"The pursuit of material self-interest is the primary reason that the international community struggles to tackle collective bordercrossing problems." Do you agree or disagree with this statement? Why or why not?"

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Introduction

As globalization and the interconnectedness of the world only seems to keep increasing, some of the major contemporary issues appear to follow this trend. A significant portion of the crucial issues of today are expected to be solved in multilateral settings. But, as the international community continues to struggle solving these issues, I argue that it might be worth while to dig deeper into the causes of what caused these issues and why they are so hard for the international community to solve. Due to length limitations this assignment will focus on the border-crossing issues of international taxation and economic development. *This assignment will argue that border-crossing issues still remain largely unresolved as a consequence of material self-interested decision making, the subsequent unintended consequences and institutional path-dependent effects of those decisions.* Following the introduction, a presentation of the theoretical framework, Historical Institutionalism and Rationalism, guiding the analysis in this paper will be presented. Then, both theories are applied in an empirical analysis of the issues of international taxation and economic development. Lastly, a discussion of other challenging theoretical approaches, such as constructivism is presented and rebutted.

Theoretical framework

First established in the 1960s and 1970's as a reaction to the structural-functionalist approaches of political science (Hall, P. y Taylor, 1996), Historical Institutionalism (HI) focused on how events through time affected the creation and development of institutions that govern political and economic relations. During the 1990's it saw an enormous growth of usage together with the other newinstitutional theories due to its empirical capacity and analytical sophistication (Fioretos et al., 2016). In this paper HI will particularly be utilized to explain how initial rational interests of actors at critical junctures might be subject to unintended consequences which due to path-dependency can create irrationally stable institutions and consequently divert from the initial interests of those actors (Fioretos et al., 2016; Rixen, 2012). The concepts of critical junctures refer to specific time periods where for some reasons there is a significant change. This allows actors a much more dominant role of agency and HI argue that it is in these periods, actors with specific interests can create institutions that become path-dependent and evolve until a possible new critical juncture. It is important to note, that this paper will follow the broad definition of institutions presented in the theoretical literature and as defined by Hall & Taylor: *"they define them as the formal or informal procedures, routines, norms and conventions embedded in the organizational structure of the polity or political economy* (Hall & Taylor, 1996)*."* Another pivotal analytical tool from HI utilized in this paper is, unintended consequences. Simply put it suggests that rational actors may make decisions that might have consequences in other areas or become dysfunctional as the external society develops in a direction not expected by the actors (Fioretos et al., 2016).

Particularly in the US IPE scholarly tradition, the rationalist approach has been the dominating in many years. The overarching idea of rationalism is that states, organizations, individuals etc. have ranked preferences and that they instrumentally pursuit these, in an attempt to maximize their utility (Cooley, 2009). What often constitutes a rationalist approach is furthermore the focus on interests over ideas as the explanatory variable. These interests are most often classified as material interests which, though can be variable throughout time, are considered facts. Furthermore, interests are generally speaking seen as being the determining factor of behavior for which actors are motivated to pursue material gains (Broome, 2014c). As rationalism in nature is a very broad theoretical approach this paper will seek to utilize more specific analytical tools from Rational Institution Design (RID) and game theory (GT). At the core of RID, is a view of institutions being created purposively by actors with defined interest and goals in mind and to solve specific issues (Cooley, 2009). Furthermore, the rationalist model of decision making between actors can be modeled by game theory (Myerson, 1991), which is utilized in this paper to argue why certain decisions have led to modern border-crossing issues.

As I have now demonstrated the relevance and capabilities of HI and Rationalism for this assignment, we turn to empirical examples of contemporary border-crossing issues, which I argue can largely be explained by the previous mentioned theories. The cases analyzed through HI and rationalism are the global issues of international taxation and economic development.

Empirical implication - The case of International Taxation

The concept of sovereignty is what formally allows states to collect taxes in their respective jurisdictions, and consequently plays an extremely important role of the international taxation issues of today (Hills, 2005). Therefore, we begin by briefly exploring the concept of sovereignty and explain why it is so pivotal for understanding our current issues of international taxation.

