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3 Globalization and the transformation of the tax state

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How does globalization affect taxation? The academic wisdom is split on this question. Some argue that globalization spells the beginning of the end of the national tax state, while others maintain that it hardly constrains tax policy choices at all. This paper comes down in the middle. It finds no indication that globalization will fatally undermine the national tax state, but still maintains that national tax policy is affected in a major way. The effect is not so much to force change upon the tax state as to reduce its freedom for change. Comparing the first three decades of the 20th century to the last three decades, it is remarkable how much change and innovation there was then and how much incrementalism and stasis there is today.

National taxes and global markets

Taxes are monetary levies imposed by governments on persons or other entities. They are compulsory and unrequited: taxpayers are legally obliged to pay taxes and cannot expect to receive any specific benefit in return, such as, for example, a piece of public property or a particular health care treatment in a public hospital. Taxes are not fees. While taxes are presumably collected for the sake of the public good, the liability of the individual taxpayer is independent of the personal utility she derives from that good. This is what makes taxes such a nuisance for the taxpayer and such a versatile source of finance for the state.

Over past few centuries, taxes have become the main basis of governmental revenue. The modern state is, in Joseph A. Schumpeter's words, a 'tax state'.[27] It is sovereign because (and to the extent that) it disposes of tax revenue. The availability of tax revenue determines what the state can and cannot do, how many civil servants it can hire, how many services it can deliver, how modestly or ambitiously it can define its goals, and how effectively it can impose its authority domestically and internationally. In a very real sense, therefore, 'the revenue of a state is the state',[3] which in turn implies that public finance is 'the key'[11] to understanding what the state is and how it changes.

As even a cursory look confirms, the history of public finance is one of misery and drama. Rare are the moments of fiscal abundance and ease. Most of the time,

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finance ministers feel strapped for cash and are barely able to make public ends meet. Fiscal stress is nothing unusual; it is the normal state of affairs in public finance. What varies over time, however, is the interpretation of where the stress is coming from. During the 1990s, a lot of the blame went to globalization. The opening of national economies was feared to undermine the ability of national governments to subject their economies to tax. Tax sovereignty seemed to evaporate in global markets.

The crisis has been long in coming. The liberalization of the world economy has been going on for almost 50 years now, and for almost equally as long there has been unease and concern about its negative implications for tax policy. The purpose of this essay is to trace the evolution of these concerns, and to analyse how national tax states have coped with them. The following section briefly summarizes the characteristics of national taxation systems before the onset of deep globalization in the 1980s and 1990s. The next section analyses how these characteristics were challenged by globalization, and a subsequent section looks at tax policy reactions to these challenges. The paper concludes with a brief consideration of the future of the tax state in a global economy.

Taxes in national containment

The tax systems of OECD countries are products and symptoms of economic closure. Their main components – taxes on private and corporate income, consumption taxes on goods and services, and social security contributions – were conceived between 1910 and 1970 when national borders were relatively closed to economic transactions. The progressive income tax made its breakthrough in the huge fiscal expansion during the First World War. Taxes on general consumption were introduced on a broad front during the interwar years, when first inflation and then the depression cut into income tax revenues. Corporate income taxes made their debut at around the same time and, after the Second World War, developed into a standard tool of economic policy in OECD countries. The post-war period also saw a massive expansion of social security contributions to finance the build-up of the welfare state.[14,29]

All these taxes were introduced in a context of clearly separated national markets. Trade barriers restricted international trade, and capital controls limited the international movement of capital. Tax policy was a purely national affair. There was no international spillover because all effects were limited to the national market, and there was little escape from the national market. Tax policy was all voice and little exit. In those unusual cases where taxpayers had a viable chance to exit, the sentiment was not to adjust taxes in order to reduce the incentive for exit, but to increase the road blocks on the escape route in order to make exit impossible. The two main protagonists of the Bretton Woods negotiations, Harry

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Dexter White and John Maynard Keynes, were united on this point: states need the freedom to increase capital controls when necessary to prevent capital flight. According to Eric Helleiner, they were motivated by a desire to prevent the evasion of taxes and 'the burdens of social legislation'.[12]

Behind the wall of capital controls and trade barriers, the tax state had a notably 'good 20th century'.[13] It grew vigorously: in the major industrial countries, the tax take as a share of Gross Domestic Product (GDP) rose from an average of around 10% or less before the First World War to around 30% fifty years later, and almost 40% at century's end. This expansion was made possible by radical innovation and modernization. While, in the late 19th century, most government revenues derived from customs, excises and property taxes, by the middle of the 20th century personal income taxes, corporation taxes, social security contributions, and general consumption taxes were already the main revenue raisers by far. Within 50 years, the tax state was put on an entirely new basis. In addition, the tax state, during the period of national containment, enjoyed the liberty to develop in specifically national ways. The total tax take and the tax mix varied widely. Some countries relied heavily on indirect taxes, while others leaned mainly on direct taxes. Ireland, for example, derived more than 50% of its total tax revenues in 1970 from taxes on consumption while the same share in Luxembourg stood at less than 15%. Taxes that were popular in some countries were hardly used in others. For example, while social security contributions amounted to more than 13% of Dutch GDP in 1970, they raised barely 1.5% of GDP in Denmark. The level of total taxation also varied widely. In 1970, total tax revenue amounted to more than 40% of GDP in Denmark and less than 20% in Japan.

