Digital Taxes, Transactions Costs and Heterogeneity

By:

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The island I grew up on is 21 miles long and 7 miles wide and although it hosts most of the country's population and its capital city, almost nobody knows its name—New Providence. That simple fact tells you everything you need to know about what inspired the 2009 article excerpted here. Expecting the Bahamas, a country 1,000 times smaller than its next-door neighbor, to develop, administer and enforce an entirely new digital tax is a fantasy. When it—inevitably—can't, will it be considered a digital tax haven?

If we were able to embrace cooperation while shedding a neocolonial fixation on harmonization, the radically reduced transaction costs that have made innovations like the U.S. Foreign Account Tax Compliance Act possible could allow states to play productively complementary roles. A large state might calculate and collect a tax for its neighbor, allowing both to benefit from economies of scale. Or, recognizing that some states look very different than others, a small state might earn some of its tax revenues in proportion to its expenditures on administering a tax rather than strictly in proportion to the economic activity subject to the tax.

Finding a way for very different states to coexist—just as the farmers and ranchers in the fabled American west once did—by allowing them to share the costs of building the fence that makes them good neighbors would be a welcome development in a today's world. Shedding our imperial insistence on uniformity (Gathii, 2020) to embrace specialization could allow states to play complementary roles in the taxation of the digital economy.

As long as national tax systems develop in response to unique social and administrative pressures, jurisdictions will continue to rely on tax systems that exhibit at least as many differences as similarities. Tax harmonization represents the traditional answer to that entropic pressure, reflecting a confidence that nations can avoid international tax conflicts by becoming more like one another. Unfortunately, in part because many of the jurisdictions that populate today's international tax landscape have little in common, it seems that harmonization is no longer equal to the task. This Part introduces the concept of deharmonization, an alternative to harmonization that may be more robust.

Tax Deharmonization

If the drive for harmonization is motivated by the potential benefits of conformity, deharmonization draws inspiration from the advantages of specialization. In a sense, pining for global homogeneity in taxation and the welfare benefits it could produce is not so different than farmers in the nineteenth-century American West wishing ranchers and their crop-trampling cattle would just disappear into the sunset. (Coase, 1988) Those farmers, like newly arrived homeowners unhappy about a smoke-bellowing factory in their midst, only wanted their neighbors to be like them. (Calebresi & Melamed, 1972) Unfortunately, they lacked the power to compel conformity and could not rely on consensual private ordering tools to achieve it.

Of course, as those two scenarios suggest, under the right circumstances conformity might not be necessary or even desirable. The groups might collectively be better off if the ranchers could pay the farmers to install fencing around their fields or if the homeowners paid the factory owner to use a better grade of coal to eliminate noxious emissions. In a perfect world, all such deals would be struck and there would be less need for potentially inefficient rules ensuring conformity. One reason many such arrangements are not created is the presence of transaction costs.

The Age of Easy Symmetry

Of the many ways that harmonization assumed a central role in the international tax regime, perhaps the least obvious to even those most familiar with that regime, is a byproduct of the influence of the small group of economists generally credited with its creation. Their nearly century-old blueprint provides the framework around which that regime has evolved. As this Subpart suggests, it may have been inevitable that they would incorporate symmetry deeply into their design.

This Subpart starts by taking a step back from the modern international tax regime to consider how governments addressed questions of asymmetry and harmonization before the threat of double taxation and the treaties meant to tame it took center stage. It begins by describing the world in which the principal architects of today's international tax regime learned to tackle important cross-border tax policy challenges. Put bluntly, it presents a picture of a time when symmetry could be, and emphatically was, taken for granted.

By importing that presumption of uniformity into the institutional structures that form the foundation of today's international tax regime, that small group of experts implicitly chose harmonization (homogeneity) over deharmonization (specialization). From the start, that choice proved to be problematic. Over the course of the twentieth century, as the international community came to be populated by an increasingly diverse group of independent actors and as technological change forced them to live in close virtual proximity to one another, the limitations of tax harmonization became increasingly troublesome.

Although tax harmonization has come to be perceived as the primary counterbalance to a host of ills, that need not have been the case. The historical context in which the international tax regime's foundation was laid raises the possibility that uniformity may have been made important simply because it was familiar, rather than because of any normative commitment to it.

During the nineteenth century, Europe and its sub-Saharan African colonies could not have been more different. Nevertheless, from a tax standpoint, the two became a well-matched pair. Certainly, it is remarkable that the tax systems of the metropoles and colonies were so similar. One could also ask a more fundamental question. Why would those colonies even attempt to collect taxes? The relative revenue potential of the metropolitan and colonial tax bases was obviously quite different. Presumably, the metropoles could have eliminated the need for any taxes at the colonial level with relatively subtle rate increases at home.