Tracing back its roots to philosopher Jean Bodin in the mid-16th century, the idea of supreme authority, absolute independence and sole right of law making, has long influenced many issues of the world. Building on these ideas, the end of the 30 year war of Europe in 1648, the peace of Westphalia, resulted in the two treaties of Münster and Osnabruck. Even though the treaties, created at this time do not perfectly reflect the modern international law on sovereignty, pivotal principles of non-intervention and equality of states are still core to modern perception of sovereignty (Dar, 2018). As the United Nation was created in 1945 one of their founding principles was that of article 2(1), which states that *"The Organization is based on the principle of the sovereign equality of all its Members* (United Nations, 1945)*."* As a result, sovereign equality became enshrined in the core of modern society and now repeatedly ensures that small nations such as Cayman Islands, Luxembourg, British Virgin Islands, Panama etc. has equal right of sovereignty and all of which that encompasses.

Having briefly explored the historical background for our modern principles of sovereignty we turn to its relevance for modern taxation issues. The last three decades of economic globalization has enabled companies and extremely wealthy individuals to easily restructure their finances and on paper move their capital around the world. This is often done by an internal cross-border transfer pricing, consequently moving profits created in high tax jurisdictions to low tax jurisdictions (Hills, 2005).
Even though some guidelines, especially from the OECD on transfer pricing and the arm's length principle do exist (Oecd, 2003), the rise of service and digital products, such as intellectual property rights and algorithms practically makes it impossible to determine a *fair value* for transfer pricing. The combination of international capital mobility, lack of multilateral tax agreements and the hallowed rights of sovereign equality have enabled states to commercialize their sovereignty, consequently earning substantial revenue in exchange for writing corporate and private friendly tax laws (Palan, 2002).

I will now continue by applying the theoretical framework of Rationalism (RID & GT) and HI. I argue that the current structure and issues of international taxation can be divided into three overarching explanatory categories. Firstly, rational utility maximizing states, followed their interest of material gains, by creating an institution to combat double taxation. Secondly, this framework becomes the dominant idea of international taxation, creating a strong path-dependence, which in turn creates unintended consequences. Lastly, as modern international taxation is still guided by the double tax avoidance framework, certain states are able to, and have a material self-interest in commercializing their sovereignty by accommodating companies and wealthy individuals, making it nearly impossible to reach an international solution.

In the beginning of 1920 all countries still maintained their right to tax their own jurisdiction, which rendered trans-border economic activity difficult, as it meant that potential profits would become taxed in both the source- and residence country (Rixen, 2012). As Rixen argues with basis in general comparative advantage economic logic, there were mutual gains to an abolishment of double taxation. Analyzing the situation through game theory, a coordination game describes the decisions made by states. This is because there is both a collective gain, but also an individual gain regardless of actions made by the other actors (Rixen, 2012). Therefore, as expected by RID, a double taxation avoidance (DTA) institutional framework was created, as it served the material self-interest of all nations to do so.

The first many years after the creation of the principles of DTA, international tax revenue were very low and there were little need for grand tax agreements (Rixen, 2012). However, the 1920 principles were still the main guiding tool of international taxation when the international community faced a critical juncture at the end of world war two, and the OECD's Committee on Fiscal Affairs (CFA) took over from the League of Nations as the leading international tax forum (Rixen, 2012). In accordance with historical institutionalism the previously agreed upon rules had become sticky and path-dependent, making them hard to divert from. Thereby also ending up as serving as the base for an updated version of international taxation principles created by the CFA. Furthermore, countries increasingly began to enter DTA agreements between each other which were based on the founding principles of the 1920 agreement, resulting in over 2000 bilateral tax treaties from 180 countries today (Rixen, 2012). Following the logic of HI as more and more bilateral tax treaties were created a feedback loop of path-dependency for the principles guiding international taxation appeared, rendering change harder and harder after each one. This have had extremely important consequences as, combined with other economic liberalization policies (Broome, 2014a), that due to limitations of this paper I will not delve further into, companies and wealthy individuals were now able to take advantage of different nations' different tax laws (Rixen, 2012).