The challenges of globalization

The size and heterogeneity of national tax systems were no cause for concern so long as the fences separating national markets were up. When these fences began to come down, however, cross-national differences in taxation started to give politicians headaches. There were four problems in particular that governments worried about: competitiveness, tax evasion and avoidance, tax competition, and the transnationalization of the tax base. Of course, these problems are not independent of one another; rather, they embody different aspects of the same syndrome – national taxation in a context of international markets. However, since they developed at different times and at different speeds, and triggered different political reactions, it is useful to consider them separately.

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Competitiveness

The 1950s witnessed the first cautious reductions of trade barriers. At this time it was the implications of national taxes for the international competitiveness of national industries that most concerned tax policy makers. The reasoning was simple: if domestic taxes imposed a higher tax burden on domestic producers than foreign taxes imposed on foreign competitors, then, in the absence of offsetting customs regulations or quotas, domestic producers were at a competitive disadvantage. Their costs of production were higher with potentially negative consequences for profitability, output, and employment, and, indirectly, for tax revenues.

The history of the European Coal and Steel Community provides a showcase example of these concerns. Shortly after the Community had, with much fanfare, opened its Common Market for Coal and Steel, a fierce dispute erupted between Germany and France over trade and taxation. Germany charged high company but low turnover taxes, while France charged low company and high turnover taxes. The German government suspected that this difference in taxation worked to the disadvantage of German industry, because exports were routinely relieved of domestic turnover taxes but not of company taxes.[a] As a consequence, French exports entered the German market free of high French turnover taxes, while German exports, in turn, entered the French market without compensation for high German company taxes. This disadvantage had been offset by tariffs and export subsidies in the past, and it was feared that the elimination of these protections in the Coal and Steel Community would leave Germany defenceless, ultimately resulting in 'an extended "marché français" rather than a true "marché commun"'.[26]

An expert panel under the economist Jan Tinbergen was hurriedly formed to settle the matter. It ruled that the German argument was wrong because any tax-induced competitive disadvantage for German exporters would be offset by automatic exchange rate adjustments.[37] This so-called equivalence theorem was a striking academic achievement. Its practical value, however, was limited because exchange rates were fixed by the Bretton Woods system – and nobody wanted them to be flexible. There simply was no room for compensatory exchange rate adjustments. The tax conflict eventually died down because the French Franc was, for political reasons, fixed at such a high level that whatever advantage French producers might have had from their tax treatment was more than offset by the unfavourable exchange rate. The fear that high taxes might undermine national competitiveness remained, however, and continues to be a top concern of policy makers.

[a] This, of course, had practical reasons. While it is relatively straightforward to compute the turnover tax burden of goods, it is very difficult to estimate the company tax burden falling on goods.

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Tax evasion and avoidance

The erosion of the fences separating national markets accelerated during the 1960s. Not only did the Kennedy round of GATT negotiations and the EEC Customs Union result in further reductions of trade barriers, but the divisions between national capital markets were also breaking down. In part, this was the states' own doing. By 1958 most European countries had made their currencies fully convertible, and during the early 1960s they cautiously eased off capital controls. In part, however, it followed from processes beyond state control, namely the emergence of offshore capital markets and the rise of multinational companies. The resulting increase in the cross-border movements of capital raised a new set of problems for tax authorities: international tax avoidance and evasion, i.e. the reduction of tax liabilities by legal (avoidance) and illegal (evasion) means.

