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The undersigned

SURNAME	Allevato
FIRST NAME	Giulio
PhD Registration Number	1460401

Thesis title:

The Relationship between Tax Sovereignty's Regulatory Function and State Sovereignty:

From the Rise of Nation States to Globalization

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INTRODUCTION

Tax Sovereignty: An Essential Component of State Sovereignty and Its Dual Prerogative

"*To speak of tax sovereignty is generally to suggest that taxation is an inherent and necessary component of state sovereignty*".[1] Traditionally, the reasoning behind this proposition lies with the revenue-raising function of taxation, which provides governments with the funds necessary to exercise their sovereign powers.

Although state sovereignty has no single definition, in a political and international scenario characterized by the predominant existence of the so-called "nation-states", a reasonable starting point envisions a sovereign state as one which possesses three core elements: territory, people, and a government.[2] With specific regard to the latter element – the government – a unanimously accepted general statement is that it involves an effective exercise of certain essential functions aimed at both controlling and protecting the two other core elements of state sovereignty - population and territory.[3] Such functions, which can be referred to as "essential state functions", certainly include the exercise of effective local administration and police power, and the establishment and implementation of a system of national law within a territorial area over which no other entity exercises similar functions.[4] It is indeed through such activities that any state government can pursue its ultimate goal, that is, designing, implementing and protecting a social and economic order.

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[1] CHRISTIANS, A., *Sovereignty, Taxation and Social Contract,* 18 MINN. J., INT'L L. (2009) 99, 104.
[2] ROSS FOWLER, M., BUNCK, M., LAW, POWER, AND THE SOVEREIGN STATE: THE EVOLUTION AND APPLICATION OF THE CONCEPT OF SOVEREIGNTY, (University Park: Pennsylvania State Press, 1995), 33.
[3] This concept of sovereignty has been used for the first time by the arbitrator of the leading case on the issue of the acquisition of territorial sovereignty, the *Island of Palmas Case* (1928) – See DIXON, M., INTERNATIONAL LAW, 6th ed. (New York: Oxford University Press, 2007), 154-158.
[4] DIXON, M. *supra.*

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But, as with any other human organization, no state government activity can be carried on without sufficient resources. And it is mostly through the revenue raised by means of taxation that the continued operation and existence of a functioning government is granted. For this reason, the taxing power has always been considered as "*an essential part of the power to govern*"[5] and has thus traditionally been conflated with the concept of sovereignty. As a consequence, state sovereignty cannot be considered complete without tax sovereignty which allows for full revenue-raising power. The same consideration led Thomas Hobbes - in his most renowned masterpiece, *The Leviathan*, - to expressly differentiate "*the power to raise money*" as one of "*the rights which make the essence of sovereignty*".[6]

However, as this work will demonstrate, an additional function of tax sovereignty – certainly less studied and mentioned by legal scholarship – contributes to the existence and exercise of full state sovereignty. Indeed, raising revenue is not the only legitimate purpose and effect of the sovereign power to tax. Instead, the power to tax also serves as a tool of indirect regulation (or regulation *sensu lato)* and, therefore, as an alternative or complementary instrument to design and implement public policies. As this work will illustrate, in every nation state, tax policy – i.e., the design of the tax system – has been on many occasions intentionally and pervasively employed to indirectly regulate certain economic sectors and activities, or to advance economic and social reforms by inducing a change in social structure, or a modification of certain behaviors, or by encouraging other behaviors. Governments have used their tax sovereignty to promote a variety of public policy goals in the following ways: to foster national industrial development through the

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[5] RATNER, S., AMERICAN TAXATION: ITS HISTORY AS A SOCIAL FORCE IN DEMOCRACY, (New York: Norton & Company, 1942), 18.

[6] HOBBES, T., THE LEVIATHAN, Ch. XVIII, (London: Andrew Crooke, 1651), 112. See also BRAUTIGAM, D., BUILDING LEVIATHAN: REVENUE, STATE CAPACITY AND GOVERNANCE, 33 IDS BULLETIN 3, 2002, 10-20. On the same path see GRAETZ, M.J., TAXING INTERNATIONAL INCOME: INADEQUATE PRINCIPLES, OUTDATED CONCEPTS, AND UNSATISFACTORY POLICIES, 54 TAX L. REV. (2001), 261-336, 277, according to whom "*national governments assign tax burden and provide benefits. No function is more at the core of government than its system of taxation*"; and STEWART, M., INTRODUCTION: NEW RESEARCH ON TAX LAW AND POLITICAL INSTITUTIONS, 24 LAW IN CONTEXT 1(2006).

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imposition of tax restrictions on foreign products, to help sectors which suffered from industrialization itself through tax incentives or tax reductions, to regulate and control particular economic sectors, to advance social justice and equality among social classes, to favor certain businesses over others; or to attempt to correct market failures by making businesses or consumers internalize certain negative externalities provoked by their behaviors, even to further foreign policy. This view of tax sovereignty has been concisely expressed by Thomas M. Cooley, one of the most authoritative American constitutionalists of the 19th century, who, referring to the taxing power, stated that "*no attribute of sovereignty is more pervading, and at no point does the power of government affect more constantly and intimately the relations of life than through the exactions made under it*".[7] More recently, Professor Reuven Avi-Yonah also highlighted that "*regulation is a legitimate role of taxation*" and "*in some instances taxation is the most effective way to achieve a specific regulatory goal*".[8]

The coexistence of revenue-raising and regulatory functions as legitimate prerogatives of tax sovereignty - and, in turn, as essential components of a full state sovereignty – has for centuries been at the basis of nation states' tax policies, as Part A of this work will discuss. With specific regard to the regulatory function of tax sovereignty, it has found express or implicit recognition in many nation states' constitutional charters and case law. The most illustrative case is represented by the United States. In the United States - where the process which led to the attribution of the taxing power to Congress was strongly intermingled with the establishment and the development of an effective national federal government – both revenue-raising and regulatory prerogatives of tax

[7] COOLEY, T.M., CONSTITUTIONAL LIMITATIONS, 6th ed. (Boston, 1890), 587; A TREATISE ON THE LAW OF TAXATION, 3rd ed. (Chicago, 1903), 1: 191.
[8] AVI-YONAH, R., *Taxation as Regulation: Carbon Tax, Health Care Tax, Bank Tax and Other Regulatory Taxes*, July 2012, PUBLIC LAW AND LEGAL THEORY WORKING PAPER SERIES, University of Michigan Law School. Available at: http://ssrn.com/abstract=1664045, at 4. It must be noticed that Avi-Yonah adopts a smaller concept of regulatory function of tax sovereignty than we do in this work. Indeed, he distinguishes taxation's redistributive function, mostly exercised through the individual income taxes, from its regulatory function. See AVI-YONAH, R., *Three Goals of Taxation*, 60 TAX LAW REVIEW 1, (2006-2007). On the contrary, this work, in chapter 3, holds that redistribution by means of taxation should be qualified as an exercise of tax sovereignty' regulatory function.

