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**WHY WORLDWIDE WELFARE AS A
NORMATIVE STANDARD IN U.S. TAX POLICY?**

Daniel Shaviro*

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I. INTRODUCTION

People do not always mean what they say, or say what they mean. Indeed, they do not always know what they mean. A good case in point is the perennial debate over the proper direction of U.S. tax policy with respect to U.S. firms' outbound investment.¹ Much of this debate, on one side in particular, emphasizes worldwide rather than national welfare, despite the fact that the audience consists of national rather than worldwide politicians and voters.

U.S. multinationals, in arguing for lower U.S. taxes, typically emphasize international competitiveness,² thus appealing to national welfare defined in terms of their overseas business success. The surprise lies on the other side. Advocates of higher U.S. taxes on U.S. multinationals have a contrary national welfare argument, based on the view that the U.S. benefits from imposing at least as high a tax rate on foreign as on domestic investment.³ Yet they often instead emphasize capital export neutrality (CEN),⁴

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¹ Inbound and outbound investment raise symmetric issues. In keeping with world practice, however, I take it as a starting point that countries will generally tax inbound investment by foreigners.

² See, e.g., Joint Committee on Taxation, *The Impact of International Tax Reform: Background and Selected Issues Relating to U.S. International Tax Rules and the Competitiveness of U.S. Businesses* 5, 56 (2006).

³ See, e.g., U.S. Treasury Department, *The Deferral of Income Earned Through U.S. Controlled Foreign Corporations* 41 (2000).

a worldwide efficiency standard that is satisfied with respect to a given taxpayer when it would face the same worldwide tax rate on foreign as on domestic investments, inducing it to favor whichever investments offer the highest pre-tax returns.

Where applicable, CEN maximizes worldwide welfare, without regard to how the world's wealth is split between nations, by inducing choice of investments with the highest pre-tax return. It abstracts from the question of whether a given dollar of tax revenue goes to the U.S. government or some foreign government – an issue obviously relevant to U.S. welfare, even if more or less a wash from the standpoint of worldwide welfare.

As it happens, proponents of lower U.S. taxes on U.S. multinationals can also invoke a worldwide efficiency standard, capital import neutrality (CIN), which is satisfied when anyone who made a given investment, regardless of residence, would face the same tax rate.⁵ So both sides can (and do) argue on both the worldwide and the national fronts. While the worldwide welfare aspect of CIN comes up mainly in rebuttal to CEN, rather than as the multinationals' main argument,⁶ even this limited use of it accepts the relevance of worldwide welfare to U.S. tax policy.

There are strong normative arguments for treating worldwide welfare as the proper standard for policymaking. If each individual's welfare across the entire world has the same moral weight, differences in nationality notwithstanding, then this is the standard that in some sense we all ought to use. Why, however, would one expect it to be

⁴ See Joint Committee on Taxation, *supra*, at 3.

⁵ See *id.* at 5.

⁶ See, e.g., National Foreign Trade Council, *The NFTC Foreign Income Project: International Tax Policy for the 21st Century, Part One: A Reconsideration of Subpart F* (Washington, 1999).

the standard that anyone short of a saint actually does use? Even the most philosophically altruistic among us often do not, in practice, give all of their possessions to the poor. At the international level, selflessness in pursuit of worldwide welfare surely is not a sustainable policy. Nor is it one that typically gets voiced in U.S. policy debate.

Taken literally, CEN advocates' apparent focus on worldwide welfare invites the retort, made recently by Michael Graetz, that "this nation's international tax policy [should instead] be fashioned to advance the interests of the American people."⁷ Yet, while invited by the rhetoric of CEN, this retort begs credulity. Is the main problem with U.S. tax policy in the international realm really one of its being too noble, selfless, and idealistic? What could possibly be the politics of such an orientation, or even the ideology behind it given that CEN proponents are not generally advocates of U.S. self-abnegation in the service of humanity as a whole? Don't these proponents likely believe, whether rightly or wrongly, that the policies they support under the banner of CEN are actually good for the United States? Graetz therefore appears to be tilting at a straw man.

In this article, I argue that something else is actually going on. Support for CEN as a policy guidepost is a frequently sensible, albeit sometimes misguided, response to a basic prisoner's dilemma that all countries face in taxing cross-border investment. The tax policies that may be best for one country when acting unilaterally are collectively disastrous if followed by all. And, while the fact that countries' tax rules are observable may seem to create the equivalent of a repeated-play prisoner's dilemma, in which cooperative behavior naturally emerges, short-term responsiveness to each other's tax

⁷ Michael J. Graetz, "Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies," 54 Tax L. Rev. 261, 281 (2001).

policies is limited. The long-term maintenance of cooperation therefore may require the dissemination of norms urging cooperation as good in itself.

From an intellectual standpoint, the problem with basing international tax policy arguments on worldwide welfare is not that the U.S. national interest is being sacrificed, but rather that clear thinking is being impeded. We need to know why and under what conditions we benefit from thinking in terms of worldwide welfare, in order to make best use of the concept. Whether thus looking behind the norm conceivably might end up undermining it is a question I leave for another day.

The remainder of this article proceeds as follows. Section II discusses two of the core prisoner's dilemmas in international tax policy, pertaining to double taxation of cross-border investment and tax harmonization. Section III discusses the need for cooperative norms based on worldwide welfare to address the coordination problems between countries that might not arise in a simple two-party repeated-play prisoner's dilemma framework with binary choices to cooperate or defect. Section IV discusses some of the main implications of the prisoner's dilemmas for rules addressing double taxation and tax harmonization. Section V provides a brief conclusion.

II. AVOIDING DOUBLE TAXATION AS A PRISONER'S DILEMMA

A. Basic Setup of the Prisoner's Dilemma

By now, the prisoner's dilemma is familiar fare in legal scholarship. On average, U.S. and Canadian law reviews publish more than 150 articles per year that mention it.⁸ Nonetheless, a quick review may be useful. In the classic setup, two partners in crime are being held and interrogated by the police in separate rooms. Each must decide whether to confess, and in so doing implicate the other, or to stonewall the police. If both hold out, the police will be unable to prove the crime but will convict each on some lesser charge, resulting in short jail terms. If only one prisoner confesses, he or she will get to turn state's witness and be set free after sending the other one to prison for a long time. If both confess, no testimony will be needed, and each will be sentenced to a medium-length jail term.

Each prisoner faces a choice between cooperating and defecting from the other prisoner's standpoint (i.e., cooperating with the police constitutes "defecting"). What gives the prisoner's dilemma its bite is the fact that, while collectively the prisoners would be best off cooperating with each other and stonewalling the police, each of them, considered in isolation, is better off defecting no matter what the other does. By defecting you eliminate any jail term if the other prisoner cooperates, and you shorten your jail term if he or she defects. Thus, if they cannot observe each other and coordinate their behavior, their pursuit of rational self-interest may have the pathological effect of leaving them worse-off than if they had acted altruistically.

