalous tax results that could cause taxpayers to make rational, but socially suboptimal, choices. For example, the prospect of double taxation could cause a taxpayer to choose a less profitable domestic investment over a more lucrative foreign investment. Eliminating those distorting incentives clearly would be efficient. That view is nicely summarized by Dagan:

The prevailing view regarding tax treaties emphasizes their role as *the* indispensable mechanism for alleviating double taxation of international transactions. Policymakers assume that tax treaties benefit everyone involved. By reducing the burden of double taxation, the treaties facilitate the free movement of capital, goods, and services and help achieve allocational efficiencies. Although countries are required to forego potential tax revenues and although treaty negotiations are often quite cumbersome, tax treaties are perceived to be well worth the effort, because they allegedly provide significant benefits for all once they are implemented.¹³⁸

Such an explanation is entirely consistent with the philosopher king model of international tax.

135. See I.R.C. § 904(a) (2000) (imposing a limit on the amount of the foreign tax that may be credited against U.S. tax to an amount equal to the total amount of U.S. tax multiplied by the ratio of income earned in the foreign jurisdiction to worldwide income). As the amount of U.S. tax falls, the amount of foreign tax that can be credited currently will also fall.

136. That fortunate taxpayer, having eliminated (i) U.S. taxes by relying on favorable domestic law and (ii) foreign taxes by relying on the treaty will arguably be no better off from a U.S. tax point of view than a similar, but purely domestic, business (ignoring U.S. state and local taxes paid by the domestic business). However, it will certainly be better off than a business that earns foreign income in a non-treaty jurisdiction. That second business, owing no U.S. tax, will derive no benefit from the availability of foreign tax credits. In such situations double tax treaties produce double non-taxation while foreign tax credits preserve one tax. That double non-taxation could be viewed as a "tax expenditure" that is inconsistent with the basic rationale of double tax treaties.

137. Double tax treaties' coordinating role serves the same critical purpose as rules of priority within an individual tax system. See, e.g., I.R.C. § 1297(e) (granting priority to the controlled foreign corporation rules over the passive foreign investment company rules).

138. Dagan, *supra* note 131, at 939.

If tax treaties created large amounts of wealth by eliminating double taxation, that would explain why economically rational actors, each interested only in boosting its GDP, would enter into and comply with them. However, because foreign tax credits serve the same purpose, the efficiency benefits credited to tax treaties are largely illusory.¹³⁹ Dagan drives this point home by using game theory to demonstrate that countries will generally benefit by unilaterally eliminating double taxation using a mechanism like the foreign tax credit. Dagan's conclusion, borne out by the U.S. experience (i.e., the United States adopted the foreign tax credit regime decades before entering into its "early" tax treaties),¹⁴⁰ is that whatever purpose double tax treaties serve, that purpose must involve something other than merely eliminating double taxation.

That insight poses a profound challenge to the philosopher king model. If foreign tax credits could, and did, eliminate the threat of double taxation without help from tax treaties, then there must be another explanation for the success of tax treaties. Dagan suggests that tax treaties exist because they favor strong nations over weak ones.¹⁴¹ Even if that is true, it can only be part of the story. It does not explain why weak nations seem eager for treaties even when strong nations do not¹⁴² or why treaties appear to be most successful when treaty partners are highly similar.¹⁴³

Parts III.C and III.D attempt to make sense of the success of bilateral double tax treaties by exploring the implications of committing to and complying with those treaties. By relaxing the unrealistic assumptions of the strong form of the philosopher king model, the remainder of this Part opens the door to the possibility that national governments might enter into tax treaties either to advance legitimate national interests other than boosting their GDPs or to advance the interests of influential domestic constituencies. Those motivations could explain why tax treaties exist even though their contribution to economic efficiency is limited. More importantly, it would offer an explanation for the failure of economically efficient international tax policy proposals like the OECD's cooperation commitments.

139. Foreign tax credits would not provide all of the efficiencies produced by treaties. They would not, for example, reduce administrative burdens in the same way a treaty might. See *supra* text accompanying note 33.

140. See *infra* note 150 and accompanying text.

141. See Dagan, *supra* note 131.

142. See *id.*

143. See, e.g., Christians, *supra* note 85, at 641 ("[T]here are currently no treaties in force between the U.S. and any of the LDCs in Sub-Saharan Africa.").

C. DOUBLE TAX TREATIES AND THE WEAK FORM OF THE PHILOSOPHER KING MODEL

If the strong form of the philosopher king model, with its emphasis on mutual GDP gains, explained the existence of the bilateral treaties that form the core of the international tax regime, the OECD's cooperation commitments should have been more successful. Conversely, if the strong form of the philosopher king model does not provide a satisfying account of the success of the bilateral double tax treaty, the failure of cooperation commitments is less surprising. This Subpart takes as its premise that, as is widely accepted in the domestic context, governments often act in ways that have either an ambiguous or even a negative effect on GDP.¹⁴⁴ It assumes that the promise of economic efficiency alone cannot be relied on to spur governments into action and that, in some cases, economic efficiency is not even necessary for cooperation to be effective. It then considers other factors that could help to explain why bilateral double tax treaties have been so successful.

For instance, the same political dynamics that have long been recognized in the domestic tax policy context offer a relatively straightforward explanation for why tax treaties persist and proliferate. Because tax treaties provide valuable benefits to a limited number of taxpayers, those taxpayers can be expected to exert influence on government decisionmakers that is unlikely to be counterbalanced by significant opposition.¹⁴⁵ When bilateral double tax treaties allow taxpayers to reduce their tax liability below the equivalent of a single jurisdiction collecting tax at the prevailing rate, those tax treaties no longer simply resolve an international tax conflict but act as a "tax expenditure" subsidy for cross-border investment.¹⁴⁶ That subsidy may have either no effect or even a negative effect on GDP (especially when compared to other available tax or spending options) without reducing the support it receives from the taxpayers benefiting from the subsidy.

Another possible catalyst for the success of the double tax treaty could be the unique historical circumstances in which they were

144. For example, nations sometimes specifically enact tax rules to give them an advantage in future treaty negotiations. As a result,

the tax treaty route [becomes] self-perpetuating. Treaties are a one-way street; they lead only to more treaties. . . . One state will introduce a crazy tax system with the knowledge that other countries will come running to its door asking for a treaty in familiar form, which it will willingly give the other state, subject, of course, to some concessions on the part of the other state, which it does not mind giving because its system was designed to allow for this.

Jones, *supra* note 5, at 3.

145. To the extent bilateral double tax treaties represent a zero-sum benefit to some taxpayers at the expense of all other taxpayers, public choice theory suggests that the interests of the few will win out. See Shaviro, *supra* note 32, at 6–7.

146. See *supra* note 136.

developed and ultimately took root. Like many of the most important characteristics of current U.S. domestic tax law, the two central features of the international tax regime—the foreign tax credit and the bilateral double tax treaty—owe their existence to the World Wars. The link between the World Wars and the expansion of the role of the U.S. income tax is widely acknowledged.¹⁴⁷ Their successive revenue demands transformed the U.S. income tax first into a significant, but limited, tax on a relatively small number of high-income taxpayers and ultimately into a mass tax. The relationship between World War I and the development of the international tax regime is less direct. The foreign tax credit and the bilateral tax treaty were each conceived as a means of ameliorating the impact of the higher taxes prompted by the exigencies of the war.