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sovereignty have been expressly recognized in the Constitution. Article 1, Section 8, cl. 1, indeed, grants Congress taxing power not just "*to pay debts and provide for the common defense*" but also to provide for the "*general welfare of the United States*", a general clause which allows for substantial government intervention. And in fact, as this work will illustrate, the federal government has widely used its tax sovereignty to accomplish certain fundamental regulatory policies. Moreover, the U.S. Supreme Court, a fundamental institution for the construction and the interpretation of the American legal system, has in several cases explicitly approved and asserted the use of tax policy to accomplish social or economic (i.e. regulatory) objectives, in addition to revenue-raising purposes. Referring to this regulatory function of taxation, Justice Marshall pronounced one of his most memorable statements: "*The power to tax involves the power to destroy*",[9] where the word 'destroy' must be intended as the power to modify and the subject of such destruction is any social or economic activity. In several subsequent cases, and even recent decisions, the U.S. Supreme Court has confirmed that Congress can legitimately use its taxing power to indirectly regulate non-tax behaviors and areas that it may not regulate directly under the "enumerated powers rule".[10] The Court expressly stated that "*every tax is in some measure regulatory*"[11] and that "*it is beyond serious question that a tax does not cease to be valid merely because it regulates, discourages, or even definitely deters the activities taxed*".[12] Such case law, indeed, has been fundamental for the enlargement of the federal government powers and, as a result, for the development and preservation of complete national state sovereignty over that of the

[9] U.S. SUPREME COURT, *McCulloch V. Maryland*. See 4 WHEATON 316 (1819).
[10] According to the "enumerated powers rule", the U.S. Congress and government are entitled to exercise only those powers expressly provided for in the Constitution, while all of the remaining powers are attributed to the States. Among the enumerated powers are coining money, raising taxes, collecting taxes, regulating interstate commerce and commerce with other nations, regulating immigration, creating and maintaining the army, declaring war, and many others. See SULLIVAN, K.M., GUNTHER, G., CONSTITUTIONAL LAW, (New York: Foundation Press, 2010).
[11] *Steward Machine Co. v. Davis* 301 U.S. 548 (1937), 589; *Sonzinsky v. United States*, 300 U.S. 500 (1937), 513.
[12] *United States v. Sanchez*, 340 U.S. 42 (1950), 44.

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states.[13]

In addition, the dual prerogative of taxation has certainly been a solvent part of the ambitious and not yet completed project of construction of the European Union and of one of the first steps of a progressive transfer of political sovereignty to its institutions. Indeed, as the EU Treaty itself reflects, the suppression of internal custom duties and the complementary implementation of a common customs tariff for relations with third countries have been aimed at achieving two main objectives: providing the European Union's institutions with their own resources for a general budget (revenue-raising prerogative) and promoting free circulation and trade of goods between the Member States as a means to come to a common market (public policy-regulatory prerogative).[14] Furthermore, even the European Court of Justice's case law has played a very important role in defining the scope of nation states' tax sovereignty by identifying its regulatory public policy function. In particular, the European Court of Justice, in its exercise of scrutiny of the Member States' legislations to ensure their consistency with the EU rules concerning the principle of non-discrimination and the prohibition of state aids, has often highlighted the legitimate use of tax policy for non-raising-revenue purposes. Indeed, in recognizing the legitimacy of many national laws providing special tax advantages[15] or disadvantages to certain categories of taxpayers as long as they are not discriminatory towards other taxpayers on the basis of their country of residence or nationality, the ECJ has repeatedly and constantly affirmed that tax policies constitute a legitimate tool for governments to implement economic, social, environmental and many other types of non-

[13] For a detailed review of this case law, please see MASON, R., *Federalism and the Taxing Power*, 99 CALIFORNIA LAW REVIEW (2011), 975.
[14] MORTELMANS, K.J.M., *The Functioning of the Internal Market: The Freedoms*, in THE LAW OF THE EUROPEAN UNION AND THE EUROPEAN COMMUNITIES, (P.J.G. Kapteyn, A.M. McDonnell, K.J.M. Mortelmans, C.W.A. Timmermans edts.), (Alphen aan den Rijn: Wolters Kluwer, 2008), 575 and 601-602.
[15] In the form of tax breaks like special deductions, exclusions or deferral, for example. Such types of tax measures fall within the general category of the so-called "tax expenditures". In Chapter 2, the main features and the regulatory role of tax expenditures will be discussed.

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revenue-raising public policies.[16]

Regulatory Tax Policy vs. Tax Neutrality

The prerogative of tax sovereignty as a regulatory instrument to promote public policy – in addition to and distinct from the revenue-raising function – also constitutes the principal underlying reason why absolute neutrality of the tax system has never been realistically pursued by any state government.