Of course, there had always been an incentive for private investors to hold financial assets abroad in order to evade domestic taxes. For most intents and purposes, however, this incentive had been neutralized by the costs of escaping from or overcoming capital controls. The partial reduction of capital controls in the EEC reduced these costs, and thus increased the attractiveness of tax evasion. Hence, when – in the mid-1960s – Belgium, Italy and Germany imposed new source taxes on capital income, the result was an 'anti-economical capital flight of the largest magnitude'.[36] The emergence of offshore capital markets further added to the appeal of international tax evasion by reducing the attendant currency risk. If a capital owner residing in country A invested in country B in order to evade domestic capital income taxes, she ran the risk that country B's currency would depreciate, and thus reduce the value of her assets in terms of her home country's currency. Offshore markets took care of this risk by allowing for foreign investments in domestic currency. For example, an offshore market physically located in country B would trade assets and liabilities denominated in the currency of country A. This allowed tax evaders from country A to hold their capital in B, and thus beyond the reach of A's tax collectors, but in A's currency, i.e. without any currency risk. This advantage, according to some observers, was a key factor behind the rapid growth of offshore or Euro-markets during the 1960s and 1970s: 'Half of all Eurobonds are held by individuals, whose motives are a combination of the security offered by a hard-currency investment in a high-rated borrower, as well as tax evasion'.[22]

While offshore markets were a new phenomenon, multinational companies were not. Many major industrial and raw material enterprises were already established on a global level by the end of the 19th century. However, for a variety of reasons – the European recovery, the improved military position of Europe after Stalin's death, convertibility of most European currencies, the creation of the EEC – transnational corporate activity rose sharply only from the late 1950s. The

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ascendancy of the multinational corporation increased concerns about tax avoidance for two reasons. First, the real investments of multinational companies are likely to be more tax sensitive than the investments of purely national companies. While it is improbable that a purely German company would terminate its operation in Germany and move to, say, Ireland, to take advantage of lower corporate taxes there, it appears much more probable that an American multinational company that wants to set up shop in the Common Market would be attracted by low Irish taxes and locate its European headquarters there rather than in Germany. Second, and potentially more importantly, the simultaneous presence of multinational companies in various countries allows them to optimize their tax liabilities between these countries (international tax planning). They can, for example, manipulate the prices used in internal exchanges in order to artificially shift profits from high tax to low tax countries. For this purpose, company subsidiaries in low-tax locations will charge inflated prices for deliveries to subsidiaries in high-tax countries, and, in turn, pay deflated prices for deliveries from them (*transfer pricing*). Other techniques can also reduce the tax bill of the multinational corporation as a whole. The specifics are complicated but the basic concept is simple: taxable profit is rerouted from parts of the company located in high-tax countries to parts located in low-tax countries, and is then stored there. The company saves taxes, high-tax countries lose revenue.

Tax competition

Tax avoidance and evasion brought formerly separate tax systems into contact. How much money the tax authorities raised no longer depended on national tax levels alone but also on foreign tax levels. Low foreign tax levels threatened to depress domestic revenues by causing an outflow of mobile tax base. High foreign tax levels, in turn, promised to boost domestic revenues by attracting a mobile tax base in from abroad. One country's revenue became dependent on other countries' tax policies. This interdependence created not only constraints for national tax policy but also opportunities. Governments could exploit it to their advantage by undercutting the tax rates of other countries. Tax-sensitive business activities could be lured away from foreign markets and into the home economy, bringing in their wake not only additional revenues but also growth, employment, and wealth. This was a particularly attractive option for small countries. Small countries have little domestic tax base to lose but a lot of foreign tax base to win. Hence, the chance that lower tax rates will be overcompensated for by an enlargement of the tax base is rather high. This is why tax havens are always relatively small countries, and why it is always large countries that feel victimized by them.[4]

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Already in the 1960s, the US was incensed by what it saw as the blatant abuse of Swiss holding companies for the purpose of reducing the tax bills of American multinationals in the US. In reaction, Congress passed a first piece of 'anti-avoidance' legislation in 1962, intended to limit the tax advantages that US-based enterprises could derive from holding companies in foreign tax havens. Other (large) countries also began to look into the problem. In 1973, for example, France and Germany formally requested the EC Commission to investigate the fiscal treatment of holding companies in Luxembourg. They suspected that these companies were being misused by multinational enterprises for the purpose of reducing French and German tax liabilities. Luxembourg, they insisted, should not be allowed to take a fiscal free ride at their expense.[10]