Persistently high post-World War I tax rates¹⁴⁸ presented a new reality for U.S. investors and businesses. Those relatively high tax rates made double taxation a much greater threat than it might have been in a lower rate environment. For U.S. taxpayers, understandably concerned with their own bottom line, that double taxation would have made otherwise appealing investments in post-war Europe unprofitable. Because private U.S. investment in Europe was crucial to post-war stability and prosperity, double taxation represented a direct threat to the nation's security interests.¹⁴⁹

The first policy response to the concern that double taxation would impede private investment in Europe was the foreign tax credit.¹⁵⁰ Undoubtedly, the tax policy experts that designed and supported the credit believed the credit to be sound tax policy,¹⁵¹ rather than merely a subsidy designed to serve the nation's foreign policy goals and to appeal to politically influential business interests. Nevertheless, without the support of the business community that stood to benefit from the creation of the credit, the political fortunes of the credit might have been very different.¹⁵² That support, combined with understandable concern

147. It has been noted that the creation of the modern income tax and its expansion into a mass tax coincided with, and can be viewed as a product of, the first and second world wars. *See, e.g.,* Anne Alstott & Benjamin Novick, *War, Taxes, and Income Redistribution in the Twenties: The 1924 Veterans' Bonus and the Defeat of the Mellon Plan* 1 (Yale Law Sch. Pub. Law & Legal Theory Research Paper Series, Paper No. 109, 2006), available at <http://ssrn.com/abstract=877397>.

148. *Id.*

149. *See* Graetz & O'Hear, *supra* note 127, at 1052–53 (“[I]f Europe was going to get the dollars necessary for the repayment of its debts, the purchase of American exports, and the economic stability necessary for peace, the source would have to be private investment.”).

150. *Id.* at 1051–54.

151. Fairness, rather than efficiency, was the normative goal the tax credit's creator intended the credit to serve. *Id.* at 1047 (“At bottom, Adams [the designer of the foreign tax credit] objected to double taxation because it offended his sense of fairness.”).

152. “To Adams' surprise, the FTC provoked little opposition (or indeed notice) and became law

for the stability of the post-war political environment, saved the foreign tax credit from becoming just another good idea without prospects.

Bilateral tax treaties emerged, albeit more slowly, in response to the same concerns that produced the foreign tax credit. The development of the modern bilateral income tax treaty came in response to a call in 1920 by the Financial Committee of the League of Nations for a new method for reducing the threat of double taxation.¹⁵³ The League, created in the wake of World War I, represented an effort to combat the risk of future conflict by fostering increased interdependence among nations. The League chose to use formal international institutions that would permit nations “to conduct their foreign policies through certain machinery, in certain conferences, and on the basis of certain obligations providing for international co-operation and peaceful settlement of disputes.”¹⁵⁴

Tax treaties served the League’s goal of building stronger ties between nations through their form and through their function. By acting as a bulwark against double taxation, which would have inhibited international trade and investment, double tax treaties secured economic links between treaty partners. That effect on private cross-border interaction generally mirrors the effect of foreign tax credits.¹⁵⁵ Just as importantly, double tax treaties work through diplomatic channels, developing formal relationships at the governmental level at the same time they encourage private cross-border activity.

The study conducted at the League’s request eventually, and indirectly, resulted in the 1928 creation of a model treaty that became the “framework” for the early U.S. and European bilateral tax treaties.¹⁵⁶ The current U.S. model treaty is generations removed from the 1928 League model, but the fundamental features of that model persist. Although both the wisdom and the necessity of this type of treaty remains the subject of vigorous discussion,¹⁵⁷ treaties based on the

in 1919.” *Id.* It is not too great a stretch to assume that the foreign tax credit would have attracted more (negative) attention had its benefits been diffuse and its costs concentrated, rather than the reverse.

153. H. David Rosenbloom & Stanley I. Langbein, *United States Tax Treaty Policy: An Overview*, 19 COLUM. J. TRANSNAT’L L. 359, 361 (1981). More recent scholarship has provided a richer account of the origins of the modern bilateral double tax treaty. See Graetz & O’Hear, *supra* note 127, at 1066–89.

154. C. HOWARD-ELLIS, *THE ORIGIN, STRUCTURE & WORKING OF THE LEAGUE OF NATIONS* 58 (The Lawbook Exchange 2003) (1929).

155. Double tax treaties arguably have a greater impact than foreign tax credits. To the extent that double tax treaties can produce more favorable results with respect to cross-border investments than foreign tax credits, they effectively provide a bigger subsidy for cross-border investment.

156. Rosenbloom & Langbein, *supra* note 153, at 365. *But see* Graetz & O’Hear, *supra* note 127, at 1079 (“[T]o characterize the 1923 Report as the fountainhead of tax treaties is to miss much of the story.”).

157. See, e.g., Dagan, *supra* note 131, at 947–52 (using game theory to demonstrate that bilateral tax treaties are not necessary for the avoidance of double taxation); Jones, *supra* note 5, at 6–8

principles developed in response to the League's initiative form an essential part of the international tax regime. Is it just coincidence that tax treaties served the League's purposes through their diplomatic nature as well as their substantive effect? Although that is possible, and even if the creators of the treaty merely stumbled on a form that was highly suited to the League's goals, one can reasonably assume that a form that would have produced identical increases in GDP, without the same diplomatic benefits,¹⁵⁸ would have received a cooler welcome.

Bilateral double tax treaties were designed in the post-World War I environment to advance important public interests that the strong form of the philosopher king model would essentially ignore. Arguably, those are also the reasons that they became increasingly popular over the course of the twentieth century, particularly after World War II.¹⁵⁹ The urgency of building strong diplomatic ties between the United States and the rest of the world would have been at least as great following the second World War as it was after the first.¹⁶⁰ Tax treaties remained a relatively anodyne method of building diplomatic ties.¹⁶¹ Although the diplomatic benefits bilateral double tax treaties offer are not typically the focus of tax scholars attempting to explain the proliferation of double tax treaties, it is not unreasonable to think that they played an important part in the story. However, because the risk of war may not have a significant effect on GDP, the strong form of the philosopher king model might ignore, or understate the importance of, the double tax treaty's capacity to limit the risk of future combat. The weak form, looking beyond narrow measures of welfare, would do a better job of reflecting whatever value individuals assign to the reduced risk.

The weak form of the philosopher king model recognizes a broader range of social welfare benefits than the strong form, but neither form would reliably account for the double tax treaty's subsidy effect. Although it is possible that subsidizing international transactions provides the largest welfare increase among the available tax and spending alternatives, as with any subsidy (or any tax expenditure) it is also possible that it will not. Only in the event that the double tax treaty's

(considering alternatives to bilateral double tax treaties, including multilateral treaties).