Today, the DTA framework indirectly allows companies and individuals to select their desired taxation jurisdiction. And as rationalism would predict, we observe that states are rational and driven by a material self-interest, which motivates them to accommodate companies and wealthy individuals with very beneficial tax laws (Palan, 2002). This would not have been possible without the equality of sovereignty previously described.

Consequently, the prior optimal self-interest decision to solely focus on the removal of double taxation (Rixen, 2012) became institutionalized and path-dependent, which led to the unintended consequence of states pursuing their material self-interest, by commercializing their sovereignty. Finally resulting in a current situation where divergent self-interests hinders the international community in solving international taxation.

Empirical implication - The case of economic development

The study of economic development has seen many policies and approaches come and go, each suggesting that they have had the magic answer to solve our collective border-crossing issues of inequal economic development (Phillips, 2020). Dominating in the years after the second world war modernization theory, argued that underdeveloped countries would *catch up* and converge toward their western counterparts. Following modernization theory, in the 60’s and 70’s dependency theory argued that a core of western countries systematically conditioned the development of semiperipheral and peripheral less developed countries (Broome, 2014b). Later in the 80’s and 90’s the Washington consensus took the center stage and argued that economic development was best achieved through some policy best practices. Which briefly explained focused on, strict fiscal discipline, market liberalization and strong legal protections of property rights. However, the market based approach of the Washington consensus lived side by side with several state based economic development strategies, such as the Import-Substitution-Industrialization (ISI) strategy (Broome, 2014b). Questions of economic development is still highly contested and evolves constantly, therefore the following paragraphs will present various historical cases which will be analyzed through rationalism and HI and serve as empirical evidence for the argument that the developmental differences of today can be explained as results of material-self-interest and institutions such as the state.

Arguing through the lens of HI, institutions in of themselves matter in creating and modifying a countries development. Throughout this part, I will focus on the coercive institution, namely the state and what role it has played in international economic development. Firstly, by looking at countries in the sub-Saharan region of Africa, we observe that many countries can be classified as neopatrimonial (Kohli, 2016). In line with our rationalist analysis, leaders in these states are motivated by their own materialistic self-interest and seek to maximize their utility, often on behalf of the countries shared resources. The result is massive corruption and an ineffective state that cannot develop economic prosperity. More generally Gourevitch (2008) argues that institutions such as the state are created in interconnection with the sources of power. From an RID perspective, it could be argued that countries that struggle with corruption and neo-patrimonialism would tend to create institutions that serve the material self-interest of those already in power such as in Mexico where the closed political process created, allowed for actors to follow their own materialistic self-interests and favor their supporters (Gourevitch, 2008). This can also be seen in the form of bureaucratic officials, military and police, diverting from the public good to utilize their own power and exploit the common citizens, as it happened in Nigeria (Kohli, 2016). From an HI perspective a country which has institutionalized corruption and neo-patrimonialism, can create a path dependency of ineffective governments and political instability.

In a broader sense, political instability has major consequences for the possibilities of a country to develop economically. This is due to the fact that much economic development is created by some sort of investment, let it be private in-country investment or foreign direct investments (FDI) (Kohli, 2016). Arguing from the basic economic logic and rationalist approach, an increase in uncertainty and risk of little to no return on investment will result in materialistic self-centered investors will look for other investment opportunities which better maximizes their utility. This was empirically observed by Roe & Siegel as they had tracked different countries for the past 40 years and saw that those countries plagued by political instability were not able to create the conditions needed for economic development and investments and as a result were economically underdeveloped (Gourevitch, 2008).

Discussion

When studying collective border-crossing issues in International Political Economy, it is pivotal to understand and recognize the complexity at hand. Therefore, even though this paper has sought to argue that a rational self-interest behavior, analyzed through HI, is the main reason that the international community still struggles with global issues, other theories of IPE might suggest otherwise.