To Luxembourg, of course, the issue decidedly did not look like free-riding. In a debate on the Commission's holding report, a socialist Member of the European Parliament from Luxembourg asked the Commission 'whether it felt that it ought to organize the capital movement of holding companies towards Liechtenstein or the Swiss canton of Glaraus [sic!], rather than allowing these companies to establish themselves in a Community financial centre where, apart from anything else, they provided employment for young professional people' (*Bulletin of the EC* 6–1973:83). From Luxembourg's point of view, the holding law was part of a national development strategy. Luxembourg's old industrial base in coal and steel was in decline, and the financial service industry looked like a promising substitute. Helping this industry through appropriate (low-)tax legislation would, it was believed, eventually also benefit France and Germany through better access to capital and more efficient financial intermediation. Other countries followed Luxembourg's example. In 1983, for example, Belgium established a preferential tax regime for so-called coordination centres that provided overhead functions, such as financing, accounting, or captive insurance for multinational companies. Shortly thereafter, Ireland established the so-called *International Financial Services Center* in Dublin – a regime that awards a special, reduced corporate tax rate of only 10% to companies providing financial services to non-residents. Outside Europe the number of tax havens also increased, as small states such as the Seychelles, the Netherlands Antilles, and Barbados entered the business of providing individuals and corporations with a low-tax basis for international tax planning activities. The selling point of these locations was that they provided protection from foreign taxation without the need to physically relocate there, i.e. people and companies did not actually work and operate in the tax havens, they just let themselves be taxed there. Tax havens offer '*juridical* rather than *de facto* abodes'.[20:163]

Tax competition, however, is not limited to a contest for attracting virtual activity. Governments also use low tax strategies to attract real economic activity, i.e. real investment in 'real' production. When Ireland entered the EC in 1973, for example, it insisted on the right to apply a reduced corporate tax rate to all

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manufacturing operations, with a view to increasing inward investment. This strategy is generally seen as quite successful and as a major ingredient in the long Irish boom of the 1990s. It is hardly surprising, therefore, that Ireland has become a role model for the new EU Member States from Eastern Europe. The Baltic States and Slovakia in particular have made low or no corporation taxes[b] a selling point of their economic policies, and have thereby attracted the wrath of some of the old member states. The German government has been particularly outspoken in its criticism of fiscal free-riding. The emerging conflict shows the same normative ambiguities as the conflict with Luxembourg some 30 years ago. On the one hand, it is true that the large countries are taken advantage of: after all, a small country's low tax strategy only pays off if another high tax country loses tax base. On the other hand, it is unclear on what normative and legal grounds the large Member States can deny their smaller peers the freedom to structure their national tax systems to national advantage.

The transnationalization of the tax base

The twin problems of tax avoidance/evasion and tax competition are exacerbated by a third one: the transnationalization of the tax base. The traditional architecture of the tax state was based on the assumption that all taxable events have a clearly identifiable place in space: either they fall within a national tax jurisdiction, and are therefore liable to national tax, or they fall within the jurisdiction of some other state, and are therefore liable to tax there.[34] Of course, this notion of a 'natural nexus' between tax base and a particular territory has always been a fiction. Some taxable events, such as inheritance, always posed problems for separate national taxation. If somebody died in country A while the heir resided in country B, in which state did the inheritance take place and become liable to tax? These exceptions were of little practical importance, however, and did not significantly reduce the workability of the 'natural nexus' assumption. The process of globalization threatens to make transnational tax bases less of an exception, thereby raising the difficulties of establishing nexus.[2] Two developments in particular contribute to this: the ascendancy of multinational corporations and the emergence of electronic commerce.

The problem with multinational corporations is that their organizational reality is not adequately reflected in law. At the organizational level, they constitute a transnational whole. At the legal level, however, they are fragmented into a multitude of national parts. Formally, each national subsidiary of a multinational company is an independent business firm of its own. This legal fragmentation is supposed, inter alia, to allow each state to tax its part of the profits of the

[b] Estonia charges no corporation tax on retained profits.

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multinational company independently. However, it tends to thwart this purpose by opening up options for international tax planning that multinational corporations can use in order to reduce their tax liabilities in high tax countries: only because subsidiaries in low tax jurisdictions are independent legal entities can they serve as tax shelters for profits generated in high tax jurisdictions.[20:172] Tax planning was comparatively easy for governments to check and control as long as the organizational structure of multinational corporations resembled a loose confederation of largely self-contained national companies, i.e. as long as the gap between the organizational and the legal concept of a multinational enterprise was still fairly narrow. However, as most multinational companies went from a confederative structure towards integrated transnational production in the course of globalization, it became much harder to find meaningful criteria for the division of overall profits. Consider a recent quarrel between GlaxoSmithKline, a big multinational drugs company, and the US tax authorities. At issue was how much of the profits of Zantac, Glaxo's hugely successful ulcer drug, derived from advertising and marketing in the US, and how much from research and development in Britain.[1] The problem is, of course, that there is no simple answer to this question because the profits reflect synergies from transnationally integrated production. It is impossible, therefore, to allocate them unambiguously to any particular location. This implies, on the one hand, that Glaxo potentially enjoys very large degrees of freedom in allocating profits between Britain and the US in the most tax efficient way. The mistrust of US authorities is thus well founded. On the other hand, it also implies that any national claim to a particular share of Glaxo's profits is hard to justify on the basis of principle.