According to the "tax neutrality" theory, as developed by the standard public finance model, a tax is efficient only when it is neutral, that is, when it does not change the relative prices/costs of goods, services or any other economic activities.[17] Therefore, taxation should not play any role in controlling and (indirectly) regulating behaviors. Direct regulation and government subsidies should be the exclusive instruments for this purpose. Conversely, if taxes do change relative prices and, as a natural consequence, alter the preferences of economic actors, they give rise to "distorted" decisions. The reason why such tax-affected decisions are considered as "distorted" by the advocates of the 'tax neutrality' approach is that, under a purely economic perspective, they produce less total social wealth than would result in their absence.[18] Therefore, the only goal and function of tax sovereignty should be the collection of revenue, and, above all in a free-market economy system, the design of all the tax systems should be oriented to full tax

[16] See, for example, EUROPEAN COURT OF JUSTICE, *Case C-148/77*, at par. 16, where the Court states that "*tax advantages of this kind may serve legitimate economic or social purposes*". See also *Case C-140/79*, judgment of 13.1.1981, at par. 13 and 15; *Case C-46/80*, judgment of 14.1.1981, at par. 12; *Case C-132/88*, judgment of 5.4.1990, at par.17.
[17] ROSEN, H., PUBLIC FINANCE, 7th Ed., (New York: MacGraw-Hill, 2005); HASEN, D., *Tax Neutralities and Tax Amenities*, available at: http://ssrn.com/abstract=1907076, 20.
[18] Such an argument is clearly based on the classic Adam Smith's theory of the invisible hand of the market.

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neutrality.[19]

Nevertheless, as this work will clearly show, the goal of reaching a neutral tax system has never been concretely pursued by the nation states' governments, not even by those libertarian governments which expressly claimed to support it.[20] As mentioned above and as it will be illustrated in the following chapters, nation states' governments largely used their tax sovereignty to purposely distort the market and actively advance and achieve political, economic and social changes and reforms.

As highlighted by opponents to the tax neutrality theory, the latter is founded on the wrong assumption that it is possible to structure taxation in a way which deprived it of any non-fiscal consequence. Instead, theoretical and practical consideration suggest that even merely incidental regulation is inherent and inextricably linked to exercise of the taxing power and it would be simply impossible to levy a tax which did not have any social and economic consequence of a non-fiscal nature.[21] As observed by an authoritative American political scientist,

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[19] ROSEN H., *supra*,; HASEN D., *supra*, 21. To illustrate the significance of such an approach, it is worth mentioning that its 'orthodox' supporters oppose, in principle, even the implementation of the basic traditional individual and corporate income taxes. This is due to the consideration that even if pure income taxes applied at a flat rate on everybody's income – and without being characterized by any statutory exclusion, credit, special rates etc. -, they would still distort economic actors' free preferences and decisions, since they would alter the relative prices of work and leisure.[19] Thus, advocates of pure tax neutrality identify a lump-sum tax – that is, a head tax imposed without regard to what the taxpayers does – as the 'optimal theoretical tax'. Obviously, the actual implementation of a lump-sum tax is affected by serious questions of political feasibility.

[20] For example, in its report anticipating and setting the guidelines for the 1986 tax reform, the United States Treasury officially endorsed tax neutrality by stating that: "*An ideal tax system would be as neutral as possible toward private decisions. Any deviation from this principle represents implicit endorsement of governmental intervention in the economy – an insidious form of industrial policy based on the belief that those responsible for tax policy can judge better than the marketplace what consumers want, how goods and services should be produced, and how business should be organized and financed*". U.S. DEPARTMENT OF THE TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH (1984), reprinted in 1984 FEDERAL TAXES (P-H) BULLETIN 12 EXTRA, and in 1984 STAND. FED. TAX REP. (CCH) EXTRA ED. NOS. 52, 53 & 56. Nevertheless, as it will be illustrated in Chapter 2, the U.S. government continued to make a large use of regulatory taxation, particularly in the form of tax expenditures, even after the tax reform. See AVI-YONAH, R., *The Three Goals of Taxation*, 60 TAX LAW REVIEW 1 (2006-2007), 3-4, according to whom, "*it is hard to deny that taxation has been and is still used for this* [regulatory] *purpose, as shown inter alia by the spread of the tax expenditure budget around the world following its introduction in the US in the 1970s*". For a complete analysis of the scholar debate concerning the so-called "tax expenditures" please see Chapter 2.

[21] RANDOLPH, E. P., TAXATION FOR PROSPERITY 214 (1947), according to whom "*any tax that produces revenue will in some way alter the social and economic order*".

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"*Taxation means burden; freedom from taxation means freedom from burden. The selection, by governments and legislatures, of the persons, things and transactions which shall bear or escape that burden requires the formulation of a regulatory policy affecting the social and economic life of the nations, a function supplementary but different from the mere job of filling the national treasury. Thus, in levying each tax, sovereign governments must inevitably have a purpose other than the raising of revenue, since they cannot escape the responsibility of controlling in the national interest the non-fiscal regulatory effects of its distribution of tax burdens. There can, in shorts, be no such thing as taxation for revenue purposes only*".[22]

Therefore, voluntarily abdicating to such regulatory function in favor of tax neutrality would represent an implausible and unrealistic self-limitation of governments' tax sovereignty.

Goals and Structure of the Work

In light of the observations and considerations above, it emerges that a full tax sovereignty - and in turn its contributions to the achievement and the retention of a full state sovereignty - certainly implies the power of governments to use taxation for the purposes of both raising revenues and implementing regulatory public policies. Otherwise, tax sovereignty, and so state sovereignty, is not full.

The main goal of this work is indeed to demonstrate how tax sovereignty's regulatory function, just like (and not less than) its revenue-raising function, is and actually has been essential and played a significant role in the establishment, the exercise

[22] CUSHMAN, R., *Social and Economic Control Through Federal Taxation*, 18 MINN. L. REV. 759 (1933-1934), 764.

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and the maintenance of full nation state sovereignty. To illustrate this point, we will identify and analyze certain "waves" of regulatory tax legislation that present similar justifications, features and goals among all of the main nation states and which, more than other legislation, played a decisive role in the history of such countries in regard to the creation itself of the latter and the establishment and consolidation of state sovereignty. The analysis will be divided into two parts.

In Part A, this work will analyze that regulatory tax legislation which accompanied nation states' rise, their industrialization and their subsequent shift to welfare state systems. Simultaneously, this work will highlight the relevance of such legislation for the establishment of full state sovereignty and for the achievement of some of the most historically important and structural economic and social reforms.