Popular resistance to the idea of subsidizing the colonies, along with a skepticism regarding the benefits of colonial investments and simple indifference, made it essential for the colonies to collect taxes. Faced with a need to generate tax revenue in the colonies to satisfy the demands of administering and expanding those colonies, the metropoles by and large did the obvious. Administrators relied on the same taxes that served them well at home.

Because the complex relationship between taxation and sovereignty has no bearing, the explanation may be more straight-forward. The metropoles appear to have simply been reluctant to use metropolitan revenues to finance colonial expenditures. That parochial reticence and the resulting need for sub-Saharan colonies to finance all or part of their own administration have been called the principle of "colonial self-sufficiency." Although not independent states, it seemed self-evident that the colonies should possess a complete taxing apparatus and that it should mirror that of the metropole.

For tax experts of the day, the role of taxation in the colonial enterprise would not have been foreign at all. One of the so-called "four economists" that are often credited as architects of the international tax regime, Edwin Seligman, even contributed to a volume titled "Essays in Colonial Finance" published by the American Economics Association in 1900. The colonies and the notion that each jurisdiction, no matter how different, should have essentially interchangeable tax regimes were simply part of the world those tax experts knew. Given that context, it may be difficult to imagine experts such as Seligman doing anything other than creating an international tax regime that would take both the existence and importance of uniformity for granted.

Cross-Border Symmetry in a Heterogeneous World

As the preceding discussion suggests, homogeneity has long been both a product of and a precondition for the success of the international tax regime. On the whole, this dynamic has been fruitful, but it also creates a problem. Because harmonization presupposes a meaningful degree of uniformity among cooperating states, when that underlying homogeneity is lacking, our harmonization-based international tax regime is rendered powerless, effectively making cooperation itself very difficult.

Interjurisdictional Transaction Costs

The primary obstacle to achieving the benefits that specialization - or harmonization, for that matter - can produce is the need to coordinate. The principal advantage of uniformity-based approaches to cooperation is that they tend to reduce the need for costly negotiations. In the international tax context, relying on model treaties and invoking the power of informal norms to advance the cause of tax harmonization serve that transaction cost-minimizing role.

Although the transaction cost differential between harmonization and deharmonization remains significant, it is clear that interjurisdictional transaction costs, particularly the costs of communication and of acquiring and processing information, have fallen dramatically since the birth of the modern international tax regime. Particularly over the past few decades, the same changes that have driven globalization - and the resulting need for increased international tax cooperation - such as improvements in telecommunications and information technology, have also made intergovernmental coordination far less expensive.

In A New World Order, Anne Marie Slaughter considers the implications of the fact that "networks of government officials - police investigators, financial regulators, even judges and legislators - increasingly exchange information and coordinate activity to combat global crime and address common problems on a global scale." In essence, she argues that the vastly increased bandwidth of the connections among states have allowed individuals at all levels of government to collaborate in ways that would have been impossible even in the relatively recent past. Put differently, the transaction costs of intergovernmental cooperation have fallen significantly. Those lower costs open the door to strategies that would once have been prohibitively expensive.

In an era in which intergovernmental transaction costs were higher, it might not have made sense to imagine narrowly focused, possibly short-term international tax arrangements that call on participating nations to play specialized roles. Today, given the ease with which government officials interact on a broad range of issues, there are likely to be circumstances in which states can reasonably provide one another with targeted assistance that addresses idiosyncratic or temporary needs. The systemic changes that have led to the blossoming of transnational networks could also facilitate the emergence of an entirely new order of cross-border tax relationships.

The Benefits Principle

The benefits principle presents a problem that is unique to deharmonization. Even if the surplus that would be generated by a particular cooperative arrangement would be greater than the transaction costs of setting it in motion, there remains the challenge of finding a way to share the efficiency gains produced by the arrangement. Unless each partner happens to derive benefits from the arrangement that more than offset its costs, that could mean cash payments by one state to another. That would represent a clear break with the benefits principle that in some respects is the cornerstone of the modern international tax regime.

Even those who agree on nothing else when it comes to international taxation would likely agree that each state should be entitled to revenues derived from economic activity that occurs within its borders. The benefits principle formalizes that parochial impulse by assigning taxing jurisdiction according to the state that "earns" the right to tax economic activity by facilitating that activity. That approach works well if the relative size of each jurisdiction's tax base serves as a fair proxy for its contribution to a tax, as it presumably would be in a harmonized regime. When a state makes administrative or other contributions that are disproportionate to the size of its tax base, that system breaks down. Because it explicitly disaggregates functions across states, deharmonization requires a more sophisticated mechanism for allocating tax revenues than the benefits principle.

(First three paragraphs excerpted from Steven A. Dean, *More Cooperation, Less Uniformity: Tax Deharmonization and the Future of the International Tax Regime*, 84 Tul. L. Rev. 125 (2009))