158. One example of such an approach is the statutory reciprocal exemptions for shipping profits provided by statute. See I.R.C. §§ 872(b)(1), 883(a)(1) (2000).

159. See Rosenbloom & Langbein, *supra* note 153, at 375–77 (noting that only three “early” treaties with France, Sweden and Canada were entered into in the late 1930s and early 1940s and that the bulk of the U.S. tax treaty network evolved after 1945).

160. See Graetz, *supra* note 28, at 1407–08 (noting that U.S. post-World War II tax policy was designed “not only to stimulate economic development in countries devastated by the war, but also to spread capitalism and democracy through economic interdependencies and political alliances”).

161. See *id.* at 1409–10 (suggesting that the United States may be able to pursue foreign policy goals less obtrusively using tax policy than more direct measures such as foreign aid).

subsidy effect has a uniquely strong positive impact on welfare would the philosopher king model reflect the eagerness taxpayers can be expected to exhibit for that subsidy. If the subsidy has a negative effect on welfare, the philosopher king model would draw precisely the wrong conclusion regarding the effect of the subsidy on the political viability of double tax treaties. By drawing strong support from beneficiaries and little antipathy from others,¹⁶² that subsidy could enhance the double tax treaty's political fortunes while reducing national welfare.

D. AN INTEGRATED ANALYSIS OF BILATERAL DOUBLE TAX TREATIES

One reason the philosopher king model has survived longer in the international context than it did domestically is the dearth of alternatives. Even though the philosopher king model is flawed, it does offer an objective method of evaluating tax policies. For example, although both the strong and the weak forms of the model may fail to provide a realistic assessment of the interest taxpayers (and the governments that serve them) will show with respect to a given tax rule, applying even the strong form of the model will, at a minimum, reveal whether the rule will generate economic surpluses that might indirectly be used to generate political support. Over the past few years, additional alternatives have become available as international law scholars, incorporating key insights from the political science literature, have constructed new models that attempt to make sense of what might otherwise appear to be hopelessly irrational government behavior in the context of international cooperation.¹⁶³

Hathaway's integrated theory attempts to provide a more complete model of state action with regard to international agreements. Like the weak form of the philosopher king model, the integrated theory takes account of considerations beyond measures of economic efficiency such as GDP. However, unlike both variations of the philosopher king model, it does not make implicit assumptions about the motivations of governments.¹⁶⁴ Instead, it identifies and sorts the wide range of

162. See *supra* note 145.

163. See, e.g., Claire R. Kelly, *Realist Theory and Real Constraints*, 44 VA. J. INT'L L. 545, 574 (2004). Kelly tackles the puzzle of why nations would voluntarily cooperate via international legal regimes when those regimes force them to take actions that leave them worse off (what Professor Kelly calls the hard cases). She explains that the most effective international law regimes, constraining institutions, make the act of cooperation itself valuable. Because a nation expects to derive future benefits from its membership in the regime that are greater than the cost of the action in question, the regime "may increase the cost of non-compliance to the point where, even in the hard cases, it will be in the powerful nation's interests to comply with the regime rules." *Id.*

164. The philosopher king model assumes that governments always act to maximize the collective well-being of the nation, ignoring, for example, the possibility that a well-organized minority could persuade government actors to provide them with valuable benefits at the expense of the general public.

considerations that are likely to affect a government's decision to commit to and comply with international agreements according to two criteria. First, those consequences that are explicitly provided for in the agreement are distinguished from consequences that are indirectly produced by the success or failure of the agreement.¹⁶⁵ The outcomes specified by the terms of the agreement are considered to be the product of "legal enforcement" while others are "collateral consequences."¹⁶⁶ Second, the effects generated either directly or indirectly by an agreement are identified based on the location of the actor or actors, either domestic or transnational, whose agency triggers those consequences.¹⁶⁷ Those two criteria produce four factors that weigh on a nation's decisions with respect to international agreements: domestic legal enforcement, domestic collateral consequences, transnational legal enforcement, and transnational collateral consequences.¹⁶⁸

For example, one could evaluate a proposed free trade agreement using the integrated theory. The strong form of the philosopher king model would simply predict that governments will accept the trade agreement in order to boost their respective GDPs. The integrated theory would paint a different, arguably more complete, picture of the factors that will influence each government's decision-making process. For each government, the domestic collateral consequences of entering into the agreement could include (i) negative responses from businesses that would benefit from being protected from foreign competition, (ii) positive responses from businesses that would gain from unfettered access to foreign markets, and (iii) the positive response of the general public to the lower prices and greater choice that the agreement would produce. Transnational collateral consequences would not only mirror the responses of those domestic interests (i.e., with foreign interests lobbying that government, to the extent permitted under domestic law, for and against the agreement for the same reasons as their domestic counterparts) but also would encompass the benefits of being viewed as an upstanding member of the international community. If the agreement clearly articulated the obligations of each nation and also specified the sanctions to be imposed for failing to meet those obligations, the agreement would make legal enforcement by domestic or transnational actors a relatively straightforward matter.¹⁶⁹

165. Hathaway, *supra* note 16, at 492.

166. *Id.* at 473.

167. *Id.*

168. *Id.* at 473 & tbl.1.

169. Significantly, the integrated theory would separate the normative question of whether free trade is beneficial from "the positive question" of whether the agreement in question in fact will result in freer trade. If the agreement produces more political costs than benefits for the government (even if

Because they provide a more complete picture than the strong form of the philosopher king model and, to a lesser degree, the weak form, these four factors create a framework that can be used to isolate the advantages double tax treaties enjoy over the foreign tax credit-based system of double tax relief that preceded it. As a result, the integrated theory offers an explanation for the otherwise puzzling emergence and persistence of a second anti-double tax regime well after the first had taken root. As described in greater detail in the remainder of this Subpart, those advantages consist of both domestic and transnational collateral consequences and transnational legal enforcement. From the perspective of a government considering entering into a double tax treaty, the domestic collateral consequences are primarily a function of their subsidy effect (i.e., the tax benefits a treaty offers to specific taxpayers vis-à-vis foreign tax credits).¹⁷⁰ Because a bilateral tax treaty would produce a comparable subsidy for residents of the treaty partner, transnational collateral consequences would also be a factor. Lastly, because tax treaties formally tie the favorable treatment each nation provides to the maintenance of reciprocal benefits, they create a transnational legal enforcement mechanism that foreign tax credits do not.

Insisting, as the philosopher king model does, that governments only respond to potential improvements in the nation's welfare, tends to mask the significance of the collateral consequences that are critical to the success of bilateral tax treaties. Even though those treaties reduce the taxes each nation imposes on the citizens and residents of its treaty partner rather than on its own residents (i.e., treaties generally only limit the taxation of non-resident taxpayers), the treaties' reciprocal nature ensures that the ultimate effect is the same as an ordinary tax cut. Each treaty partner sacrifices revenue and, as a result, taxpayers in both jurisdictions face a reduced tax burden. Assuming both treaty partners are roughly comparable in size and level of economic development, the amount of the (private) reduction in taxes each country experiences should be about the same as the (public) decline in tax revenues produced by the existence of the treaty. Unless the particular tax cut in question has clear social utility, a philosopher king would be indifferent to it. In other words, the enthusiasm of the philosopher king for a tax burden on his subjects that is \$x lower should be entirely offset by the \$x decline in tax revenues the treaty produces for his treasury.