In Part B, this work will illustrate how, although economic globalization has reshaped the concept and the way of exercising both state sovereignty and tax sovereignty, the importance of tax sovereignty's regulatory function to the existence and the exercise of state sovereignty has remained substantially unaltered. Specifically, with regard to certain issues, the design and implementation of certain regulatory tax policies has shifted from a purely national dimension to a supranational level within international organizations and in the form of cooperation and coordination between nation states. Nevertheless, it will be demonstrated that such supranational design of regulatory tax policy, rather than diminishing national tax sovereignty, actually may be considered a new way to exercise the latter and may play a pivotal role in the preservation of state sovereignty within a globalized economic and financial framework. This work will analyze supranational design and implementation of regulatory tax policies and specifically focus on three international issues posed by globalization - harmful tax competition between jurisdictions, multinational enterprises' base erosion and profit shifting strategies, and financial sector's speculative behaviors. These three issues represent, indeed, three of the cases of international negative externalities arising from globalization on which nation states, scholars and policy-makers have been focusing the

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most to study and develop internationally-coordinated regulatory tax measures.

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Part A

REGULATORY TAX POLICY AND NATION STATES

Chapter I

THE CREATION OF NATION STATES, THE STRENGTHENING OF CENTRAL GOVERNMENTS, AND INDUSTRIALIZATION: THE ROLE OF TARIFFS

In this chapter, it will be illustrated how the use of the taxing power for regulatory public policy purposes is intrinsically linked to the creation itself of nation states and to their development in terms of both strengthening the central governments' political sovereignty (at the expense of local rulers) and industrialization. In the early days of nation states, central governments, indeed, frequently made use of a specific type of taxation, that is, tariffs, as leverage to reduce the political and fiscal fragmentation which previously characterized their countries and, subsequently, to consolidate and promote the industrial development of their national economies.

I.1 The Fragmentation of Sovereignty in the Middle Age and the Toll System

The imposition, by the various jurisdictions, of tariffs and custom duties on the transportation of marketed goods from other jurisdictions dates back to the toll system of the Roman and feudal times and has always been considered as a legitimate use of tax sovereignty by rulers. The inclusion of the right to levy tolls in the list of the fundamental prerogatives (*regalia*) of the sovereign (at that time the emperor) - drawn up in 1152 at

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the *Diet of Roncaglia*[23] – demonstrates that the power to collect tariffs and custom duties has a long history.[24]

The fundamental idea behind the imposition of the tolls was that it was the price the travelling merchants had to pay for protection provided by the local administrations to their body and their goods. Progressively, the tolls lost their linkage to the benefit provided to merchants in terms of protection and evolved into a separate source of revenue for the local administrations. Such a shift in the nature of the levy is demonstrated by the circumstance that while initially the tolls were gathered from every traveler or every ship that passed and payment was made in kind, subsequently the levy became more sophisticated and the amount of the payment was represented by a percentage of the value of the transported goods.[25] As a result, the levy took the main features of what is still defined as a tariff today.

With the exception of England, which had enjoyed both political and fiscal unity since the 11th century, the tariff system in Europe in the Late Middle Ages through the Modern Era reflected the fragmentation of governmental authority characterizing the feudal society. Despite the formal recognition of the superior authority of the emperor in German and Italian territories and of the Pope in almost all the continent, indeed, the political scenario arising from the Late Middle Ages resulted in the exercise of substantial rulings at the local level by numerous lords, princes, bishops, and municipalities. One of the consequences of this situation was that also trade across continental Europe was characterized by an infinite number of local tariff barriers, as many as the local lords or towns were. A merchant who wanted to practice commerce outside his town of residence, even within a still relatively limited regional area, had to pass through a number of

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[23] The so-called *Diet of Roncaglia* was a general assembly of the nobles and ecclesiasts convened in 1158 by Frederick Barbarossa in Roncaglia, a little town near Piacenza, Italy, to discuss the contents and scope of the royal rights, the so-called *regalia*.

[24] See GRAPPERHAUS, F.H.M., TAX TALES FROM THE SECOND MILLENNIUM, (Amsterdam: IBFD, 2009), 12-14.

[25] GRAPPERHAUS, F.H.M., *supra*; TAXES, LIBERTY AND PROPERTY; THE ROLE OF TAXATION IN DEMOCRATIZATION AND NATIONAL UNITY (Amsterdam: Meijburg & Co, 1989).

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custom barriers. This made commerce a highly costly activity.[26]

I.2. The Establishment of Nation States and the Mercantile Systems: The Role Of Taxation

The extreme political and economic fragmentation characterizing Europe in the Late Middle Ages started to change only with the establishment, in vast regions, of stronger centralized governments built around the authority of a monarch, and the claims for nationalist interests. This eventually led to the formation and the industrial development of the so-called modern nation states. Between the 16th and the 19th century all the regions approximately corresponding to the current continental European nation states experienced this process.[27]

The bulk of the policies aimed at strengthening national state governments during those centuries, and which created the necessary conditions for the industrialization of the national economies, were all profoundly influenced and inspired by the economic doctrine historians and economists refer to as "*Mercantilism*". Such doctrine was centered on the idea that the government had to set the direction of national economic life, and in particular of foreign trade, so that it could be carried out in the interest of national strength and independence.

In the mid of 17th century, the English economist Thomas Mun illustrated what would have later been considered by Adam Smith as the '*Manifesto of Mercantilism*'.[28] In a posthumously published work, *Treasure by Foreign Trade*, Mun used for the first

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[26] For a complete analysis of the fragmentation characterizing the toll and tariff system in Europe arising from Late Middle Ages, please see WEBBER, C., WILDAVSKY, A., A HISTORY OF TAXATION AND EXPENDITURE IN THE WESTERN WORLD (New York: Simon and Shuster, 1986); ARDANT, G., HISTOIRE DE L'IMPOT (Paris, 1971); GRAPPERHAUS, F.H.M., TAX TALES FROM THE SECOND MILLENNIUM, *supra*.

[27] For an exhaustive description of the process which led to the formation of nation states in Europe, please see TILLY, C. (ED.), THE FORMATION OF NATIONAL STATES IN WESTERN EUROPE, (Princeton, N.J. - US: Princeton University Press, 1975).