The problem with electronic commerce is often viewed as structurally similar to that of integrated transnational production. Established tax rules assume that the generation of income presupposes a physical presence, i.e. a 'permanent establishment'. The new information technologies challenge this assumption. Internet addresses are relational constructs that often do not reflect physical location. Servers routinely shift clients from location to location to balance loads. Buyers can log on to any server remotely. Service suppliers such as architects, software writers or lawyers may collaborate just as easily from offices in Tokyo, Palo Alto and Bremen, as they do within the same office building. Enterprises may conduct substantial business in countries where they have no 'permanent establishment'. Territoriality-based tax claims are hard to justify, and hard to enforce.[19,21] Since the burst of the new economy bubble, however, concern over the tax implications of electronic commerce has abated. As it turns out, it has proved quite difficult to effect electronic transactions in high tax jurisdictions without establishing any physical presence there. And even in cases where physical presence can be avoided, it seems relatively easy to adjust international tax law concepts to establish a territorial nexus – for example, by defining a minimum threshold of sales as constituting presence in a jurisdiction for tax purposes.

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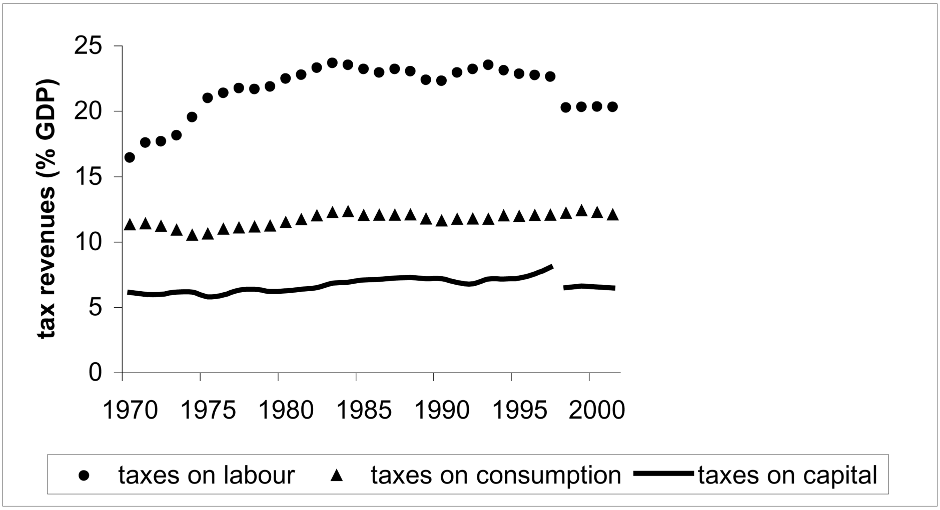

Notes: Data are unweighted averages from Eurostat *Structures of the Taxation Systems in the European Union* 2001 and 2003. Countries included are Belgium, Denmark, Germany, France, Ireland, Italy, Luxembourg, Netherlands and United Kingdom. Data for periods 1970–1997 and 1998–2002 are based on different national account systems (ESA 79 and ESA 95) and not fully comparable.

Figure 1. Tax revenues according to macroeconomic tax base in nine EU member states, 1970–2002.

Coping strategies

Looking at aggregate revenue levels, there can be little doubt that the tax state copes rather well with the onslaught of globalization. Figure 1 presents data for the EU, arguably the most economically integrated area of the world economy. It shows, first, that the total tax take of the average EU state is holding firm at about 40% of GDP. This is high by historical standards, and definitely much higher than during the years of relative economic closure in the 1950s and 1960s. The figure also shows that the tax base that is potentially the most mobile, most susceptible to tax avoidance and evasion, most endangered by tax competition, and most transnational in character, namely capital, contributes least to total tax revenues. Therefore, even if globalization were to undermine the ability of the state to derive revenue from this basis, its impact on the state's fiscal viability would be modest. Finally, there is no evidence of a decline in capital tax revenues; to the contrary, Figure 1 suggests a slight increase since the mid-1980s. If tax revenues have declined at all, then it is in labour taxation and not in capital taxation.

Some observers conclude from this rather innocuous picture that globalization has not really changed much for the tax state. It retains considerable taxing power: governments 'wishing to expand the public economy for political reasons may do so (including increasing taxes on capital to pay for new spending)'.[8:823,23,32] This

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conclusion, however, is not completely warranted. First, it overlooks the fact that globalization was not the only challenge that the tax state had to meet during the 1980s and 1990s; there were also slow growth and massive unemployment, and there were high spending requirements, especially in social policy. Given these internal challenges, globalization did not trap the tax state in a race to the bottom in taxation so much as box it in between external pressures to reduce the tax burden on capital, on the one hand, and internal pressures to maintain revenue levels and relieve the tax burden on labour, on the other. Tax aggregates did not change much, not because globalization was business as usual for the tax state but because the tax state was left with very little room to manoeuvre.[6,9,33] Second, the continuity in aggregate indicators masks underlying structural changes. Precisely because they had so little freedom to adjust tax levels in reaction to globalization, governments looked for revenue-neutral ways to make their national tax systems more globalization-proof. To this end they introduced an increasingly complex body of anti-avoidance and evasion legislation; they intensified international cooperation in tax matters, and, most importantly, they fundamentally reformed their income tax systems.