⁸ A Lexis search that I conducted on June 22, 2006 revealed that the number of articles in U.S. and Canadian law reviews mentioning prisoner's dilemmas was 156 over the prior year, 328 over the prior two years, and 837 over the prior five years.

Two possible complications are worth mentioning. First, a prisoner's dilemma may involve any number of parties rather than just two, potentially making cooperation even more unlikely. Second, a prisoner's dilemma may involve repeat play, with the consequence, at least in a two-player game, of making cooperation a lot easier. For example, suppose each prisoner anticipates that the other will play tit-for-tat the next time around by repeating whatever he or she just did. This makes cooperating the best strategy, even from a narrowly selfish point of view, if the time horizon is unlimited (as it generally would be when, as in the international tax setting, the players are governments).

Prisoner's dilemmas are ubiquitous in public policy. Thomas Hobbes' state of nature, featuring the war of all against all,⁹ is an example, since all would be better off observing peace but no lone individual has an incentive to do so. Another classic example is pollution, where each individual's contribution to the sum total is sufficiently trivial that he or she would be better off not having to comply with emissions standards. One way of solving prisoners' dilemmas is through centralized command, be it Hobbes' sovereign or a government enacting pollution laws. Another possibility is that the parties will be able to achieve cooperation by following social norms, which can be defined as "informal social regularities that individuals feel obligated to follow because of an internalized sense of duty, because of a fear of external non-legal sanctions, or both."¹⁰

B. The Double Taxation Prisoner's Dilemma

Turning to international taxation, a prisoner's dilemma arises from the fact that countries commonly assert jurisdiction to tax on both a source and a residence basis.

⁹ See Thomas Hobbes, *LEVIATHAN*.

¹⁰ Richard H. McAdams, "The Origin, Development, and Regulation of Norms," 96 *Mich. L. Rev.* 338, 339 (1997).

They may levy taxes both on all economic activity within their borders, and on all of the worldwide economic activities of those they define as residents, including legal entities such as corporations. Thus, when a resident of one country earns income in another country, the income may be taxed twice.

Suppose, for example, that both the U.S. and France levy a 40 percent income tax on both a source and a residence basis. A company from either country that invests at home and earns \$100 before-tax will end up with \$60. In the case of a cross-border investment, however, the company will end up with only \$20 after-tax if each country entirely ignores the payment of taxes to the other. Even if the residence country treats foreign taxes paid as an allowable deduction, the company will end up with only \$36 after-tax.

The resulting violation of CEN – companies face a higher tax rate on foreign than domestic investment¹¹ – may lead to lost welfare in both the U.S. and France, as productive investment opportunities by companies with distinctive skills are foregone. Acting in isolation, however, neither country has reason to recede from levying its share of the double tax. At least in a simple economic model, absent strategic interactions each country would maximize its economic welfare through the policy, dubbed “national neutrality” by economist Peggy Musgrave, of allowing only a deduction for the other country’s source-based taxes.¹²

¹¹ The double tax on cross-border investment also violates capital import neutrality (CIN).

¹² See Peggy B. Musgrave, *Taxation of Foreign Income: An Economic Analysis* (1963). The underlying intuition is that, from the standpoint of national economic wealth, paying taxes to another country is a cost just like paying for gasoline. Thus, treating foreign taxes as a deduction like any other cost induces the taxpayer to seek the highest pretax return, defined in terms of the resources held at the end of the day by nationals.

While each country has an incentive to follow national neutrality no matter what the other one unilaterally does, they would both be better off cooperating so that cross-border trade will not be inefficiently tax-deterred. Both CEN and CIN offer means of cooperating, although they support choosing different margins for the creation of tax neutrality.

With just two countries whose tax policies are identical and publicly known, the double taxation prisoner's dilemma is easy to solve. Both of the two main solutions that have emerged involve the residence country's receding on its tax claim, thus restoring CEN in the simple hypothetical set forth above. One common solution is for the residence country to allow a tax credit for foreign taxes paid. Thus, the U.S. might determine that a U.S. company earning \$100 in France owes \$40 of tax, minus a \$40 foreign tax credit for the amount it paid to France. The second common solution is to forego any taxation of one's nationals' foreign source income. Thus, the U.S. might simply not levy tax on U.S. companies' foreign source income (although in fact we use foreign tax credits). In the above example, the two approaches came out identically, but this reflected the assumption that the U.S. and French tax systems were identical.

Suppose, therefore, that we revise the above hypothetical so that France's tax rate is 30 percent. Now, while a U.S. company earning \$100 in France would pay no U.S. tax under exemption, it would pay \$10 under a foreign tax credit system, this being the excess of the \$40 U.S. liability over the \$30 of French tax actually paid. From the French standpoint, if allowable foreign tax credits are unlimited, France would actually have to rebate \$10 to French companies earning \$100 in the United States, this being the excess of foreign taxes over the French tax on the income.

CEN requires a foreign tax credit system with full refundability for credits in excess of the domestic tax on the foreign income, so that U.S. companies will face a 40 percent worldwide tax rate, and French companies a 30 percent worldwide tax rate, no matter where they invest. (In practice, however, foreign tax credits are limited to offsetting the domestic tax on the foreign source income, as opposed to being allowed to offset all domestic tax liability.) Exemption, by contrast, fulfills the competing international tax norm of capital import neutrality (CIN), under which a given investment will face the same tax rate no matter who makes it. The two norms are thus similar, rather than being polar opposites, commonly accepting the need to prevent double taxation, in practice by deferring to the source jurisdiction, and differing only in whether to take account of differences between domestic and foreign tax rules.

Despite the substantial similarities between CEN and CIN, they often conflict on the prevailing political battlefields in U.S. international tax policy. One example is the debate over deferral of U.S. tax on the foreign earnings of U.S. companies' foreign subsidiaries until the earnings are repatriated,¹³ in practice moving the U.S. tax system closer to CIN. A second example concerns efforts by the U.S. Treasury to make U.S. companies effectively disgorge the benefits of foreign tax reduction that they achieve through foreign tax planning.¹⁴ Such tax planning is inconsistent with CEN, insofar as it lowers the companies' effective tax rates abroad, but advances CIN and competitiveness if the companies' foreign rivals can engage in the same practices without disgorgement.

¹³ See U.S. Treasury, *supra*.

¹⁴ An example is Code section 954(d) making foreign source income currently taxable in the U.S. in certain circumstances where the taxpayer appears to be potentially shifting taxable income from high-tax to low-tax foreign countries.