[28] MAGNUSSON, LARS G. (2003), *Mercantilism*, in A COMPANION TO THE HISTORY OF ECONOMIC THOUGHT, (Samuels, Warren J.; Biddle, Jeff E.; Jeff E.; Davis, Jon B., eds.), (Malden, MA: Blackwell Publishing, 2003), 47.

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time the expression '*mercantile system'* to describe a situation in which a country, in order to flourish, has to export more than what it imports - that is, having a trade balance surplus.[29] Since then, many more authors and policy makers contributed to the elaboration and the development of the mercantilist doctrine, which always laid on two main pillars: the supremacy of political power over the economic dynamics and the accrual of a nation's wealth by means of international trade policies aimed at generating a trade balance surplus. For these reasons, the mercantilist authors, according to authoritative observers, must be credited for laying the foundation of the Political Economy discipline.[30]

Despite the undeniable differences between the various mercantilist policies adopted by each country, due to the difference in economic contexts characterizing each nation, a feature typical of all of them is represented by dualism between the *laissez-faire* approach adopted to promote the internal traffic and the protectionist approach characterizing the international trade policies. Such a contrast, however, is nonetheless consistent with a uniform rational and pragmatic strategy aimed at enhancing the overall national wealth and national industries. In order to secure a money surplus on transactions with other countries, the mercantilist doctrine required, in fact, to favor as much as possible the creation of strong national industries able to compete in the international market and dominate over their foreign equivalent.[31] Restrictions or prohibitions on internal traffic, a heritage of the medieval world, had therefore to be repealed so that, on one hand, a larger domestic competition could induce the natural selection of the most efficient activities, and, on the other side, the infant manufacturing industries could benefit from a larger internal market and the consequent economies of scale. But,

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[29] MUN, T., ENGLAND'S TREASURE BY FOREIGN TRADE (1630). With reference to the specific case of England, he explained that ENGLAND should have imported raw materials and exported manufactured goods, so that it could generate an inflow of currency which, if reinvested in international exchange, could have produced more wealth for the Commonwealth.

[30] TIBERI VIPRAIO, P., DAL MERCANTILISMO ALLA GLOBALIZZAZIONE, (Bologna: Il Mulino, 1999).

[31] TIBERI VIPRAIO, P., *supra*, 22-30; HORROCKS, J.W., A SHORT HISTORY OF MERCANTILISM, (London, 1975); GOMES L., FOREIGN TRADE AND THE NATIONAL ECONOMY: MERCANTILIST AND CLASSICAL PERSPECTIVES, (London: Macmillan Press, 1987).

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according to the mercantilist view – which drastically differed from the classic economic view – foreign trade, and thus national wealth, could only be increased at the expense of other countries' industries.[32] Therefore, heavy protections and prohibitions had to be imposed upon the importation of the concurring manufactured goods coming from other regions and the exportation of raw materials of strategic importance for the national industries.

In light of these two main conditions for the implementation of the mercantilist policies - the creation of a large and free internal national market and the pursuance of protectionism towards the external market -, it is quite intuitive to understand how, among the various measures adopted by national governments, a major role was certainly played by tax measures. Such tax measures substantially consisted of eliminating internal tariffs, on the one hand, and enacting national-wide protective custom policies towards foreign states on the other hand.

The analysis of such mercantile tax policy measures constitutes the core of this chapter. In particular, in the following sections it will be shown how, in certain cases, such mercantile tax measures were strongly associated with the rise of nation states and the growth of national governments' sovereignty and represent, chronologically, the first significant use of taxation for regulatory public policy purposes by nation states. The importance of the mercantile policies, including protective tariffs, for the formation itself of nation states and its contribution to economic and industrial development has been effectively summarized by a German authoritative economist, Gustav Von Schmoller, who wrote that mercantilism "*is at root nothing but state formation (Staatsbilding) – but not simply the formation of a state, rather the combined formation of state and economy. This is state formation in its modern sense, in which the state community is formed into an economic entity at the same time, thus lending it an enhanced significance. The nature*

[32] CONYBEARE, J.A.C., TRADE WARS: THE THEORY AND PRACTICE OF INTERNATIONAL COMMERCIAL RIVALRY, (New York: Columbia University Press, 1987), 5-15.

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of the system lies not only in the doctrine of monetary accumulation or of the balance of trade, not only in frontiers, protective tariffs and shipping regulations, but in very much more: to wit, in the total reformation of society and its organization, as well as of the state and its system, in the replacement of local and regional economic policy by that of state and nation".[33]

I.3 The Various Mercantile Tariff Systems Adopted by Nation States

The degree to which and the reasons why various European countries adopted mercantilist policies differed according to their relative national context. While certain countries adopted such policies as part of a planned strategy aimed at enhancing their national economic power at expenses of other states, other countries' mercantile policies were basically retaliatory measures against their competitors' initiatives.

The most illustrative example of the latter is constituted by the United Provinces of Holland's use of mercantile policies. Until the 17th century, the Dutch were leaders in the naval shipping and carrying trade. Their territories were not particularly endowed with natural resources, and therefore they had not set up a significant manufacturing industry. Instead, in light of the character of their geographical position, they focused their efforts on the development of a modern and efficient naval shipping and carrier industry. Their naval commercial shipping industry was significantly superior to those of its main competitors like England or Spain or France. As a result, in the United Provinces of Holland the merchants had a substantial influence on their rulers (they contributed about

[33] SCHMOLLER, G., STUDIEN ÜBER DIE WIRTSCHAFTLICHE POLITIK FRIEDRICH DES GROßENS UND PREUßENS ÜBERHAUPT VON 1680-1786; TRIBE, K., *Mercantilism and the Economics of State Formation*, in MERCANTILIST ECONOMIES, (Magnusson L., ed.), (Boston: Kluwer Academic Publishers. 1993).