Anti-avoidance and evasion legislation

Since the 1960s, practically all OECD states have developed anti-avoidance rules to rein in international tax planning. The basic purpose of these rules is to limit the tax advantages that multinational companies can derive from their legal fragmentation.[6:623] Transfer pricing and thin capitalization regulations limit the extent to which multinational companies can use commercial or financial transactions between subsidiaries to optimize their overall tax load. 'Controlled Foreign Company' legislation restricts their freedom to evacuate profits to subsidiaries in tax havens. By attributing part of the income of the tax haven subsidiary to the parent company at home, this legislation reduces the benefits of offshore deferral and, hence, the leeway for international tax planning. Some governments, including those of the US, Australia and Great Britain, have also introduced advance information requirements obliging tax advisers to reveal to national tax authorities the tax avoidance schemes they sell to corporate customers. This reduces the information gap between tax authorities and tax planners. The problem with anti-avoidance rules is that they tend to be exceedingly complex. Compliance and administration costs are high for tax payers and tax authorities alike, and must be balanced against any potential revenue gain.[c] In

[c] It is hard to come by data on the exact magnitude of the compliance and administrative costs connected to anti-avoidance rules. It is interesting to note, however, that in a country such as the United Kingdom, the total administrative compliance costs of the tax system are estimated to be 1.5% of GDP, which implies that tax administration is an industry as large as agriculture, forestry and fishing.[18]

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addition, to the extent that anti-avoidance rules are successful in effectively reducing opportunities for artificial cross-border shifts of profits, they may increase the incentives to shift the underlying profit generating assets. An out-migration of production facilities, however, is much more painful than the out-migration of the mobile tax base because it harms not only tax revenues but also growth and employment.

Anti-evasion measures focus mostly on personal capital income from interest and dividends. Unlike corporations, individuals are not subject to elaborate bookkeeping requirements. If individual capital owners hold their assets abroad, national tax authorities will usually not know. Some observers, like Jeffrey Owens, the head of OECD's Centre for Tax Policy and Administration, conclude that taxes on private capital income are now 'almost a voluntary tax': they can be evaded at liberty.[17] Anecdotal evidence suggests, however, that anti-evasion measures can be effective at deterring capital tax evasion. During the 1990s, German tax authorities conducted a series of well-publicized country-wide investigations of German banks, prosecuting bank managers for aiding and abetting international tax evasion.[6:624] Of course, they uncovered only a fraction of total German capital tax evasion, but they sent a powerful signal to potential tax evaders and their helpers about the unpleasant consequences if detected. The cost–benefit balance of tax evasion was thus somewhat tilted towards the cost side.

International cooperation

Tax policy experts like Vito Tanzi, an economist associated with the International Monetary Fund for decades, often lament the lack of international cooperation in taxation,[35] but it does exist, and it has a fairly long history. As early as the 19th Century, states began to conclude bilateral tax treaties, codifying common rules for sharing transnational tax bases. These helped the contracting parties to keep their tax systems separate even in cases where they participated in the same tax base. As long as transnational tax bases were few in number and fiscally unimportant, the number of tax treaties remained low: by the mid-1950s only about 100 treaties had been concluded worldwide. With the advent of globalization, however, the treaty network began to expand. Today, it connects virtually all OECD member states to each other and extends to almost all other countries worldwide, with the total number of treaties approaching 2300. Why the tax treaty regime is still organized bilaterally although, as many argue, a multilateral regime would be much more efficient and effective is, in itself, an interesting question.[25] Still, there can be no doubt that the spread of this regime is a reaction to the increased coordination needs of national tax administrations in a globalized economy.

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Recently, international institutions such as the OECD and the EU have also become active in the struggle against international tax evasion and avoidance. In 1998, the OECD started a project on so-called 'harmful tax practices'.[16,24] One purpose was to coax tax havens outside the OECD into agreement on common standards on information exchange in civil and criminal tax matters. Only a handful of tax havens, including Andorra, Liechtenstein, and the Marshall Islands, still refuse to accept this international infringement on their sovereign right to 'commercialize'[20] their state sovereignty. In contrast to the OECD project, which aims only at forcing tax havens to provide relevant tax information upon request, the recent EU directive on the taxation of interest income provides for an automatic exchange of all tax relevant information between the member states.[5] If a financial institution in member state A pays out interest to a resident of member state B, it will automatically inform B's tax authorities about this. The scope for international capital tax evasion in the Internal Market is thus substantially reduced while the national tax sovereignty of the member states is buttressed.