The sharp conflict between rival CEN-based and CIN-based policies makes it easy to overlook the fact that both involve a cooperative response to the double taxation prisoner's dilemma. Again, both CEN and CIN are generally inferior to national neutrality from the standpoint of a home country acting unilaterally. Thus, suppose a U.S. company is choosing between a U.S. investment that pays \$95 before tax and a French investment that pays \$100 before-tax. The U.S. investment is actually better from a U.S. standpoint, albeit worse from a worldwide standpoint, since under it Americans keep \$95 (counting the tax revenues that remain in the U.S.), rather than only \$70 after paying French tax on the French investment. So the U.S. is likely acting against its own interest in providing exemption or foreign tax credits unless its behavior affects that of France.¹⁵

Another way of putting the problem, from the U.S. standpoint, is in terms of the effect on other parties' incentives. Not fully taxing foreign source income gives U.S. taxpayers the wrong incentive from a U.S. national standpoint, given the lack of any national benefit from foreign taxes paid. Foreign tax credits have the additional vice of making both the U.S. taxpayer and the foreign country indifferent to the level of foreign taxes, since the U.S. government will refund them to the taxpayer. Absent the credits, not only would the U.S. taxpayer be averse to foreign taxes, but foreign countries could not levy them on inbound investment without concern about discouraging such investment. Foreign tax credits therefore encourage efforts to drain the U.S. Treasury, on top of the

¹⁵ Under some circumstances, however, a small country that mistakenly, from the standpoint of its own self-interest, imposes a source-based tax on inbound investment may benefit from lowering its tax rate on outbound investment. *See* Carl Hansen, Roger Procter and Joel Slemrod, *The Seesaw Principle in International Tax Policy*, 65(2) *J. Pub. Econ.* 163 (1997).

incentive to defect, by following national neutrality, that other countries have no matter what the U.S. unilaterally does.

C. The Tax Harmonization Prisoner's Dilemma

A further classic example of a prisoner's dilemma is the problem faced by a producer cartel that seeks to extract monopoly profits from consumers by colluding on supply and price. Acting unilaterally, each cartel member would be best off defecting from the group by selling more than its allotment and under-cutting the monopoly price, whether other members of the cartel similarly defect or not. This, of course, is a prisoner's dilemma that we may generally be glad about, as it impedes monopolistic behavior that would create deadweight loss in addition to transferring resources from consumers to cartel members. The analysis of the prisoner's dilemma would not change, however, if we stipulated that the cartel's attempted actions were for some reason socially desirable.

The cartel problem has a direct analogue in international taxation. Since people generally do not pay taxes voluntarily, governments must exercise a kind of monopoly power over their jurisdictions in order to raise revenue. When governments lack sufficient market power due to the ease of exiting from their jurisdictions, they must in effect cartelize in order to succeed in (or at least do better at) raising revenue. This involves, at a minimum, coordinating their efforts so that everyone has to pay tax at a minimum rate somewhere, and at the limit fully harmonizing their tax systems so that taxpayers cannot get any tax benefit by locating any activity here rather than there.

As with any other cartel, governments have a motive to defect if by doing so they can attract business that gives them extra net revenues. Defecting frees them to engage in

tax competition, thus in effect under-cutting the cartel price. The only distinctive factor in the government setting is that stronger arguments might be made in favor of the social welfare benefits derived from the cartel. Governments cannot supply public goods, or those with non-rival, non-excludable benefits, without monopolistic exercise of the power to tax.¹⁶ On the other hand, there is no guarantee that any given exercise of this power is socially desirable, and one could argue (depending on broader philosophical and empirical views) that governments' current ability to raise revenue is either too low or too high. In addition, avoidance of competitive pressures has the undesirable effect of reducing governments' incentive to offer prospective entrants attractive tax-benefit packages.¹⁷

This normative ambiguity has led to a longstanding public policy debate about the relative benefits of tax competition as opposed to tax harmonization. One need not take a stance on this debate, however, to recognize that governments' success in achieving revenue-raising objectives, whether for good or bad socially, may often depend on their ability to cartelize notwithstanding each potentially participating government's incentive to defect.

One rationale that has been offered for favoring cartelization in lieu of tax competition is that globalization would otherwise threaten adequate levels of tax progressivity and funding for welfare state institutions.¹⁸ Other rationales include

¹⁶ See Daniel Shaviro, "Some Observations Concerning Multi-Jurisdictional Tax Competition," in Daniel Esty and Damien Geradin (eds.), *Regulatory Competition and Economic Integration: Comparative Perspectives* (2001).

¹⁷ See Charles Tiebout, "A Pure Theory of Local Expenditures," 64 *J. Pol. Econ.* 416 (1956).

¹⁸ Reuven Avi-Yonah, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 *Harv. L.Rev.* 1573 (2000).

avoiding preferential worldwide treatment of mobile as opposed to immobile economic activity,¹⁹ and eliminating taxpayers' incentive to engage in costly tax avoidance behavior that relies on cross-border activity or cross-border paper-shuffling.²⁰

The term "tax harmonization" is often used to refer to countries' adopting identical rather than divergent definitions of shared tax concepts such as residence, asset ownership, corporation, debt, and equity.²¹ Harmonization in this sense may benefit taxpayers by reducing compliance costs. For governments, it offers the benefit of foreclosing tax planning that exploits gaps between countries' definitions of common concepts, at the cost of foregoing whatever advantages attach to customizing and controlling one's own definitions of tax concepts. Here, while coordination between governments is important, it does not involve a prisoner's dilemma unless it is being used as a vehicle for tax competition. Countries may benefit (or not) from adopting common definitions of shared legal concepts, but there is no strategic advantage to being the holdout unless one thereby attracts business by offering lower taxes.

¹⁹ Shaviro, *Some Observations*, *supra*, at 61.

²⁰ Daniel Shaviro, *Money on the Table? Responding to Cross-Border Tax Arbitrage*, 3 *Chicago Journal of International Law* 317 (2002).

²¹ See, e.g., Shaviro, *Money on the Table*; Diane Ring, *One Nation Among Many: Policy Implications of Cross-Border Tax Arbitrage*, 44 *B.C. Law Rev.* 79 (2002); Mitchell Kane, *Strategy and Cooperation in National Responses to Cross-Border Tax Arbitrage*, 53 *Emory L.J.* 89 (2004).

