Harmful tax competition: to participate or not to participate?[1]

'Prisoner's Dilemma' games illustrate conflicts of interest between parties.[2] They are based on a familiar scenario: two prisoners are incarcerated and face interrogation. If neither prisoner divulges any information, they will both go free due to lack of evidence. However, the police aim to coax at least one of them into talking. The promise is that if one prisoner speaks up, they will be spared at the expense of the other, who will be incriminated. With no means of communication, participants cannot ensure that the other won't speak first and implicate them. Ultimately, there is no guarantee that both won't eventually talk, resulting in mutual incrimination.

In scenarios involving conflicting interests, a comparable risk arises. This conflict pertains to disputes between states. A coalition of states establishes specific rules with the goal of achieving a balanced equilibrium of interests. However, due to conflicting agendas, each state faces the temptation to deceive the other party—ostensibly adhering to the agreed-upon 'rules of the game' while subtly deviating from them to advance its own interests at the other party's expense. Such a strategy is effective only as long as the deviation from the rules is minor. However, as the scope of deviation augments, and the other party opts for a similar strategy ("tit-for-tat"), all parties may lose.

In this 'Prisoner's Dilemma' game, the conflict of interests illustrates the global phenomenon of harmful tax competition, whereby states use unfair practices to attract investors and potential taxpayers to them at the expense of other countries, e.g., by acting as tax havens. To prevent such practices, the participating countries set forth an agreed-upon body of fair rules, corresponding to the real OECD – BEPS (Organization for European Cooperation and Development – Base Erosion and Profit Shifting) rules,[3] set forth in 2015. However, the parties to the game must struggle with the temptation to deviate from these rules, to attract more tax revenues at the expense of their allies. The game illustrates that the

---

[1] The framework for the game is inspired by a well-known Prisoner's Dilemma game developed by Ebner and Winkler and was adapted to the Tax Law context by Nellie Munin. For the original game with detailed notes on preparing, conducting and debriefing the game, see: Noam Ebner & Yifat Winkler, *The Pasta Wars: A Prisoner's Dilemma Simulation-Game* Ebner, 40 Simulation & Gaming 134 (2008).

[2] The term was coined by Allbert W. Tucker, A Two-Person Dilemma, presented at the Stanford University Psychology Seminar (1950) but was conceptualized by Merrill M. Flood & Melvin Dresher, A Study of Rational Behavior in the Context of Conflict (RAND Corp., unpublished manuscript, 1950). See William Poundstone, Prisoner's Dilemma (Anchor Books 1992).

[3] See more details in the OECD website: https://www.oecd.org/en/topics/base-erosion-and-profit-shifting-beps.html

more parties give in to this temptation to deviate, the greater the general damage to the entire group will be.

Instructions

Divide the class into four groups and read the instructions together. Give each group a sheet with the instructions, a slip sheet, and a balance sheet.

There should be no communication between the four groups. Messages from each group are passed to the instructor each round, using a slip from the slip sheet held by each group.

Each country must decide separately what its policy will be for the next month. They do not know what the other countries will do and will find out only after all slips are handed to the instructor.

The game is played for two consecutive rounds.

Towards the **third round**: The OECD Secretariat announces that since the global financial crisis severely hit the global economy, any effect of the Members' tax policy may be <u>doubled</u> in the next round. Consequently, the Members decide to send their representatives to a coordination meeting. It should be mentioned that the years of alliance did not wipe out the bad memories of the allies, and their relationships bear mutual suspicion.

Towards the **fourth round:** the financial crisis that hits the global economy makes market term shift, including the options for profit and loss, much more extreme. According to the OECD Secretariat, expected profit or loss may be <u>quadrupled</u>. Due to the obvious potential danger to the alliance's market, it is further announced that the sanctions for breaching the agreements will be extended proportionally to be $400,000 per each month of breach. The Members decide to meet again. This is the last meeting – no other meeting will be possible.

After the last round, ask each country:

How much did each of you gain/lose?

If there were a ninth round – what would you do?

Would you form a 'coalition' in the future? With whom?

Questions for discussion:

- What can be learned from this exercise regarding international taxation interests?

- What are some of the similarities and differences you can find when comparing this game to taxation practices you know?

- Considering your experience from this game and real-life, if you were to draft a new tax policy, what would you make sure to include in it?

Background

After hundreds of years of free (and sometimes wild) tax competition, the OECD rules, and particularly the 2015 BEPS, aim to establish global cooperation to ensure fair competition. Over 140 countries and jurisdictions globally are collaborating to implement the BEPS measures.

All four countries participating in this exercise are OECD Members. However, Alpha and Beta are large, economically strong developed countries. Gamma and Delta, the other partners, are smaller in size and economically weaker countries that joined the alliance to enjoy the economic benefits the OECD membership offers. Alpha and Beta are economic patrons of Gamma and Delta and they were struggling to obtain Gamma and Beta's OECD membership. In fact, Alpha and Beta were keen to get a political hold in Gamma and Delta, to prevent these countries from turning to other influential countries, which are Alpha and Beta's political rivals. In addition, Alpha and Beta hope that their businesses may have access to cheap labor and services in Gamma and Delta.

Alpha and Beta led the process of drafting the BEPS rules, planning them in the best way to suit their economies and interests. Gamma and Delta agreed to the rules because they wanted access to the prestigious OECD club, but in fact they know very well that their weak economies depend heavily on nurturing and encouraging what the OECD considers harmful tax competition.

If the four partners respect OECD rules against harmful tax competition (HTC), each of them will gain net $100,000 per year. If one of them engages in HTC, it would be fined by $100,000 per that year. This sum will be contributed to the OECD budget and will only be used to finance further enforcement, so the Members cannot enjoy it for other purposes.

The Conflict

Unfortunately, in recent years, due to the global financial and economic crisis, all four allies face economic temptation and political pressure by local industries to engage in HTC. As their financial and economic situation disintegrated, each of them (separately) concluded that if only one country will breach the rules, it may gain $300,000 per year. So, even having to pay a $100,000 fine it will still enjoy a net gain of $200,000. If two countries breach the rules, each will enjoy a $200,000 gain, diminished to $100,000 net gain after paying the fine. If three breach the rules, each will enjoy a $100,000 gain, but the fine will totally diminish it, so the net gain will be 0. However, if all four countries breach the rules, each will lose $300,000 per year.

Members breaching Rules	Gross Profit	Net profit (after fine payment)	Members obeying rules	Net profit
0	****	****	4	100,000
1	300,000	200,000	3	100,000
2	200,000	100,000	2	100,000
3	100,000	0	1	100,000
4	****	-300,000	****	****

To engage or not to engage in HTC?
Policy Decision Slip

Year # 1 Country _____ Decision: _____	Year # 2 Country _____ Decision: _____
Year # 3 Country _____ Decision: _____	Year # 4 Country _____ Decision: _____
Year # 5 Country _____ Decision: _____	Year # 6 Country _____ Decision: _____
Year # 7 Country _____ Decision: _____	Year # 8 Country _____ Decision: _____

Profit / Loss Balance Sheet

Year #	Our choice	Members breaching rules	Members obeying rules	This Year's Profit / Loss
Total Profit / Loss:				