International institutions have been less successful in fighting international tax competition. The problem is that, unlike cooperation against tax evasion and avoidance, international cooperation against tax competition tends to limit rather than buttress national tax sovereignty. Since tax competition is driven by incentives to undercut other countries' (effective) tax rates, the way to stop it is to agree on some harmonized level of tax rates. Some countries, such as the UK, object to such harmonization for reasons of principle. They insist that the national parliament and not an international body should have the final say on tax levels. Other states, especially small and relatively poor ones, object to the idea of tax rate harmonization for reasons of national interest; for them, tax competition is not a threat but a promising strategy for national development. This is why Ireland, for example, has always opposed attempts to harmonize corporate tax rates in the EU.[4]

Tax reform

The most important tax policy response to globalization has been tax reform. Practically all OECD countries revamped their tax systems during the 1980s and 1990s with a view to making them more competitive and globalization-proof. The most visible result of this was a significant drop in the corporate tax rate: in the average OECD country it fell from about 50% in 1983 to about 30% in 2003, and looks set to fall even further.[7] Since the tax cuts were paralleled by measures to broaden the tax base, they did not usually result in substantial tax revenue losses. This did not mean, however, that they were painless.

The problem is that corporate income tax is intimately linked with personal income tax. The distinction between corporate profits and personal income is one

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of legal form rather than material difference. Hence, if corporate income is taxed at significantly lower rates than (top) personal income, (rich) taxpayers can potentially save tax by reclassifying their personal labour and/or capital income as corporate income.[28] As a consequence, most OECD countries have tended in the past to treat the corporate and the individual income tax as a more or less integrated block (with more or less aligned tax rates and tax base definitions) rather than as two completely separate taxes.

Tax competition forced governments to slice up this block. There were basically two options for doing this.[7] One option was to slice up the block vertically so as to separate the taxation of mobile income, which is susceptible to tax competition (mostly corporate profits and personal capital income), from the taxation of immobile income, which is not (mostly wage income). This option was taken, for example, by the Swedish government in 1991, when it introduced its so-called dual income tax system. The essence of the dual income tax is to remove capital income from the scope of the progressive individual income tax and to tax it separately at low proportional rates. Personal capital income is now taxed at a uniform rate of 30%, which is closely aligned with the corporate tax rate of 28%. Labour income, by contrast, continues to be taxed at fairly steep progressive rates. The top individual income rate stands at 57%. The advantage of the dual income tax system is that it increases competitiveness at minimal fiscal cost. It targets tax cuts where they matter most in terms of tax competition and are most easily made up through tax base broadening, thus avoiding unnecessary revenue losses. However, there is a price to be paid in terms of efficiency and equity. In terms of efficiency, the problem is that the gap between the top personal income tax rate and the proportional rate on capital income weakens the backstop function of the corporate tax. Given the gap, there is an incentive to reclassify labour income as capital income. This makes taxation difficult wherever labour and capital income accrue jointly, as, for example, in unincorporated businesses or closely held corporations. The equity problem is that one Swedish Crown in capital income is no longer liable to the same amount of income tax as one Swedish Crown of labour income. True, there are good economic arguments for taxing capital income at lower rates – or not at all. However, it is hard to sell these arguments politically: after all, why should (rich) heirs contribute less to the common good than (poor) wage earners? The efficiency and the equity problems of the dual income tax increase with the size of the tax rate gap between capital and labour income. The higher the tax rate on labour and the lower the tax rate on capital, the more difficult it becomes to police the border between them, and to explain to an electorate of mostly wage earners why this tax system is in their interest. Stabilizing the tax rate gap, or even increasing it in the face of increased tax competition, are, therefore, major problems of a dual income tax.