III. THE ROLE OF COOPERATIVE NORMS BASED ON WORLDWIDE WELFARE

A. Norms as a Needed Supplement to Treaties and Direct Responses to Observed Behavior

In the simple two-party prisoner's dilemma with repeat play, coordination need not rely on centralized command. It also may not require that the two prisoners share a cooperative belief structure, such as honor among thieves or aversion to snitching. So long as one expects the other party to play tit-for-tat and is sufficiently concerned about future as opposed to just current outcomes, cooperation follows from the direct consultation of narrow self-interest. In other settings, however, norms' internal or self-enforcement mechanisms, involving a sense of duty to conform and guilt or shame upon defecting, may be required in order to keep the norms going.

In the international tax setting, there is good reason to believe that norms based on worldwide welfare are critical to sustaining cooperative behavior, and that their effectiveness may depend on their being internalized by policymakers around the world as defining good tax policy, rather than just on prudential concern about demonstrable threats of retaliation. The considerations supporting this view include the following:

--As generally in international law, there is no worldwide sovereign that can demand compliance with particular rules.

--There are more than two hundred countries, each empowered to set its own tax policy, thus making general cooperation a lot costlier to achieve than it would be in a two-party case.

--Multilateral tax treaties are limited, and generally address trade issues of protectionism, rather than double taxation or tax harmonization.²²

--While there are hundreds of bilateral tax treaties, often including specific reciprocal concessions, the treaties leave countries considerable freedom of action to determine the extent of their commitment to avoiding double taxation and promoting tax harmonization.

--Relatedly, cooperation versus defection is not simply a readily observable binary choice. Thus, consider the foreign tax credits offered under U.S. tax law, which are nonrefundable and thus can only offset the U.S. tax on what the U.S. deems to be foreign source income. One way of moving, an inch at a time, towards effective repeal of the foreign tax credit is simply to tailor the definitions of domestic and foreign source income with an eye to pushing gross income items into the former and deduction items into the latter. With no worldwide convention for defining source, which in any event “is not a well-defined economic idea,”²³ the U.S. (along with other countries, whether using foreign tax credits or exemption) has considerable leeway to stack the deck in the direction of increasing its tax take at the cost of discouraging cross-border investment, without other countries even noticing, at least in the short run.

--A number of other factors further limit the political responsiveness of a given country’s tax system to defection or cooperation by other countries. Political systems

²² On multilateral treaties that affect income taxation, see Alvin Warren, “Income Tax Discrimination Against International Commerce,” 54 *Tax L. Rev.* 131 (2001). On the poorly defined boundary between tax and trade issues, see *id.* and Joel Slemrod, “Free Trade Taxation and Protectionist Taxation,” 2 *International Tax and Public Finance* 471 (1995).

²³ Hugh Ault and David Bradford, “Taxing International Income: An Analysis of the U.S. System and Its Economic Premises,” in Assaf Razin and Joel Slemrod (eds.), *Taxation in the Global Economy* 31 (1990).

often have inertia or status quo bias, impeding their responsiveness. Often, the number of items that can make it onto the legislative agenda is limited. Moreover, the incentives of political actors inevitably diverge from promoting national welfare. Political systems have their own prisoner's dilemmas and other collective action problems. In the United States, tax policy is a plaything of interest group politics,²⁴ ideological divisions related to progressivity and the size of government,²⁵ and the games played by politicians to extract rents²⁶ or improve the political optics of what they are doing.²⁷

--Political actors who need to worry about the next election often have short time horizons, inducing them to undervalue the national welfare cost of deferred retaliation by other countries. A norm that treats cooperation as good in itself can help to counter this institutionalized impulse to shortsightedness.

--Even for actors who will be on the scene indefinitely, and indeed for individuals facing prisoner's dilemmas in their private interactions, cooperative norms can serve as a pre-commitment device that make them both actually and apparently more likely to cooperate without calculating the odds each time. A belief in cooperation can aid in self-control when defection has short-term advantages, and, when visibly part of one's makeup, can make one appear more trustworthy. Similar considerations may hold in the national political setting.

²⁴ See, e.g., Stanley Surrey, "The Congress and the Tax Lobbyist – How Special Tax Provisions Get Enacted," 70 Harv. L. Rev. 1145 (1987).

²⁵ See, e.g., Daniel Shaviro, *Taxes, Spending, and the U.S. Government's March Towards Bankruptcy* (forthcoming).

²⁶ See, e.g., Edward McCaffery and Linda Cohen, "Shakedown at Gucci Gulch: The New Logic of Collective Action," 84 N.C. L. Rev. 1159 (2006).

²⁷ See, e.g., Leonard Burman, "Roth Conversions as Revenue Raisers: Smoke and Mirrors," 111 Tax Notes 953, 954 (2006) (describing change in individual retirement account rules designed to frontload tax revenues so that budget deficits would appear smaller).

With all these departures from the simple prisoner's dilemma with unitary rational actors and binary choices, much of what countries do in choosing between cooperation and defection may look unilateral, and at least in the short run may indeed be so. Thus, while the United States might provoke swift responses from other countries if it explicitly repealed the foreign tax credit, changes that simply shaved the credit a bit by shrinking measured foreign source income could well draw no direct or discernible response.

While some degree of freedom is plausible, norms tend to be strengthened by compliance and weakened by violation.²⁸ Thus, nationalistically driven departures from promoting worldwide welfare may tend to feed on themselves and push overall policy in a direction where at some point it really would be noticed and become likely to provoke retaliation. To be sure, this does not mean that the nationally optimal level of defection from promoting worldwide welfare is zero. With imperfect observability, others are unlikely to expect perfect compliance, or even to believe it fully when actually practiced. A priori, however, reducing cooperation from a given level is no more likely to serve the national interest than increasing it, even if direct responses by other countries, and in the short run any responses, are unlikely.

These considerations support treating worldwide welfare as an important value in setting national tax policy, albeit not one to be treated as the exclusive value. They also suggest that one should cooperate most when one's behavior is most visible, and should make one's actual cooperation as easy as possible to observe. Moreover, in the confused world of public policy debate, it may be best that defection not be too self-conscious and explicit, thus limiting its domestic precedential significance, as opposed to just its

²⁸ See McAdams, *supra*, at 367.

observability by others. As we will see, U.S. tax policy follows these principles to some extent, despite its not being the work of a unitary actor concerned solely with promoting national welfare.

B. Why Define Worldwide Welfare Mainly in Terms of CEN Rather Than CIN?

In principle, the choice of terrain between worldwide welfare and unilateral national welfare need not dictate the outcome of political battles concerning the U.S. tax burden on U.S. multinationals. From a worldwide standpoint, the multinationals can pit CIN against CEN,²⁹ while from a unilateral national standpoint they can pit competitiveness against moving closer to national neutrality.³⁰ Why, then, do debates about the U.S. taxation of U.S. multinationals typically feature CEN on the one side and competitiveness on the other, thereby seemingly suggesting that the choice depends on one's choice between worldwide and national perspectives?