Obviously, tax cuts can be politically appealing even when taxpayer

the agreement has the potential to increase welfare), the agreement is unlikely to receive its support. As a result, the agreement will fail and will not in fact produce freer trade.

170. See *supra* note 133 and accompanying text.

gains are fully offset by government revenue losses. That political appeal is often a product of their distributional effects. If the costs of the revenue decline are widely dispersed while the benefits are concentrated in the hands of a relatively small number of taxpayers, the tax cut may generate more political support than opposition.¹⁷¹ Moreover, to the extent that tax treaties permit a subset¹⁷² of taxpayers to capture most of the tax reductions they offer, politicians may be able to translate support for tax treaties into substantial political contributions. Those political advantages represent collateral consequences, providing a powerful incentive for politicians and governments to support tax treaties. Because some taxpayers in both treaty jurisdictions will enjoy the distributional advantages of tax treaties, each nation will face both domestic and transnational collateral consequences that will encourage them to enter into bilateral tax treaties and to live up to their treaty obligations.

Another advantage bilateral tax treaties enjoy over the older foreign tax credit regime, but that the philosopher king model would tend to overlook, is that because they represent “hard” rather than “soft” international law,¹⁷³ they provide for more effective transnational legal enforcement. In contrast to the informal arrangement pursuant to which nations adopted the U.S. foreign tax credit approach to eliminating double taxation,¹⁷⁴ tax treaties are a textbook example of hard law. Bilateral tax treaties create precisely articulated obligations. As a result, it is reasonably clear when a treaty partner is, or is not, living up to the terms of its bargain. In addition, bilateral tax treaties allow a treaty partner to easily sanction defections by withholding reciprocal benefits. Taxpayers play an important part in the enforcement process by drawing attention to those defections.¹⁷⁵ This entire process is facilitated by the existence of the special administrative bureaucracy created to enforce

171. The classic example of this is the “useless military base.” See Shaviro, *supra* note 32, at 40 (noting that members of a congressional district may be able to exploit information asymmetries and collective action advantages to secure the creation of an inefficient military base in their district). It has been suggested that the estate tax repeal effort offers a contemporary illustration of the same phenomenon. See *supra* note 31 and accompanying text.

172. The tax benefits provided by tax treaties will always be enjoyed by less than all taxpayers because not every taxpayer will engage in cross-border activity. The degree of concentration will vary from country to country. In a country in which wealth is relatively concentrated, as is often the case in developing countries, the distributional effect of tax treaties will be exacerbated.

173. The efficacy of legal enforcement is dependent on the degree to which it represents “hard” rather than “soft” law. Hard law is distinguished by a high degree of obligation, precision and delegation. See Kelly, *supra* note 163, at 576–77.

174. See Reuven S. Avi-Yonah, *International Tax as International Law*, 57 TAX L. REV. 483, 500 (2005) (“Countries . . . generally grant either an exemption for foreign source income or a credit for foreign taxes paid . . . even in the absence of a treaty.”).

175. By asserting claims that they have been denied treaty benefits, particularly if they do so through the competent authority regime, taxpayers act as whistleblowers. As a result, treaty partners do not need to actively monitor each other’s compliance.

each treaty, known as a competent authority regime.¹⁷⁶ In effect, treaty partners understand that defections are likely to be detected and the consequences of defecting are likely to be unambiguous.

Hathaway's collateral consequences and legal enforcement offer insights into the success of bilateral double tax treaties that the philosopher king model cannot. The integrated theory acknowledges the relevance of benefits enjoyed by some groups at the expense of others, such as the double tax treaty's subsidy effect, and of the double tax treaty's status as hard law. Because of that, the integrated theory is more helpful than the philosopher king model in explaining why double tax treaties became such an essential part of the international tax regime even though foreign tax credits predate modern tax treaties by several decades and continue to serve the same basic function as double tax treaties. That capacity to distinguish between normatively interchangeable tax rules and to determine whether one is more likely than the other to achieve their shared objective could have broad application in the international tax policy context. Part IV tests that hypothesis by using the integrated theory to compare three different mechanisms for combating tax flight.

IV. TOWARDS A MORE EFFECTIVE SOLUTION TO THE TAX HAVEN PROBLEM

The OECD's cooperation commitments have done little to reduce tax flight. Fortunately, that is not because international tax cooperation is inherently ineffective. Bilateral double tax treaties offer compelling evidence that such cooperation can work. Until now, however, the dynamics that have made double tax treaties so effective have been obscured by reliance on the strong form of the philosopher king model and its conclusion that the secret of their success is their positive impact on GDPs.

Part III illustrated how the philosopher king's shortcomings can produce inaccurate conclusions regarding the success of international tax cooperation. This Part builds on that analysis by introducing two alternatives to the OECD's approach to combating tax flight and comparing their prospects for success in actually reducing tax flight. It concludes that the solution with the greatest chance of success is the one that would fare the worst under a philosopher king analysis.

The first alternative it presents is Reuven Avi-Yonah's withholding tax proposal, a solution that offered tax flight jurisdictions an opportunity to reduce tax flight without help from tax havens. It then

176. See Rosenbloom & Langbein, *supra* note 153, at 403-04 (describing the role of competent authorities).

briefly describes an original proposal that the integrated theory suggests could be more effective than either the withholding tax proposal or the OECD's cooperation commitments. The third possibility, the tax flight treaty, would involve a quid pro quo exchange between flight jurisdictions and tax havens. Like the private collection agencies the I.R.S. has hired to enforce small tax debts,¹⁷⁷ tax havens would provide enforcement assistance in exchange for a stake in the increased revenues enjoyed by flight jurisdictions as a result of that assistance.

In a sense, tax flight treaties would operate like a rule that allows an individual to pay a neighbor to stop generating a nuisance.¹⁷⁸ Under such a nuisance regime, "victims" of pollution may view themselves as worse off than if the relevant government were simply to adopt a favorable regulatory regime. They might, for example, pay \$100 to eliminate pollution that deprives them of \$150 of well-being, yet still resent being \$100 poorer than they would have been had pollution been prohibited outright. A tax flight treaty would present what might appear to be an even less appetizing prospect for a tax flight jurisdiction. Because it is almost certainly true that flight jurisdictions would be required to pay tax havens an amount larger than the increase in well-being they, as nations, would derive from the elimination of tax flight (the equivalent of being asked to pay \$200 to eliminate a \$150 harm), the philosopher king model would suggest that tax flight treaties simply would not work.