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two-thirds of total revenue) and in general were not in favor of protective measures.[34] For this reason, the United Provinces of Holland tended to be generally open to free trade. An additional motive for this liberal commercial policy was Holland's military vulnerability compared to the strength of its powerful neighbors. Dutch tariffs on imported goods were therefore usually low and mainly for revenue purposes.[35] Increase in tariff rates and other protective measures (prohibitions or embargoes) were adopted merely as a retaliation for foreign actions (mostly by England and France) aimed to limit Dutch supremacy in trade and shipping or to gain leverage in subsequent negotiations with foreign states to provoke them to withdraw or moderate such foreign measures.[36]

Among the countries which, instead, actively pursued mercantilist policies as part of a strategy to strengthen and expand their national wealth and economic power at the expenses of other states, certainly England, France and Spain were the most proactive States. Nevertheless, a complete exam of all of these policies is not within the scope of this chapter, which is focused on the analysis of the circumstances in which the regulatory function of tariff policies was also intermingled with the creation and the growth of nation-states and the establishment of full political sovereignty over them. In this perspective, France, Germany and the United States represent the most notable cases.

I.3.1 France

I.3.1.1 From political and economic fragmentation to the foundation of substantial national unity

In the early 16th century, France had formally completed the process of territorial and political unification under the Crown. Nevertheless, its legal system and above all its

[34] GOMES, L., FOREIGN TRADE AND THE NATIONAL ECONOMY: MERCANTILIST AND CLASSICAL PERSPECTIVES, (London: Macmillan Press 1987), 91-92.
[35] HERINGA, A., FREE TRATE AND PROTECTION IN HOLLAND (London: Unwin, 1915), 4-12.
[36] CONYBEARE, J.A.C., TRADE WARS: THE THEORY AND PRACTICE OF INTERNATIONAL COMMERCIAL RIVALRY, (New York: Columbia University Press, 1987), 130-136.

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economy were still pretty much characterized by the fragmentation typical of the feudal epoch. Also with regard to trade and commerce, the local implementation of the regulations and directions issued by the central ruler was often partial or non-existent, due to the persistent substantial independence of the lordships and towns, each of which used to pursue self-regarding policies aimed at protecting its own small businesses from the other districts and characterized by local restrictions as to price, quality, and other marketing parameters. As a result, also customs and practices still varied in different parts of the country.[37]

This situation of substantial fragmentation started to change after the Wars of Religion,[38] when King Henry IV and his successors, finding France extremely dependent upon England for the supplies of many necessities, committed themselves to the foundation of national economic independence and self-sufficiency. In pursuit of this goal, the French administrators were influenced and supported by the most authoritative contemporary economists, who were advocating an active role of the government in strengthening the national economy by means of stimulation and protection of the national industry on a large scale and the exclusion, as much as possible, of foreign goods from the national market. Such approach is very well expressed by the words used by one of these economists, Barthelemy de Laffemas (1545-1611): "*to fill France with riches and wealth keep her from seeking abroad what can be made and manufactured in France*".[39]

The basic prerequisite for the practical implementation of this economic doctrine, as highlighted by all of its main theorists, was the establishment of economic unity of the

[37] HORROCKS, J.W., A SHORT HISTORY OF MERCANTILISM, (London: Methuen & co., 1975), 114; TILLY, C. (ED.), THE FORMATION OF NATIONAL STATES IN WESTERN EUROPE, (Princeton: Princeton University Press, 1975); CLAMAGERAN, J.J., L'HISTOIRE D'IMPOT EN FRANCE, 1 vol. (1867-1876); MOUSNIER, R., LES INSTITUTIONS DE LA FRANCE SOUS LA MONARCHIE ABSOLUTE, 2nd vol., (Paris, 1980).

[38] The so-called *French Wars or Religion* is a civil and military infighting fought between French Catholics and Protestants (Huguenots) during the period 1562-98.

[39] GOMES, L., *supra*, 58-67.

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country.[40] Thus, the elimination of the exclusiveness of towns' and seigneurs' economies and a consequent shift to a centrally managed economic policy capable of countering foreign competition and fostering the creation and development of strong national industries progressively became the leading directions of the French rulers. Henry IV's finance minister, Sully[41], inaugurated this process. In particular, he recognized the strategic importance, for the promotion of national wealth, of a coordinated commercial strategy. Under his government, a significant number of restrictions on internal trade were removed and government subsidies were provided to the agricultural industry and companies engaged in overseas and colonial trade.[42]

Nevertheless, it was under the two ministers who succeeded Sully, Richelieu and Colbert, that the main economic policies which shaped the French mercantile system were implemented. Under Armand de Richelieu, fundamental steps were taken toward affirming the centralization of the State and the political control over economic activities. In the first instance, Richelieu enacted an epochal administrative reform whose main elements were the division of France into thirty-two generalities, each of them administered by an officer in charge of implementing at the local level, among the others, the central government's directives aimed to provide a homogenous regulation for the economic activities and the commerce.[43] Secondly, Richelieu adopted measures through which the government heavily sustained the growth of a mercantile naval shipping industry by providing government financial aids and forbidding the exportation of French merchandise in foreign vessels.[44] In particular, Richelieu "*pursued the goal of power and wealth through the formation of trading companies, colonial exportation and the building up of naval strength*".[45] In sum, the Richelieu's measures can be correctly credited for

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[40] IRVIN, J.L., PARADIGM AND PRAXIX: SEVENTEENTH-CENTURY MERCANTILISM AND THE AGE OF LIBERALISM, (ProQuest publishing: 2011), 20.
[41] Maximilien de Béthune, first Duke of Sully (1589-1610)
[42] HORROCKS, J.W., A SHORT HISTORY OF MERCANTILISM, *supra*, 115-116.
[43] HORROCKS, J.W., *supra*, 117-118; CLAMAGERAN, J.J., L'HISTOIRE D'IMPOT EN FRANCE, 1 vol. (1867-1876).
[44] For a complete analysis of the economic policies implemented by the French government before Colbert, please see COLE, C.W., FRENCH MERCANTILIST DOCTRINES BEFORE COLBERT, (New York: R.R. Smith, Inc., 1931).
[45] GOMES, L., *supra*, 88.

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setting up the conditions for Colbert's subsequent policies.

I.3.1.2 Colbertism and trade wars with England

In fact, the French statesman who played the most decisive role in shaping France's mercantile economic policy was certainly Jean Baptiste Colbert (1614-1683), the finance minister of Louis XIV and by many labeled as "*the arch-mercantilist, the quintessential economic planner, the bureaucrat par excellence*".[46] He expressly declared his linkage to the most orthodox mercantile doctrine and, coherently, paid significant attention to the importance of foreign trade for the purposes of improving national industrialization at expense of other competitor countries.[47] Through his actions, Colbert gave rise to the establishment of a comprehensive system of industrial and commercial regulation which is by many observers considered the most advanced and coherent implementation of the mercantile idea.