One explanation may be that the worldwide efficiency case for CEN is widely, although not universally, considered stronger than that for CIN.³¹ This conclusion reflects the view that decisions regarding where to investment, which CEN makes tax-neutral for a given investor, are more tax-sensitive than decisions regarding whether to

²⁹ CEN favors the domestic tax interests of U.S. multinationals insofar as it supports making the foreign tax credit refundable, rather than limited to offsetting the U.S. tax on foreign source income. This issue, however, is not in play politically.

³⁰ A nonrefundable foreign tax credit moves the system closer to national neutrality, assuming the sourcing rules are working properly, by modifying exemption to levy some positive U.S. tax on foreign source income.

³¹ See U.S. Treasury Department, *supra*, at 53-54; Donald J. Rousslang, *Deferral and the Optimal Taxation of International Investment Income*, 53 Nat'l Tax J. 589, 597-98 (2000); Graetz, *supra*, at 272.

save, which CIN makes tax-neutral as between alternative savers, making neutrality under CEN more important.

A second reason for the identification of CEN with worldwide welfare is that, from such a perspective, it is easier than CIN to explain intuitively. To explain CEN, all one needs is an example in which Investment A has a higher pre-tax return than Investment B, but the taxpayer chooses B because it is taxed at a lower rate. The intuitive story behind CIN, if put in worldwide efficiency terms, is that Investor X has a higher discount rate than Investor Y (i.e., assigns greater disutility to saving), but nonetheless is the one who saves, because X faces a lower tax rate on the return to saving than Y. The worldwide welfare loss under CIN therefore involves psychic utility as discerned from discount rates, rather than a choice between observed market returns, making it a lot less salient.³² The CIN idea that everyone should face the same tax rate on a given investment becomes a lot more salient, however, if one thinks of Y as facing an unfair competitive disadvantage relative to X. Y, moreover, is “our guy,” struggling against the odds to compete with “their guys,” if one personifies U.S. firms as if they were U.S. individuals.

A final reason for the association of worldwide welfare with imposing U.S. higher taxes on U.S. multinationals under CEN may lie in the exigencies of seeking lower rather than higher U.S. taxes for a particular group. Multinationals might find it awkward to argue that their taxes should be reduced in order to promote worldwide welfare, concededly at the possible expense of national welfare. On the other side, the fact that

³² CIN may also be invoked with respect to the reduced incentive to save if some investors face a higher rate than others (e.g., due to worldwide residence-based taxation in high-tax countries). This is not strictly a CIN problem, however, since CIN can be restored by raising the lower set of tax rates, no less than by reducing the higher set.

one is trying to raise revenue, by making U.S. companies pay more tax on their foreign earnings, makes emphasizing the worldwide perspective less awkward. Moreover, one important motivation for many supporters of CEN, which is to make the U.S. tax system more progressive by increasing the taxation of capital income,³³ is both more controversial than promoting efficiency and often thought diametrically opposed to it. The ability to argue for progressivity in efficiency terms, even if these terms risk controversy of their own by involving a worldwide perspective, may be rhetorically welcome.

³³ See, e.g., Avi-Yonah, *supra*; Robert J. Peroni, Back to the Future: A Path to Progressive Reform of the U.S. International Income Tax Rules, 51 U. Miami L. Rev. 975 (1997).

IV. U.S. TAX POLICY IMPLICATIONS OF THE PRISONER'S DILEMMAS

The previous section suggested that a norm of advancing worldwide welfare can help countries to address prisoner's dilemmas in international taxation – even outside the bilateral treaty context, and even when they are not watching each other carefully or promptly responding in kind. Visible attachment to the norm provides a degree of credible commitment, even if no one expects cooperation to be complete or unconditional. Under this view, the manner in which countries should (and perhaps do) follow the norm becomes more nuanced than it would be under a view of worldwide welfare as an end in itself.

A. Mitigating Double Taxation

Given the importance of appearing generally cooperative, one obvious maxim for self-interested countries is to lean towards limiting overt defections to those taking a generally accepted form. An example of this is limiting foreign tax credits to the domestic tax on foreign source income. Under this approach, the U.S. reimburses foreign taxes paid at a 100 percent rate until the limit is reached, at which point the reimbursement percentage drops abruptly to zero. Considered as an optimal tax problem in which the U.S. has some formula for weighing worldwide welfare against unilateral pursuit of self-interest, this rate structure for reimbursing foreign taxes is not obviously best in creating the incentives that we prefer for multinationals and foreign governments. The current foreign tax credit regime also involves enormous administrative complexity compared to, say, reimbursing all foreign taxes paid at a fixed rate that is between zero and one hundred percent. The current structure may seem more reasonable, however, if one thinks of it as a rule of the road that has emerged defining permissible defection, and

as a form of defection that is intuitively more acceptable than other possible approaches because it appeals to the sentiment that reducing a set of taxes (i.e., those on foreign source income) to zero is less objectionable than allowing them to be negative.

A second maxim is “defect subtly, cooperate transparently,” in order to make one’s overall compliance look as great as possible. The audience for this performance includes oneself, not just other countries, since subtler and less self-conscious violations of the norm may do less to weaken its domestic political hold. The U.S. tax rules for determining whether gross income and deductions are U.S. source or foreign source arguably reflect this approach in several respects.

As background, these rules matter both for outbound investment by U.S. multinationals and for inbound investment by foreign businesses. For outbound investment, the rules determine the application of the foreign tax credit limitation (allowing the credit only against the U.S. tax on foreign source income). For inbound investment, they determine what is taxable by the U.S. on a source basis.

One way to identify defection via sourcing rules, despite the absence of a clearly correct sourcing baseline to test the rules against, is by finding asymmetries in how they treat inbound as compared to outbound activity. The U.S. rules do indeed contain such asymmetries in at least a couple of instances. An example is dividend income. While the source rules for dividends are in general symmetrically formalistic, treating them as U.S. source when paid by a U.S. resident and as foreign source when paid by a foreign resident, there is an asymmetric exception. Those paid by a U.S. company remain U.S. source even if the company has extensive foreign operations, but those paid by a foreign company are subject to pro rata classification as U.S. source if more than 25 percent of

the company's gross income over a three-year period is effectively connected with a U.S. trade or business.³⁴

The determination of whether interest deductions are taken against U.S. source or foreign source income raises a more complicated story. In general, the U.S. rules require that interest expense be allocated pro rata to the taxpayer's assets.³⁵ Thus, a U.S. consolidated group with a 50-50 split between domestic and foreign assets would treat 50 percent of its overall interest expense as an offset to U.S. rather than foreign taxable income. Interest expense of foreign subsidiaries, however, was long disregarded for certain purposes, permitting U.S.-incurred interest expense to be classified as foreign even if the borrowing of the overall worldwide group was proportionate to its ratio of U.S. to foreign assets.³⁶

In 2004, this "cheating" was reduced, at the behest of U.S. multinationals, by a new provision permitting them to take account of foreign subsidiaries' borrowing for purposes of interest allocation.³⁷ Even as revised, however, the interest allocation rules are asymmetric. They still do not permit foreign subsidiaries' interest expense to be treated as U.S. source by reason of the activities of the U.S. members of a worldwide group.³⁸

³⁴ Section 861(a)(2)(B).