In pure GDP terms, the amounts of the payments to tax havens would likely be greater than the benefits flight jurisdictions would enjoy as a result of the elimination of the economic distortions produced by tax flight.¹⁷⁹ As a result, the GDP of participating flight jurisdictions would

177. See David Cay Johnston, *I.R.S. Enlists Outside Help in Collecting Delinquent Taxes, Despite the Higher Costs*, N.Y. TIMES, Aug. 20, 2006, at A12. Both the privatization of tax debt collection and tax flight treaties could be compared to the deeply unpopular institution of tax farming: the historic practice of selling the right to collect tax to private parties. See ADAMS, *supra* note 10, at 40-41 (describing the process by which taxing rights were auctioned off to private parties in old-testament-era Palestine and Syria).

178. This payment would be consistent with Calabresi and Melamed's observation that, just as polluters can acquire the right to pollute from victims of pollution, victims of pollution can acquire the right to be free of pollution by paying polluters to cease polluting. It assumes that tax havens start with the entitlement to "pollute" the international tax regime with tax flight by not maintaining a comprehensive income tax. Because there is no central authority capable of limiting tax havens' entitlement to a liability rule, that entitlement in effect is protected under a property regime. Fortunately, because there are at most dozens, rather than thousands, of tax havens in existence, the transaction costs of creating tax flight treaties would be relatively low and a rule three solution would be practicable. Cf. Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089, 1115-19 (1972).

179. Avi-Yonah appears to conclude that the efficiency gains attributable to eliminating tax flight would be substantial. See Avi-Yonah, *supra* note 25, at 1616 (concluding that the deadweight losses associated with the "undertaxation of cross-border capital flows" are at least large enough to offset gains attributable to the beneficial effects of tax competition). Still, it is doubtful that those efficiency

be lower with a tax flight treaty than without. If the strong form of the model were accurate, tax flight jurisdictions would therefore reject tax flight treaties. Likewise, unless it were to exclude the welfare decline suffered by tax cheats,¹⁸⁰ the weak form of the philosopher king model would also suggest tax flight jurisdictions would turn up their noses at tax flight treaties. Nevertheless, if the governments of flight jurisdictions are motivated by considerations other than increasing national welfare (such as a desire to attract votes by giving law-abiding taxpayers a benefit at the expense of tax cheats or even at the expense of the nation as a whole)¹⁸¹ tax flight treaties could still succeed in reducing tax flight.

The large outflow of cash a tax flight treaty would produce would in all likelihood reduce the GDP and the collective well-being of each participating flight jurisdiction.¹⁸² More important, however, is that tax flight treaties would produce both winners and losers within each individual tax flight jurisdiction. The big losers would be tax cheats. Excluding tax cheats, flight jurisdictions would actually be left better off by virtually any measure of collective well-being.¹⁸³ Given the enormous amount of tax revenue that is lost each year to tax flight,¹⁸⁴ if flight jurisdictions are in fact prepared to see “their” tax cheats suffer, flight jurisdictions could easily afford to pay tax havens considerable sums of money.

Like Avi-Yonah’s withholding tax proposal, tax flight treaties would produce more potent collateral consequences than the OECD’s cooperation commitments. In addition, well-designed tax flight treaties

gains rival the estimated \$100 billion or more in annual revenue losses attributable to tax flight. See *supra* note 27.

180. Those tax cheats are citizens or residents of tax flight jurisdictions. Just as their market activity would count towards the nation’s GDP, the satisfaction they derive from cheating on their taxes would make up a portion of the nation’s welfare. Taking money from them and paying a portion of it to tax havens would not only decrease the flight jurisdiction’s GDP, but also the aggregate well-being of all of its citizens and residents. Disregarding their well-being would require determining the well-being of a group smaller than that of the nation as a whole, which the philosopher king model does not contemplate.

181. A generous view of such an action might conclude that the government would necessarily make the nation better off by punishing tax cheats. However, that would only be true if the suffering of tax cheats were outweighed by the benefits of sanctioning them. Even if the nation’s well-being was reduced in aggregate terms, the shift in well-being from cheaters to non-cheaters using the leaky bucket of a tax flight treaty could still generate positive political consequences.

182. How much a tax flight jurisdiction would pay would be determined by negotiation. In the case of the United States the aggregate amount would be something less than \$50 billion per year and greater than the out-of-pocket costs for the tax havens.

183. The law-abiding residents of flight jurisdictions would be materially better off because they would either enjoy additional government services or a reduced tax burden. In addition, if they value fairness, they will derive satisfaction from seeing would-be tax cheats pay their rightful share of taxes. Tax cheats, by contrast, will be both poorer and unhappy.

184. See *supra* note 27.

would provide legal enforcement mechanisms that the other two proposals do not. Contrasting the extent to which each proposal would generate collateral consequences and opportunities for legal enforcement provides a more useful means of evaluating the likelihood that they will succeed in reducing tax flight than simply comparing their potential impact on GDPs.

A. ALTERNATIVES TO THE OECD'S COOPERATION COMMITMENTS

1. *A Withholding Regime*

In his influential article, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, Avi-Yonah suggests the adoption of a uniform withholding tax on portfolio investment by developed nations.¹⁸⁵ That proposal is built on the important insight that although “[t]he world’s savings may be parked in traditional tax havens,” those savings are ultimately invested in developed countries.¹⁸⁶ “To earn decent returns without incurring excessive risk, investors must use the markets in the EU, the United States, Japan and Switzerland.”¹⁸⁷ In essence, Avi-Yonah observes that the developed world could solve the tax haven problem by essentially reintroducing the withholding taxes¹⁸⁸ on cross-border investments that they chose to eliminate in the 1980s.¹⁸⁹

The proposal capitalizes on Avi-Yonah’s observation that even assets “hidden” in tax havens are invested in developed countries.¹⁹⁰ He proposes that the non-tax haven jurisdiction in which the hidden funds are actually invested impose a tax on any investment income at the time payments of that income are made. By allowing a refund of those withheld taxes¹⁹¹ only upon a showing of proof that the income was reported to tax authorities in the investor’s residence jurisdiction, Avi-

185. Avi-Yonah, *supra* note 25, at 1667–70.

186. *Id.* at 1668. As Adams puts it, “Money in tax havens . . . is not physically in the haven. Tax haven banks transmit the money to New York, London, Zurich, Luxembourg, Paris, and other financial centers.” ADAMS, *supra* note 10, at 410.

187. Avi-Yonah, *supra* note 25, at 1668. Avi-Yonah refers to “investors” but, of course, he means tax cheats.

188. Withholding taxes are taxes collected from a payor at the time a payment is made as opposed to taxes subsequently paid by the recipient. In the domestic context, wage withholding taxes are paid by employers on behalf of employees and are credited towards the employees’ ultimate income tax liability. The same principle applies in the cross-border context when the payor of interest or dividends withholds a portion of a payment and transfers the withheld portion to the government.

189. Avi-Yonah, *supra* note 25, at 1667–68.

190. This fact was underscored by the Justice Department’s recent investigation into a Cayman Islands bank. They learned that “both the underlying funds . . . and the investment income, were generally purely domestic transactions” and that the sole foreign element was the use of the Cayman accounts. Guttentag & Avi-Yonah, *supra* note 27, at 100.

191. This refund regime would be different than the prior regime. Before the repeal of the withholding tax on portfolio income, rather than a refund, taxpayers would only receive a foreign tax credit to offset the withholding tax.