Another approach to the contemporary issues of international taxation that argues rationalism and HI falls short of properly explaining the current situation, is constructivism. In IPE constructivism emphasizes the role of identities, ideas, and norms (Abdelal, 2009). Therefore, a constructivist account of IPE takes the different side to the previously explained side of rationalism, by focusing on ideas over interests (Broome, 2014c). This leads a constructivist perspective to argue that preferences are not necessarily rational and utility maximizing, but are results of social interactions and can be limited by norms of best practice (Abdelal, 2009).

To further understand whether constructivism is a more appropriate theoretical approach I attempt to apply its analytical strategies to the case of international taxation. Taking starting point from the established DTA framework, a constructivist approach acknowledges that the current framework of international taxation has become challenging to alter. However, they tend to focus on the limitation of actions of actors in the sense of the norms guiding international taxation diplomacy. Briefly described, the constructivist approach argues that the prime reason contemporary society struggles with issues of international taxation is because states are not able to utilize military or tough coercive power, as this lies outside the norms and appropriate behavior of the tax realm (Rixen, 2012). Furthermore, it can be argued that the main supposedly impartial actor, the OECD is bounded by its liberal economic foundation and therefore cannot wholeheartedly enter the battle against the issues of tax competition (Abdelal, 2009). However, firstly what the constructivist approach fails to explain is why a DTA focus was chosen in the first place. It was well within the norms and ideas of the actors at the time, that such an approach could result in tax competition and other tax related issues further down the road (Rixen, 2012). Despite this, countries followed the previously described game theoretical model of a coordination game, as this was what was in their initial self-interest. Furthermore, it might be true that countries are unable to use military force to change tax policies of other countries directly, however, the DTA framework has survived multiple great conflicts, including the second world war, consequently, there have been many periods where forcing tax policies could have been part of other coercive strategies during these conflicts. Therefore, it seems that the reason why negatively affected countries of tax competition have not been able to change the working framework is better explained by an asymmetric prisoner's dilemma (Rixen, 2012). There are varying payoffs for cooperation and losses for non-cooperation. Moreover, potential risks of renegotiating, includes putting the sunken costs of the current agreement on the line which could push states away from revisiting the issue (Rixen, 2012).

Turning to the issues of global economic development, here constructivism also challenges the analysis of HI and rationalism. It argues that not nearly enough focus has been put on the ideas and policy norms that have been guiding economic development throughout time. First and foremost, it starts by arguing that how the concept of development is conceived has had a major impact on developmental policies (Phillips, 2020). Ranging from purely focused on poverty reduction to general economic growth, and all the way to the human developmental goals which was promoted by Mahbub ul-Haq, a UN economist (Broome, 2014b). They argue that major actors such as the IMF and the World Bank has been prominent in shaping what constitutions development, how to measure it and thereby what policies to pursuit (Broome, 2014b). However, the vastly different development histories of different countries, suggests that the policy norm establishing actors of the IMF and the World Bank might not have played such a big role after all. Exemplified, by most Latin American countries pursuing a foreign direct investment based import-Subsidized-Industrialization, while the majority of Asian countries utilized domestic resources and focused on producing for the domestic market (Kohli, 2016). This is further illustrated by the fact that while the IMF and World Bank amongst others were pushing the market liberalization values of the Washington consensus many Asian economies pursuit a national state controlled development strategy (Kohli, 2016).

Conclusion

The findings of this paper strongly suggests that the cross-bordering issues of contemporary society that the international community struggles to solve can largely be explained by a material self-interest guiding the decision making and a path-depended institutionalization hindering change. This paper has particularly based such conclusions on the current situation in areas of international taxation and economic development. Firstly, after presenting a theoretical framework, this paper found that rational utility maximizing actors logically decided to agree on a DTA framework as it was in their own interest. This in turn through path-dependency now serves the basis of international taxation today and the reason no multilateral solutions are present is due to the material self-interest of nations utilizing their sovereign equality to commercial their rights of law making. Secondly, a case of economic development illustrated how materialistic self-interested actors came to institutionalize corruption and political instability, consequently scaring of utility maximizing investors to other places, halting their economic growth. Lastly, a constructivist approach was presented, and while some points were acknowledged to better the understanding of the empirical cases, its place as a key explanatory theory was rebutted.

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