³⁵ Section 864(e). The provision is not effective until 2009, and requires a one-time election to count the interest expense of foreign subsidiaries.

³⁶ See Daniel Shaviro, *Does More Sophisticated Mean Better? A Critique of Alternative Approaches to Sourcing the Interest Expense of U.S. Multinationals*, 54 *Tax L. Rev.* 353 (2001).

³⁷ Section 864(f).

³⁸ For a differently motivated strategic use of the rules for allocating deductions, see section 864(g) (as applicable for taxable years starting in 2009), under which 50 percent of research and experimentation expenditures are allocated between U.S. and foreign sources based on where the activities take place, rather than on where they produce

Again, to say that a particular source rule defects from the worldwide cause of mitigating double taxation does not imply any normative judgment about it. From both a worldwide and a national standpoint, however, subtle defections may be better than those that are overt but not commonly accepted, if they reduce domestic weakening of the norm and the likelihood of retaliation. For an example of defection that arguably was too overt, consider the rule, enacted in 1986 and repealed in 2004, under which foreign tax credits could not offset more than 90 percent of what would otherwise have been one's alternative minimum tax liability.³⁹ This express denial of foreign tax credits, in a manner not reflecting commonly accepted worldwide practice, drew general criticism⁴⁰ and even litigation arguing (albeit unsuccessfully) that it violated U.S. treaty obligations⁴¹ before finally being repealed.

When some forms of defection are more acceptable than others, defecting the “right” way may even be consistent with the prevailing norms, which might be interpreted as only banning defection that is excessive or done in the “wrong” way. Ultimately there is no bright line between permissible defection, and that which is not even considered defection. Either way, one arguably has a retaliation-free zone where self-interest unambiguously counsels defection from promoting worldwide welfare,

income. This provides a U.S. tax incentive to locate research and experimentation activities on U.S. soil, presumably rationalized on the ground that hosting such activities yields positive externalities.

³⁹ Former section 59(a)(2).

⁴⁰ See ABA Tax Section Members Comment On FTC And Subpart F Issues Raised By The Tax Reform Act Of 1986, 34 Tax Notes 1055 (1987); Robert Peroni, Reform and Simplification of the U.S. Foreign Tax Credit Rules, 101 Tax Notes 103, 123 (2003).

⁴¹ See *Haver v. Commissioner*, 444 F.3d 656 (D.C. Cir. 2006); *Pekar v. Commissioner*, 113 T.C. 158 (1999).

unless one could conceivably change the norm and eventually raise other's cooperation by increasing one's own.

While no country is likely to benefit from completely cooperating, for the United States the optimal level thereof may be higher than for most other countries. We are a large and influential player in the world, both economically and as a producer of tax law rules and approaches, and thus one might expect our choices to have unusually great influence, whether the mechanism is tit-for-tat or simple imitation.

B. Tax Harmonization

The prisoner's dilemma that impedes government cartelization with respect to effective tax rates has a different dynamic than that related to mitigating double taxation. Two countries do not need cooperation from the rest of the world in order to mitigate double taxation as between themselves, such as by agreeing to credit each other's taxes. One could compare this to two countries' creating a mutual free trade zone, which may benefit them even if the rest of the world retains tariffs. Cartelization to prevent tax competition, however, can break down if too few parties participate. Its capacity to benefit a limited group of participants depends on their collective market power.

This, in turn, may vary depending on the basis for asserting tax jurisdiction. For example, a residence-based tax on individuals may work well for the United States acting alone, although not as well for U.S. states or individual members of the European Union. Even for a large country, however, residence-based taxation works considerably less well as applied to legal entities, unless it can sufficiently be tied to residence decisions by individuals (such as owners or managers). A source-based tax, while often considered an

invitation to tax competition, can be effective in raising revenues to the extent that those levying it control valuable resources that cannot easily be moved.

With respect to harmonizing tax base rules, it is common to emphasize the values of national sovereignty and autonomy that lead to divergence, and to note that optimal rule design may vary between countries.⁴² Thus, the U.S. may be better able to administer and enforce complicated rules, including those involving sophisticated inquiries into economic substance, than countries with less extensive tax law traditions. One should keep in mind, however, that countries' and internal political actors' incentive to harmonize are systematically too low. Some of the costs of rule divergence, such as increased compliance costs for multinationals, are externalities from the standpoint of national actors. Agency costs may reduce harmonization as well, if national political actors value autonomy in tax base design for self-interested reasons. In addition, those who benefit from the tax planning opportunities may exert political influence in countries that are weighing greater harmonization. The political obstacles to achieving optimal tax base harmonization between countries resemble those that perennially impede tax simplification within a single country.⁴³

When tax base divergence is a given, and the question is how to combat tax planning that exploits it to achieve tax savings unavailable on investment within a single country, the tax competition prisoner's dilemma reemerges. Thus, if the U.S. unilaterally denies a cross-border tax planning opportunity to its multinationals, the success of the effort will depend on its market power, along with that of any other countries that agree

⁴² See, e.g., Ring, *supra*, at 128.

⁴³ See, e.g., Sheldon Cohen, The Erwin N. Griswold Lecture, 14 *Am. J. Tax Policy* 113, 118 ("Tax simplification has no constituency. We are all for it in theory, however, we oppose it in practice.").

to join in the effort. While the U.S., as a large country, may have greater market power than many countries, it does itself no favor by basing its claim of tax jurisdiction on so fragile a reed as corporate residence, which may be close to elective for new companies.