Regarding internal policies, Colbert invested a significant amount of his government activity in the accomplishment of the creation of an effective and efficient national market. His government provided economic activities and trade businesses with new more developed infrastructures like roads, canals, and driver navigation. And, above all, he reduced or abolished tariffs within the kingdom, which constituted the most serious restriction to internal traffic. To this extent, Colbert, like his predecessors and entirely in line with the mercantilist doctrine as above illustrated, was a domestic free trader and pointed the way to an ideal of fiscal unity.[48]

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[46] GOMES, L., *supra*, 88.

[47] As reported by HORROCKS, J.W., A SHORT HISTORY OF MERCANTILISM, *supra*, 119, Colbert declared that "*The power of a nation depended solely upon the abundance of money within the State, and trade must be so directed as to secure a money surplus on transactions with other countries*".

[48] HORROCKS, J.W., A SHORT HISTORY OF MERCANTILISM, *supra*, 118-119; GOMES, L., FOREIGN TRADE AND THE NATIONAL ECONOMY: MERCANTILIST AND CLASSICAL PERSPECTIVES, *supra*, 88-91. In addition to this, "*Colbert promoted the establishment of a variety of industries subject to central control by local inspectors appointed from Paris. Industries sponsored by Colbert were organized into national guilds and received subsidies and in some cases royal patronage. Bounties and privileges were granted to individuals and corporations for the establishment of new manufactures. Besides stimulating industrial self-sufficiency, this move was directed to favor social stability and*

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Regarding external policies, Colbert completely and expressly adhered to the orthodox mercantilist view according to which national wealth and industrialization can be pursued only at the expense of other countries.[49] Therefore, his approach to international trade relationship was dictated by a view of conflict and confrontation implemented through protectionist trade measures like navigation laws and, above all, high import tariffs and low export tariffs. Precisely, the use of extremely high import tariffs against foreign goods became the most salient feature of Colbert's government and the focal point of his reputation.

Colbert's import tariff measure was a devise used principally against England. At the end of the 17th century, France and England, after having significantly downsized the Dutch maritime and commercial supremacy, were facing each other, both determined to dominate industrialization, trade and colonization. They were both ruled by governments whose policies were dictated by the mercantilist doctrine of the balance of trade, according to which, as discussed above, a country, in order to flourish, has to export more than it imports. Even during the previous centuries England and France had adopted protectionist measures against each other[50] but Colbert's government gave rise to a real

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ensure the observance of strict quality control on the products for which France was famous and in great demand abroad- luxury products such as silks, linens, tapestries, furniture and wines. The details of production were the subject of minute government regulation which was comprehensively promulgated in the Code of Commerce which incidentally through the Code Napoleon still forms the basis of modern French commercial law. In sum, the system set up by Colbert was one of rigorous control applied by an almost absolute royal power". See GOMES, L., *supra*, 88-90; CLAMAGERAN, J.J., L'HISTOIRE D'IMPOT EN FRANCE, 1 vol. (1867-1876); BONNEY, R. (ED.), ECONOMIC SYSTEMS AND STATE FINANCE (Theme B of the series: The origin of the Modern State in Europe in 13th to 18th Centuries), 1995.

[49] As reported by HORROCKS, J.W., A SHORT HISTORY OF MERCANTILISM, *supra*, 119, Colbert declared that "*The power of a nation depended solely upon the abundance of money within the State, and trade must be so directed as to secure a money surplus on transactions with other countries*".

[50] As illustrated by CONYBEARE, J.A.C., TRADE WARS, *supra*, 136-137: "*England and France had been taking hostile measures against each other way before Colbert's era. King Richard (1189-1199) and King John (1199-1216) used England's monopoly in wool supplies as a weapon against Franc. The French disrupted wine exports to England, particularly toward the end of the Hundred Years War, as the French gained territorial control over Gascony, the main source of English wine. In 1443, Charles VII forbade the importation of English cloth. Damaging trade controls continued after the war: various Navigation Acts (e.g. under Henry VII in 1489) required French wines to be carried to English ships; wood exports to France were sometimes prohibited; French ships were penalized by higher harbor taxes; French imports bore higher duties; and English companies sold to France essential raw materials at monopoly prices. French measures against England were import prohibitions on cloth (e.g. in 1538 and 1572) to promote domestic production, and restriction on the export of raw materials and grains*."

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trade war which lasted for almost two hundreds years. In 1664, Colbert significantly raised tariffs on imported textile, one of the main products imported from England.[51] After this increase, diplomatic efforts were made by England (which was affected by an unfavorable trade balance), aimed at bringing the French tariffs on textiles back to the pre-1664 level. Nevertheless, this diplomatic attempt was not successful due to French unwillingness to effectively moderate her customs policy. As a result, French tariffs kept increasing by an average of 60%, and up to 100% in certain cases. In particular, in 1687 textile tariffs were raised by 200%.[52] Consistent with the balance of trade doctrine, while Colbert raised tariffs on foreign products, he drastically reduced export duties on French products so that French products would sell in external markets.[53]

After realizing that France would not reduce its import tariffs, England retaliated by substantially increasing (by over 50%) its import tariffs on French products.[54] As a result of this trade war mainly through taxation, for the greater part of the 18th century, trade between France and England was almost completely frozen. This situation, and the actual regulatory function of Colbert's measures, is accurately documented by Adam Smith in his Wealth of Nations:

"*Seventy-five per cent may be considered as the lowest duty to which the greater part of the goods of the growth, produce or manufacture of France were liable. But upon the greater part of goods, those duties are equivalent to a prohibition. The French in their turn have I believe treated our goods and manufactures just as hardly. […] Those mutual restraints have put an end to almost all fair commerce between the two nations. And smugglers are now the principal importers, either of British goods into France or of*

[51] COLE, C.W., COLBERT AND A CENTURY OF FRENCH MERCANTILISM, (New York: Columbia University Press, 1939), 432.
[52] CONYBEARE, J.A.C., TRADE WARS, *supra*, 137-138.
[53] TILLY, C. (ED.), THE FORMATION OF NATIONAL STATES IN WESTERN EUROPE, *supra*; HORROCKS, J.W., A SHORT HISTORY OF MERCANTILISM, *supra*, 119.
[54] GOMES, L., s*upra*, 90.