Yonah's regime would make tax flight impossible. Would-be tax cheats would be forced to choose between paying a withholding tax in the source jurisdiction or paying tax in their residence jurisdiction.

It is important to note that Avi-Yonah explicitly links his withholding tax proposal to the "fiscal crisis of the welfare state."¹⁹² By doing so, he implicitly rejects the strong form of the philosopher king model. He suggests that a flight jurisdiction would voluntarily trade some amount of GDP growth in order to preserve the right "mix" of taxes¹⁹³ and its "social safety net" of welfare programs.¹⁹⁴ However, he ultimately concludes that such a choice is unnecessary because devoting resources to eliminating "harmful" tax competition not only would redistribute resources from tax cheats to the needy, but also would create wealth.¹⁹⁵

2. Tax Flight Treaties

The tax flight treaty offers a new alternative to the existing menu of anti-tax flight proposals. Unlike those proposals, and unlike most international tax policy proposals, the tax flight treaty is designed to be effective even if it has no net effect on worldwide wealth. Tax flight treaties are likely to leave tax flight jurisdictions (including tax cheats) worse off, particularly in narrow GDP terms. Nevertheless, they still could prove effective in reducing tax flight because of the collateral consequences and legal enforcement opportunities they would create.

A tax flight treaty would consist of two key elements. First, a tax haven would commit to developing the information infrastructure that would permit it to fully participate in the "exchange-of-information net" that tax flight jurisdictions employ to enforce their income taxes.¹⁹⁶ That investment would be financed by the relevant flight jurisdiction. To avoid any suggestion that it constitutes a handout, the financing would be structured as a loan.¹⁹⁷ In exchange, flight jurisdictions would agree to pay the cooperating tax haven a portion of the additional tax revenues generated by the tax haven's cooperation.¹⁹⁸

192. Avi-Yonah, *supra* note 25, at 1632–39.

193. The objective would be to ensure that taxes on capital income remain practicable so that their income taxes do not effectively turn into a tax on labor alone. *See id.* at 1577.

194. *Id.* at 1576.

195. *Id.* at 1616.

196. *Id.* at 1665.

197. The loan would be forgiven if tax flight jurisdictions failed to satisfy their commitments and would otherwise be repaid out of a portion of the tax haven's revenue sharing proceeds.

198. Such a deal would resemble the arrangement that currently exists in Europe among tax flight jurisdictions and tax havens pursuant to the EU Savings Directive. *See* Ruth Mason, *U.S. Tax Treaty Policy and the European Court of Justice*, 59 *TAX L. REV.* 65, 95 n.131 (2005) ("In lieu of exchanging information . . . certain countries were permitted to temporarily impose withholding taxes on interest sourced within their borders."). In a sense, by collecting those taxes and paying a portion of the amounts collected to the flight jurisdictions, the European tax havens bought the right not to provide

To some, that quid pro quo exchange will seem perverse, as though tax havens are being rewarded for bad behavior.¹⁹⁹ As discussed above, it would be more appropriate to view the payment as the equivalent of an amount paid to a polluter in exchange for a commitment to install a filtration system. Although such a bargain is unusual, in the right circumstances it can provide an appropriate resolution to a troublesome dispute. In this case, in part because the amount of tax revenues lost to tax flight is so large relative to the size of a typical tax haven, the tax flight treaty would be a perfect fit.²⁰⁰

There are two basic approaches one could take in designing a tax flight treaty. Either a tax flight jurisdiction could enter into tax flight treaties with one tax haven at a time or with tax havens as a group. The first type of treaty, a bilateral treaty, would be appropriate if existing tax havens do not have the ability to absorb the tax flight leaving a newly cooperating jurisdiction. The second, a multilateral treaty, would make sense if tax havens hold an effective oligopoly in the market for tax flight.

Choosing the right approach is a matter of understanding the characteristics of the "market" for tax flight and how tax flight responds to the loss of an existing tax haven. Assuming a limited number of tax havens of roughly comparable appeal, flight jurisdiction residents have two alternatives. One option is to repatriate their assets to their home jurisdiction. The other possibility, presumably the more likely of the two if the remaining havens are close substitutes for the former haven, would be to relocate their assets to another tax haven.

That asset shift would make being a tax haven more lucrative for the remaining havens. As a result, each successive bilateral tax flight treaty would make the next tax flight treaty more difficult to secure, because every tax flight treaty would give the remaining havens more reason to reject their own treaties. Under those circumstances, bilateral tax treaties would suffer from a potentially serious "hold-out" problem. Multilateral tax flight treaties, securing the cooperation of the entire group of havens simultaneously, would avoid that hold-out problem.

If, on the other hand, there is a significant degree of heterogeneity among tax havens, bilateral tax flight treaties could work. If tax havens are not all close substitutes, bilateral treaties would not inevitably create

information.

199. References to tax havens as poachers and parasites reveal the extent of the mistrust and hostility tax havens elicit. *See supra* note 87. The depth of that hostility may create an insurmountable obstacle to solving the tax haven problem. If providing meaningful, enforceable incentives for tax havens to cooperate is considered beyond the pale, eliminating tax flight will be much more difficult.

200. The GDP of the Cayman Islands is just under \$2 billion. CIA, *supra* note 107. If we assume that, as a leading tax haven, it accounts for at least 5% of U.S. tax flight (\$2.5 billion), the United States should be able to pay the Caymans an annualized amount that is comparable to its GDP.

a dynamic in which each treaty makes subsequent treaties more difficult to secure. For example, assume that as a result of geographic proximity or colonial ties, one haven attracts tax flight from a source that others do not. In that case, eliminating that haven would eliminate at least some tax flight. Even if other havens were able to absorb some of the tax flight that would previously have been directed towards the former haven, a significant amount of tax flight will have nowhere to go. No longer able to choose the unique combination of attributes the former haven once offered, many flight jurisdiction residents will be forced to return their assets to their home jurisdiction.

Alternatively, it is possible that there is a hierarchy of tax havens. For that to be true, all havens would appeal to the same group of unhappy taxpayers, but with different degrees of success. As a result, the more attractive havens would be able to extract a greater premium than other, lesser havens. Eliminating the most appealing haven would inevitably improve the position of the next-best haven. However, many taxpayers that would have hidden assets in the premium haven will not be satisfied by the characteristics of the second haven (otherwise, the premium haven would have been unable to demand a premium). In either scenario, bilateral treaties would permit flight jurisdictions to make real, if incremental, progress in their fight against tax flight.²⁰¹

Unsurprisingly, the amount of market power tax havens possess would determine not only the form tax flight treaties would take, but also the magnitude of the payments tax havens would receive. An oligopolistic group of tax havens, the type that would necessitate a multilateral tax flight treaty, would be able to demand relatively large payments. The size of those payments would reflect the impact their cooperation will have on the total amount of tax flight. By contrast, if each tax haven enjoys a limited amount of market power, the amount each haven can expect to receive pursuant to a bilateral tax treaty would be commensurately small.