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The alternative reform option avoids these problems by cutting tax rates across all types of income. This is basically what the Red–Green coalition government in Germany tried to accomplish with its tax reform of 2001. In order to increase competitiveness without sacrificing the formally equal tax treatment of capital and wage income, it reduced corporate and top individual income taxes to roughly the same rate: they are set to fall to 42% (income tax) and 38% (corporate tax including local business tax) by 2005. The major drawback of this reform option is, of course, that it multiplies the fiscal costs of adjustment to tax competition. By de-taxing (immobile) labour income in order to make taxes on (mobile) capital and corporate income more competitive, it causes huge revenue losses where it does not matter in terms of tax competition (since labour is mostly immobile there is hardly any inter-jurisdictional competition in labour taxation), and which are very difficult to make up for by base broadening. Despite all attempts at base broadening, it is estimated that the German reform will reduce total income tax revenues by 1.3% of GDP. Such a revenue loss will be very difficult to accommodate, especially if low growth and high unemployment continue. This approach, too, suffers from a serious equity problem. While it defends horizontal equity – different types of income are taxed equally – it reduces vertical equity. The reduction of top personal income tax rates decreases progressivity at the high end of the income spectrum; the concomitant revenue losses have to be compensated for by spending cuts or by more regressive taxes such as VAT, both of which are likely to burden low to medium income earners more than high income earners.

The transformation of the tax state

Ten or fifteen years ago it was fashionable in academic circles to make dire predictions about what globalization would do to the nation state. Nothing less than the very survival of the state seemed to be in question. Today, probably in embarrassment at this former misjudgement, it is fashionable to doubt that globalization is of any consequence to the nation state. Governing in the globalized world is now portrayed as more or less business as usual; nothing much has changed for the state. The truth, of course, lies somewhere between the two extremes. Globalization is neither fatal nor irrelevant for the nation state; it is one important factor in its continuous transformation. This study has analysed how globalization contributes to the transformation of the state by affecting the state's main source of revenue, taxation.

There is no doubt that taxation will remain the main revenue source of the modern state. Globalization has not visibly undermined tax revenue. There has been no perceptible drop in the tax levels of OECD countries. To the contrary, globalization has been accompanied, over the past 20 years, by historically high levels of taxation. Also, globalization has not undermined taxation as the

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organizing principle of public finance. There simply is no alternative conception of public income generation that could potentially raise more revenue at less opportunity cost. There seems to be no substitute for taxes: taxation's erstwhile rival, state socialism,[11] is passé. The idea that the state should live off its own economic activities rather than participate 'parasitically' via taxation in the private economic activities of its citizens, has lost much of the appeal that it enjoyed during important periods of the 20th century. There also seems to be no substitute for the state as the taxing unit. The 'globalization of taxation', as Roland Paris recently put it,[21] that is, the idea that taxation could be lifted from the level of the nation state to the supranational level of international institutions, has so far failed to gain any support. Even in the EU, where economic integration is deeper and tax coordination further developed than anywhere else in the world, the proposal of a Euro-tax has, so far, been a non-starter. Comparing today's utopian visions for the EU's future[31] with expert reports from the 1960s,[15] it appears that the Europeanization of taxation was considered back then a much more realistic option than it is now.

Even if globalization does not threaten the organizing principle or overall size of the tax state, it is, nevertheless, a challenge. By increasing the interdependencies between national economies, it increases the interdependencies between national tax regimes. These interdependencies present governments with a new set of tax policy problems: industrial competitiveness, international tax avoidance and evasion, tax competition, and transnational tax bases. Governments have reacted to these challenges in two ways. First, they have adopted measures to increase their boundary control. Such measures include unilateral acts of new or strengthened anti-avoidance and evasion legislation to stop a mobile tax base from leaking out of the national domain. They also include international cooperation to reinforce national control – for example, through cross-border information exchange or common sharing rules for transnational tax bases. The tax treaty regime and OECD and EU activities against tax evasion and 'harmful tax practices' are the most visible outcomes of this cooperation.

Secondly, governments have reformed their national tax systems in order to make them more competitive and less costly to the owners of mobile tax bases. To be sure, large cross-national differences remain in terms of tax level and tax mix. Yet there has been a strong convergence with respect to policy priorities and reform patterns.[30] Efficiency and neutrality have replaced equity and redistribution as key criteria of a 'good' tax policy. Tax reforms invariably aim to cut top personal and corporate income tax rates while at the same time broadening the tax bases, and to finance any attendant revenue loss – or additional revenue needs – through other more regressive taxes, such as VAT and social security contributions.

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In conclusion, globalization has triggered important changes in the tax state. However, the significance of these changes pales in comparison to the changes the tax state experienced during the period of 'national containment', i.e. roughly the time between the First World War and 1970, when the introduction of a set of new taxes – the personal income tax, the corporate tax, general consumption taxes, and social security contributions – completely revolutionized the tax state's revenue base and architecture. In fact, the most striking contrast between then and now is how much volatility and change there was then and how much stability and incrementalism there is now. Hence, globalization's most important consequence may not be so much to force change upon the tax state but to limit its freedom to change. The status quo is not fundamentally threatened. But it has become harder for any one government to change that status quo unilaterally. Globalization, rather than undermining the tax state, freezes it in its current form.

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