C. A Contemporary Application: Structured Financing Transactions That Generate Duplicative Tax Benefits

Clarifying the reasons for treating worldwide welfare as a U.S. tax policy value can help us in analyzing and understanding real world international tax issues. In illustration, consider one of the most prominent and controversial “cutting edge” deals of recent years, involving the use of structured cross-border financing to create duplicative tax credits for foreign taxes paid. In summer 2006, this deal hit the trifecta. First, IRS Commissioner Mark Everson denounced it as abusive in testimony before the Senate Finance Committee.⁴⁴ Second, it made the front page of the Wall Street Journal, complete with discussion of the lifestyle benefits, such as a home in Malibu and coverage in the society magazine Tatler, that it had brought to a leading promoter.⁴⁵ Finally, the prominent Tax Notes commentator Lee Sheppard featured it in a column, describing it as “offensive” but wondering if current legal doctrine can be used to stop it.⁴⁶

1. Description of the Deal

A typical example of the deal may briefly be described as follows. Suppose that the relevant market interest rate is 6 percent, the U.K. corporate tax rate is 30 percent, and the U.S. corporate tax rate is 35 percent. A U.K. bank creates a new “special purpose

⁴⁴ See Written Testimony of IRS Commissioner Mark Everson Before the Senate Committee on Finance on Compliance Concerns Relative to Large and Mid-Size Businesses, June 13, 2006.

⁴⁵ See Carrick Mollenkamp and Glenn R. Simpson, Border Crossing: How a U.K. Banker Helps U.S. Clients Trim Their Taxes, Wall Street Journal, page A-1, June 30, 2006.

⁴⁶ Lee Sheppard, Banks’ Foreign Tax Credit Arbitrage, 112 Tax Notes 222, 224 (2006).

entity” (SPE) by paying \$100 for all of its common stock and \$500 for all of its preferred stock. After a wrinkle that I discuss shortly, a U.S. bank purchases the preferred stock for \$500. The SPE uses its \$600 of capital to buy and hold securities that pay 6 percent per year (\$36) before tax. Of this return, 99 percent – for simplicity, we can treat it as 100 percent – is allocated to the preferred stock, and thus goes to the U.S. bank. In effect, therefore the U.S. bank gets an interest-free loan of \$100, the excess of the amount of capital on which it is earning interest over the amount it actually put up.⁴⁷

At the 30 percent tax rate, the SPE pays \$10.80 of U.K. tax on its \$36 of earnings, so the U.S. bank actually only gets \$25.20 in cash. For U.S. tax purposes, the U.S. bank has \$36 of foreign source income and \$10.80 in foreign tax credits. The U.S. bank therefore pays U.S. tax of \$1.80, or the excess of its pre-credit U.S. tax liability 35 percent of \$36, or \$12.60) rate over the foreign tax credit. This leaves the U.S. bank with a net of \$23.40. By contrast, had it simply invested \$500 on its own at 6 percent, its net after paying a 35 percent U.S. tax would have been only \$19.50.

The mystery, of course, is why the U.K. bank would make a \$100 interest-free loan to the U.S. bank. It does so in connection with creating U.K. tax benefits for itself – as it happens, of a sort that would not be available to a U.S. firm under U.S. tax law. Specifically, it seeks to deduct, for U.K. tax purposes, the after-tax interest on \$600 per year,⁴⁸ at the cost of tying up (and losing the opportunity to earn interest on) only \$100

⁴⁷ See *id.* at 224.

⁴⁸ Strictly speaking, the UK bank deducts the interest on only \$500, which is the amount it invested in the preferred stock. However, since the preferred stock receives 99 percent of the return on a \$600 investment, the interest deduction reflects the rate of return on 99 percent of that amount.

per year. It thus seeks to deduct \$25.20 per year, yielding annual U.K. tax savings of \$7.56, in lieu of earning \$4.80 per year after-tax on \$100.

To this end, the U.K. bank, after capitalizing the SPE with \$600, purports to sell the preferred stock to a third party (not the U.S. bank) for \$500, thus reducing its cash out of pocket to \$100. At the end of a fixed term, the U.K. Bank will repurchase the preferred stock from the counterparty for \$500. Under U.K. tax law, the soon-to-be-reversed sale is treated as a “repo” – that is, a \$500 loan, secured by the preferred stock. Effectively, the U.K. bank is treated as paying interest equal to the dividends on the preferred stock (reflecting their 99 percent profit share) that the counter-party, as legal owner, gets from the SPE.

Under U.K. tax law, since the U.K. bank is deemed still to own the preferred stock, it is deemed to receive a dividend of \$25.20 and then to pay \$25.20 in interest. Under U.K. corporate tax rules, however, intercorporate dividends are effectively tax-exempt.⁴⁹ Hence the U.K. bank enjoys a net U.K. deduction of \$25.20, reflecting that U.K. tax law includes no analogue to the U.S. tax rule disallowing interest expense, incurred by a bank, that is allocable to tax-exempt income.⁵⁰

If the repo counterparty were a U.K. company, it would be fully taxable on receipt of the \$25.20 in deemed interest, leaving it with only \$17.64 after paying this extra level of tax. This second layer of tax would make the deal economically unappealing to the counterparty, which could earn 6 percent before-tax on \$500 through its own efforts, yielding \$30 before-tax and \$21 after-tax. Hence the goal of creating a structure under

⁴⁹ See Sheppard at 223.

⁵⁰ See Internal Revenue Code section 265(b); Sheppard at 224.

which the U.S. bank is deemed to own the stock, for U.S. tax purposes, and thus can use foreign tax credits to end up with more than it could earn on its own (as described above).

Life would be simple if U.S. tax rules were more formalistic than the U.K. rules in determining tax ownership, and thus accepted the repo as a true sale. If such were the case, the U.S. bank could be the repo counterparty. Instead, however, U.S. tax law resembles U.K. tax law in characterizing such transactions as loans. This is where the deal's more complicated structure comes in handy. The U.S. bank really buys the preferred shares outright from the third party, and it is irrelevant for U.S. tax purposes that this party was itself an owner only in legal form, not in economic substance. Accordingly, the "broken repo," so called because the interpolation of a third party prevents the U.S. from recognizing that a repo has occurred with respect to the preferred stock,⁵¹ creates inconsistency between the U.S. and U.K. tax results despite the lack of inconsistent rules. Each country treats its resident bank as the tax owner of the SPE, and thus as entitled to the tax benefits associated with ownership, despite their similarly determining tax ownership. As Lee Sheppard notes, the end result is a "double dip," in that the taxes paid by the SPE effectively are credited twice, by leading both to dividend exemption in the U.K. and to the allowance of foreign tax credits in the U.S.⁵²

2. How Should the U.S. Tax Authorities Respond to the Deal?

⁵¹ See Sheppard at 223. The third party is available to perform its repo obligation, even though it has sold unique shares, because the U.K. bank, which still owns the SPE's common stock, causes the SPE to issue new preferred shares to that party for \$500 (the same amount as the resale price) shortly before the resale date. The third party therefore has no net cash flow either at the front end or at the back end of the transaction, in each case both paying and receiving \$500 (leaving aside the fee for its help that it presumably retains). See *id.*

⁵² *Id.* at 224.