Ideally, tax flight treaties would involve either a single exchange²⁰² or have limited terms.²⁰³ For example, all tax flight treaties could be drafted

201. However, the same variety that would make bilateral tax flight treaties viable would also indicate that even if tax flight could be tamed, it could never be completely eliminated. If different havens attract different sorts of tax flight, it is more likely that the pool of potential replacement havens is relatively deep.

202. If tax havens were to agree to collect and provide to flight jurisdictions comprehensive information about the residents of tax flight jurisdictions, a one-time exchange would be appropriate. Tax havens would immediately lose all leverage once they provided that information about those taxpayers. Within a specified period of time, each tax haven would provide the agreed-upon information and receive payment that reflects the present value of the estimated increase in revenues their cooperation would produce.

203. A tax flight treaty with a limited term could work if tax havens provided information about

with a uniform termination date of 2050. Such a limitation would provide flight jurisdictions with an opportunity to develop an alternative solution to their tax flight problem²⁰⁴ (while the pain of making payments to tax havens would provide the motivation to do so).²⁰⁵ It would also force tax havens, and would-be tax havens, to recognize that change is inevitable.²⁰⁶ To the extent their economic well-being is contingent on tax flight jurisdictions' continued reliance on taxes that make tax flight possible, anticipating and preparing for that change will be extremely important.

B. COMPARING THE ALTERNATIVES: AN INTEGRATED ANALYSIS

Making meaningful distinctions among the three approaches to eliminating tax flight (cooperation commitments, withholding taxes and tax flight treaties) on pure efficiency grounds is difficult. They all target the same economic distortions. As a result, the same claims that the OECD made in respect of its cooperation commitments and their impact on economic efficiency²⁰⁷ were made with respect to the withholding tax proposal²⁰⁸ and can be made with respect to tax flight treaties. For instance, if any of them were effective in reducing tax flight, it would discourage taxpayers from making inefficient expenditures to achieve tax flight.

Nevertheless, each of the three proposals would generate very different collateral consequences and opportunities for legal enforcement. Hathaway's integrated theory suggests that cooperation commitments are the least likely to succeed, because they depend on cooperation from tax havens but rely entirely on transnational collateral

each taxpayer sufficient to allow the home flight jurisdiction to impose a tax without identifying the actual taxpayer. For example, a tax haven would determine the residence jurisdiction for an individual or entity and report information about that taxpayer on an anonymous basis. Only if that taxpayer refused to pay tax (at, for example, the highest marginal rates applicable to the income in question) would the tax haven provide identifying information to the flight jurisdiction.

204. One obvious alternative would be to replace their income taxes with pure consumption taxes. Another would be to revisit Avi-Yonah's withholding tax proposal. As he has repeatedly observed, "if all OECD members enforced taxation of portfolio investment, it could be subject to tax without requiring cooperation from the tax havens." Reuven S. Avi-Yonah, *Bridging the North/South Divide: International Redistribution and Tax Competition*, 26 MICH. J. INT'L L. 371, 383 (2004).

205. Although flight jurisdictions (excluding tax cheats) would be better off with tax flight treaties than without, watching billions of dollars move from "us" to "them" (particularly when tax flight jurisdictions could solve the problem on their own by abandoning the income tax or adopting the Avi-Yonah withholding tax proposal) is likely to have greater salience than the more abstract problem of decreased tax revenues and economic efficiency caused by tax flight.

206. If flight jurisdictions can plausibly claim that by a given future date they will develop a viable alternative solution to the problem of tax flight, that would make tax havens less likely to stop complying in the future and would lessen the incentives for other nations to exploit tax flight.

207. See text accompanying note 81.

208. See Avi-Yonah, *supra* note 25, at 1616.

consequences to secure that cooperation. Avi-Yonah's withholding tax, by contrast, would capitalize on both transnational and domestic collateral consequences by (i) shifting responsibility for implementing anti-tax flight measures to flight jurisdictions and (ii) linking the problem of tax flight to the future of the welfare state. Although tax flight treaties would ask more of tax havens than of flight jurisdictions, tax havens' urgent need for capital to invest in health, education and physical infrastructure projects would produce powerful domestic collateral consequences encouraging their cooperation. Tax flight treaties would also give both tax havens and flight jurisdictions the tools necessary to make transnational legal enforcement possible.

I. Cooperation Commitments

Unlike tax flight treaties, which would represent reciprocal promises, cooperation commitments are entirely unilateral. The fact that they impose obligations only on tax havens is what has made them so ineffective. Employing Hathaway's terminology, cooperation commitments are intended to induce tax havens to help prevent tax flight, but rely principally on transnational collateral consequences to motivate tax havens.

The integrated theory would predict that such an arrangement would be sufficient to procure a commitment from tax havens, but not enough to ensure compliance.²⁰⁹ This is, of course, precisely what occurred. Faced with an indefinite promise/threat of transnational collateral consequences in the form of changes in the foreign aid policies of tax flight jurisdictions,²¹⁰ tax havens made a show of cooperation by entering into the OECD's cooperation commitments but have not developed the information infrastructure the OECD sought.

The absence of mechanisms for legal enforcement against tax havens and significant domestic collateral consequences for tax havens suggests that cooperation commitments simply will not work. The reason tax havens can fail to live up to their commitments without concern for the consequences (either in terms of legal enforcement or domestic collateral consequences) of doing so is that cooperation commitments provide tax

209. Hathaway observes a similar tendency for nations with poor human rights and environmental records to commit to, without complying with, human rights and environmental treaties. Hathaway, *supra* note 16, at 514–19. She attributes this apparently irrational behavior (why commit to treaties if they have no intention of complying?) to the absence of opportunities for legal enforcement. *Id.* Without legal enforcement, i.e. specific, mandatory consequences for failing to meet their treaty obligations, commitments allow those nations to at least temporarily avoid any negative collateral consequences without facing an increased risk of loss. *Id.* at 519 (concluding that the absence of transnational legal enforcement encourages commitment without compliance).

210. Hathaway offers such decisions about foreign aid or other transnational relationships as prototypical examples of collateral consequences. *Id.* at 504–05.

havens with no entitlements. As a result, the residents of tax havens have little reason to encourage their leaders to vigorously pursue their cooperation commitment obligations.

In theory, the potential for changes in flight jurisdiction foreign aid policy could produce secondary domestic collateral consequences for tax havens. However, because decisions about foreign aid policy would have implications well beyond matters of taxation,²¹¹ it is difficult to imagine policy changes substantial enough to make those secondary collateral consequences meaningful. Would flight jurisdictions really be prepared to risk cooperation in the wars on drugs or terror by cutting foreign aid over tax flight?

2. *Avi-Yonah's Withholding Tax*

Unlike the OECD's cooperation commitments, Avi-Yonah's withholding tax would rely on domestic collateral consequences as well as transnational collateral consequences. Under his proposal, flight jurisdictions would solve the problem of tax flight on their own, without any need to secure cooperation from tax havens with carrots or sticks. To the extent that flight jurisdictions were truly committed to eliminating tax flight, they could simply (re)enact withholding taxes on portfolio income. If leaders failed to do so, their constituents would punish them at the ballot box.²¹²

Of course, even if these withholding taxes gained political traction, they would not create a legally enforceable obligation. A nation could well decide that it would be advantageous to abandon the withholding tax entirely or to limit the circumstances in which it would impose its withholding tax without sacrificing any benefits or incurring any penalties.²¹³ If everyone else continued to impose a withholding tax, such a defection would allow a nation to seize an advantage over its neighbors without triggering a penalty. Avi-Yonah's proposal provides no

211. For example, the United States has long maintained a military submarine testing facility in the Bahamas. See U.S. Dept. of the Navy, The Atlantic Undersea Test and Evaluation Center, <http://www.npt.nuwc.navy.mil/autec/> (last visited Apr. 1, 2007). It is hard to believe that the United States would put such a facility at risk by slashing foreign aid to the Bahamas because of tax flight.

212. Avi-Yonah wisely linked his withholding tax proposal, and the menace of tax flight, to government programs likely to generate broad-based public support. By shifting the debate away from tax policy and towards the future of the welfare state, he did as much as he could to ensure that the domestic collateral consequences pushing flight jurisdictions towards cooperation would be strong. See Avi-Yonah, *supra* note 25, at 1662–63 (criticizing the OECD's approach for its “emphasis on tax-base erosion, as opposed to the potential beneficial uses of increased tax revenues”).

213. This is essentially what occurred during the 1980s. The United States repealed its withholding tax on portfolio investments and other jurisdictions followed suit. “The United States's enactment of the portfolio interest exemption has resulted in a classic ‘race to the bottom.’ One after another, all the major economies have abolished their withholding taxes on interest for fear of losing mobile capital flows to the United States.” *Id.* at 1581.

mechanism by which other flight jurisdictions could punish defection or reward cooperation.

Perhaps most importantly, the withholding tax is a tax. The creation of a new tax, particularly a new tax on investment income, would inevitably be controversial. For those that oppose the OECD's initiative on the grounds that it is no more than an effort to sustain an excessive tax burden, the new tax would serve as confirmation of their suspicions. Resistance to that new tax would dampen, and perhaps neutralize, the impact of the domestic collateral consequences described above.

3. *Tax Flight Treaties*

Tax flight treaties would solve the problem of generating domestic collateral consequences differently. While the withholding tax approach creates domestic collateral consequences by shifting responsibility from tax havens to flight jurisdictions, tax flight treaties would produce them through revenue sharing. In exchange for generating the information required by flight jurisdictions, tax havens would receive a fraction of the amounts they help to collect from tax cheats.

There are three reasons that such a revenue sharing arrangement would be more likely than the OECD's cooperation commitments to produce significant domestic collateral consequences for tax havens. First, given that the amount of revenue the United States loses to tax flight is more than twice the size of the total U.S. foreign aid budget, a share of those increased revenues could easily dwarf the amounts tax havens might have received under the OECD's approach.²¹⁴ Second, tax flight treaties would provide a clear formula for calculating the amounts tax havens would receive rather than leaving the timing and amounts of those payments to the discretion of tax flight jurisdictions. Third, by creating a regime that is formally distinct from other non-tax issues, tax flight treaties would create a clear link between cooperation in combating tax flight and the economic incentives offered by flight jurisdictions.

For their part, the governments of flight jurisdictions should be willing to agree to make large payments, even payments that are larger than the gains in GDP produced by eliminating tax flight, so long as tax flight treaties produce more positive collateral consequences than negative. If tax cheats exert relatively little political influence, that would almost certainly be the case.²¹⁵ A willingness on the part of tax flight

²¹⁴ See *supra* note 103.

²¹⁵ The other constituency that supports tax competition and therefore opposes the anti-tax flight effort are "small government" conservatives. They worry that eliminating tax flight would make it inappropriately easy to increase taxes and therefore the size of governments. Tax flight treaties would maintain the downward pressure on government revenues that tax flight produces. At least in theory,

jurisdictions to make such large payments might be consistent with the weak form of the philosopher king model (if, for example, the public has a taste for seeing tax cheats suffer that is strong enough to overcome tax cheats' taste for not suffering) but it would not be consistent with the strong form. In any event, for the governments of tax flight jurisdictions to agree to terms that will satisfy tax havens, they will need to see more political benefit than cost in tax flight treaties.

The domestic collateral consequences tax flight treaties would generate within tax havens would give them a clear advantage over the OECD's cooperation commitments. It could also be argued that those collateral consequences would give tax flight treaties a greater chance of success than the withholding tax approach. However, their advantage in terms of legal enforcement would really set tax flight treaties apart. As with double tax treaties, tax flight treaties would enable one treaty partner to use the terms of the treaty to make noncompliance costly for another treaty partner.

To the extent tax flight treaties succeed in tying revenue sharing payments to the delivery of tax information, they will permit each participating nation to respond to noncompliance in a predictable, meaningful way. If, for example, a tax haven falls short of the benchmarks laid out in a treaty and provides information about fewer taxpayers than the treaty anticipated, its revenue sharing payments could fall under a formula specified in the treaty. If a flight jurisdiction fails to make the payments required under the treaty, its access to information could be blocked. As with any contract, the more clearly each party's obligations and the consequences for meeting or failing to meet them are described, the better the treaty will function.

CONCLUSION

The goal of this Article is not merely to provide a more compelling account of the success of bilateral double tax treaties or to propose a more effective solution to the problem of tax flight. More fundamentally, this Article urges scholars and policymakers tackling international tax policy problems like tax flight to clearly reject the philosopher king model of international tax, particularly in its strong form, and to develop a more complete and nuanced understanding of what causes nations to commit to and comply with international tax regimes. While it is tempting to imagine that national governments reliably act in order to benefit their nations, as a national public interest theory of legislation would suggest, it is no more reasonable to rely on such an assumption in designing international tax policies than in designing domestic tax rules.

Tax flight treaties are no magic bullet for the problem of tax flight. As a practical matter, they offer meaningful advantages over the existing proposals for cooperation commitments and a new withholding tax. However, they will only work if the governments of flight jurisdictions prove willing to see tax cheats and, at least in a sense, themselves suffer. Put another way, tax flight treaties will only succeed if the governments of flight jurisdictions are willing to accept an arrangement that will leave flight jurisdictions (if tax cheats are included in their calculations) worse off. For tax flight treaties to work, it must be sufficient that they would make everyone else (excluding tax cheats) better off. Whether that would be enough is a question that neither the strong nor the weak form of the philosopher king model can answer.

Hathaway's integrated theory offers an alternative to the philosopher king model that acknowledges and attempts to make sense of the array of political and economic pressures that drive a nation's decision-making process. At the very least, the integrated theory provides a taxonomy for describing the different attributes that help to make international cooperation efforts a success. The theory suggests that tax flight treaties, relying on a combination of significant domestic collateral consequences and transnational legal enforcement as well as transnational collateral consequences, stand a greater chance than cooperation commitments of persuading tax havens to help reduce tax flight. Thus far, tax havens have shown little inclination to respond to the potential transnational collateral consequences of failing to fully satisfy their obligations under their OECD cooperation commitments.