From the standpoint of worldwide welfare, as interpreted to depend on CEN, the deal clearly is undesirable. It permits a particular tax structure that involves, at a minimum, various transaction costs, to pay off after-tax even if it is suboptimal before tax.⁵³ The deal also naturally arouses the ire of those, such as Lee Sheppard, who take a pro-government stance with respect to taxing multinationals.⁵⁴

Those on the multinationals' side have been, to date, less vocal on the tax policy aspects, emphasizing instead that the deals permissibly promote tax efficiency in deal structure and "serve a bona fide business purpose and benefit."⁵⁵ They certainly have a case that it would be difficult to use conventional anti-tax avoidance doctrines, such as those requiring economic substance and business purpose, against the U.S. bank, which is attracted by the above-market pre-tax return, and which gets no special tax benefits, such as extra foreign tax credits that can be used against other income, from the transaction. Defenders no doubt would emphasize competitiveness if the U.S. Treasury proposed to take action against U.S. firms' participation in the deals, such as by disallowing foreign tax credits (based if necessary on new statutory rules).

This debate, however, reflects the usual mutual failure to appreciate the significance of the prisoner's dilemmas in international tax policy as one chooses between cooperating by promoting worldwide welfare and defecting through the unilateral pursuit of national welfare. As I hope to show, while shifting to the prisoner's

⁵³ From a CIN standpoint, however, one might favor allowing U.S. firms to enjoy the tax benefits from the deal if firms from other countries could do so.

⁵⁴ See also Mollenkamp and Simpson, *supra* (quoting Richard Murphy of the Tax Justice Network to the effect that the deal "is just a complete and utter construct to get around the rules at both ends").

⁵⁵ See *id.*, quoting Richard Levy, the bank controller at a participant in certain transactions.

dilemma perspective does not immediately answer the question of how the U.S. ought to respond, it considerably clarifies the issues and points to the empirical questions on which an answer ought to depend.

From the pro-government side, a useful starting point is national, as distinct from worldwide, welfare. Recall that the main rationale for offering foreign tax credits, in lieu of following national neutrality by limiting the domestic tax benefit to deduction of foreign taxes, is to hold up one's end in the multilateral effort to avoid penalizing cross-border activity. Given the "double dip" in the U.S.-U.K. bank transaction, this extra tax relief is unnecessary from the standpoint of CEN. Perhaps more importantly, the allowance of foreign tax credits may not be needed to help demonstrate that the main U.S. strategy is to cooperate rather than defect. In addition to not causing double taxation when we deny the credits, we are cooperating in the cause of tax harmonization. The only cause for complaint that a foreign government might have is that they would rather deny the duplicative tax benefit themselves, while we continued to provide it. However, this is only a problem if they are ready to act, and even if they are a coordinated response is possible.⁵⁶

Suppose, however, that the U.S. acts unilaterally and no one else responds to the deals. The U.S. national interest is a clear winner if U.S. banks that otherwise would engage in these deals instead do things that earn the usual pre-tax 6 percent and are fully taxable in the U.S. Recall that the U.S. bank's \$500 investment, in the earlier example, yielded \$25.20 before the payment of U.S. tax. Investing at 6 percent in the United States would have yielded \$30 before U.S. tax, all of which would remain in the U.S. even after

⁵⁶ See Mollenkamp and Simpson, noting that "[t]he U.S. and U.K., along with Australia and Canada, have formed a body designed to combat cross-border tax abuses."

the payment of such tax. (This assumes, of course, that all interests in the U.S. bank are ultimately owned by U.S. individuals.)

Note, however, the importance here of assuming that the U.S. bank simply substitutes a home investment. Some recent empirical work suggests that outbound investment is typically a complement to home investment rather than a substitute for it.⁵⁷ Under this view, the U.S. crackdown simply results in U.S. banks' losing free money from interest-free loans that U.K. banks were willing to make, and in the U.S. Treasury's losing its share of the pie from the net-of-credit U.S. tax liability. Presumably, the mechanism for the complementarity is that money from worldwide capital markets flows to the companies with the best profit opportunities. In effect, under this scenario, the ability to attract interest-free loans from U.K. banks is akin to a domestic natural resource that can be sold to foreigners, and Treasury interference simply deters the profitable exploitation of this resource.

A further objection to Treasury intervention might rest on the difficulty of basing tax jurisdiction on corporate residence. If banks are best-equipped to be the counter-parties in these deals, U.S. residence, or at least a connection to a U.S. trade or business, might be hard to avoid given U.S. banking regulations. Insurance companies, however, might also be feasible counter-parties to the U.K. bank, and they can readily locate offshore for U.S. tax purposes.⁵⁸ If all that Treasury intervention did was shift the game to nonresident insurance companies owned by U.S. individuals, then, while Americans

⁵⁷ See, e.g., Mihir A. Desai, C. Fritz Foley, and James R. Hines, Jr., *Foreign Direct Investment and Domestic Economic Activity*, National Bureau of Economic Research Working Paper No. 11717 (2004).

⁵⁸ See Edward Kleinbard, *Competitive Convergence in the Financial Services Markets*, 81 *Taxes* __ (2003).

would still get to exploit the “resource,” the new tax rules would be interfering with deal structure without raising any revenue.

In sum, worldwide welfare really is not the issue in evaluating how the Treasury should respond to the U.K. bank deals. While intervention would advance worldwide welfare as measured through CEN, of greater interest to Americans is the opportunity to advance national welfare by denying foreign tax credits, without encouraging further defection (by ourselves or others) from the cause of mitigating double taxation. Treasury intervention would fail to advance national welfare, however, if closing down the deals simply reduced rather than changing investment by U.S. companies, or if it simply led to the use of foreign legal entities by American businesses and investors. These considerations pose clear empirical questions, the answers to which would determine the merits of a Treasury response.

V. CONCLUSION

No country can long afford to pursue worldwide welfare at the expense of its own national welfare. Yet this does not mean that no country can afford to treat worldwide welfare as an important value in making policy choices. Indeed, given the domestic political forces ensuring that short-term national welfare (or at least that of particular groups) will be given great weight, worldwide welfare norms can serve a valuable purpose, even just from a purely national perspective. They can strengthen the impetus to cooperate with other countries rather than following beggar-your-neighbor strategies, potentially making all countries better off if adherence to the worldwide norm is sufficiently reciprocal.

This suggests that criticisms of U.S. international tax policy debate for focusing too much on worldwide norms such as CEN and CIN, and too little on the interests of the American people, are misguided. CEN and CIN are in fact tools for promoting national welfare in the broader setting of a global prisoner's dilemma. More attention should, however, be paid to strategic interactions and to the question of when the U.S. is most likely to benefit from cooperating and from defecting in the worldwide tax policy setting.