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French goods into Great Britain."[55]

Criticism of Colbert's policies has not been unanimous. Some consider them to have been fundamentally important for the establishment of national industries and for commercial progress. Others, however, have severely criticized such policies for causing commercial and actual wars with other countries which ended up weakening the national power.[56] Nevertheless, an expansive discussion of Colbert's tax measures is not within the scope of this work. What matters for the purposes of this discourse is the strong use of tax policy, in this case tariffs, by the French government since Henry IV both as an instrument of national unification and establishment of state sovereignty and as a regulatory measure aimed at achieving public policy goals such as the promotion of national industries and, as a consequence, national wealth.

I.3.2 Germany

I.3.2.1 German political, economic and fiscal fragmentation Vs. the rise of nation states

From the late Middle Ages until the 19th Century, the political sovereignty power over Germany, despite its formal unity under the Holy Roman Empire, had been divided into many territorial principalities. In turn, the princes were rarely able to retain full political powers and practical control over the territories within which their possessions laid. The principalities were in fact fragmented into hundreds of smaller and *de facto* politically independent towns and cities characterized by exclusive economies and

[55] SMITH, A., AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS, *Book 4*, (London: Methuen, 1904), 618.

[56] In particular, some scholars observed that while in the short-run Colbert's policies may have been effective in fostering the development of national industries, in the long-run retaliation on the part of other countries – in particular England and The Netherlands - ended up affecting the trade of French products and therefore all French manufacturers. HORROCKS, J.W., A SHORT HISTORY OF MERCANTILISM, *supra*, 122-24.

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concerned only for their own interests.[57] Besides some exceptions, these localities were all rivals among each other and used to protect their own exclusive economies through a range of restrictions on external competition, the most common of which were express prohibitions, strict marketing regulations, excise taxes and tolls.[58] German industrial activity was therefore centered in such small localities; basically no national organization of economic activities existed.[59]

As already illustrated in this chapter, the political and economic scenario in Europe started to change due to the emergence, in countries surrounding Germany, of strong national centralized governments progressively more engaged in the control and organization of economic activities with the goal of strengthening national wealth. In order to pursue national economic unification and the establishment of large national industries capable of prevailing over their foreign competitors, such European States adopted the mercantile trade balance surplus doctrine. As described above, France adopted measures, in the 17th century, to favor and promote the creation and the growth of national competitive industries. The same process was happening in Spain, England, The Netherlands, and other surrounding countries. With the exception of Germany and Italy (whose situation at the time was very similar to Germany in terms of political and economic fragmentation), the European economies became shaped by mercantilist policies involving political and economic unity. In such a scenario, the German economy and industries were at a disadvantage and susceptible to economic interference from other countries with mercantilist policies.[60]

The German princes had attempted to take advantage of this tendency towards political and economic unification prevailing in the other countries. To end Germany's

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[57] HORROCKS, J.W., A SHORT HISTORY OF MERCANTILISM, *supra*, 136-37; GRAPPERHAUS, F.H.M., TAX TALES FROM THE SECOND MILLENNIUM, (Amsterdam: IBFD, 2009), 35-40.

[58] HORROCKS, J.W., *supra*, 136-37; CLOUGH, S.B., COLE, C.W., ECONOMIC HISTORY OF EUROPE, 3rd ed., (Boston: D.C. Heat & Co., 1952).

[59] The flourishing nature of the local industries suggests that such fragmented political power was not, in itself, harmful to economic development. See GRAPPERHAUS, F.H.M., *supra*, 35-40.

[60] TRIBE, K., *Mercantilism and the Economics of State Formation*, *supra*, 176.

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fragmentation, they tried to bring the localities back under their control and establish a unified economy which would regulate town and village economies alike.[61] It is interesting to note that the most ambitious attempt to unify Germany was a tax proposal. In 1522, a German prince proposed to institute a toll along the whole imperial frontier on all foreign trade in Germany. Such a proposal was formally aimed at raising revenues necessary to fund the maintenance of the imperial chamber and government and the general expenses of administration, but was also intended as a step towards political and economic unification of Germany. The imposition of this new imperial toll would have indeed progressively induced localities to reduce or even repeal some of their local duties and, above all, would have given rise to an administrative mechanism of coordination among all the various local rulers which could have represented the root of a forthcoming national customs union (i.e. the absence of internal tariffs and the set up of a common external custom duty).[62] The proposal encountered strong opposition of the towns, officially based on the argument that a similar tax would have utterly affected German industry and commerce.[63] Advocates of such a tax contended that the new toll would not have constituted a significant burden for the German economy and pointed to the success of similar measures in other countries. They blamed the towns for being driven only by self-interest and anti-national feelings. However, the towns' opposition triumphed and the proposal was dismissed.[64] The power of towns was still too strong and that of princes too weak for the enactment of such a measure.

[61] HORROCKS, J.W., *supra*, 136-37; GRAPPERHAUS F.H.M, *supra*. 33.
[62] HORROCKS, J.W., *supra*, 189-190. MOKYR J., *Mercantilism, the Enlightenment, and the Industrial Revolution*, in ELI HECKSCHER, INTERNATIONAL TRADE AND ECONOMIC HISTORY (Findlay R., Henriksson, R.G.H., Lindgren H., Lundahl M. eds.), (Cambridge, MA: EH.NET, 2007)
[63] HORROCKS, J.W., *supra*, 140.
[64] *Id*.

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I.3.2.2 The Prussian leadership and the creation of the German fiscal unity

Only after the end of the Thirty Years War,[65] the princes gained more substantial control over the German regions at the expenses of the cities. Due to the war's damage and destruction which affected the German territory and population more than any other country, the German localities were severely impoverished. In addition, the Peace of Westphalia officially recognized the princes' various *regalia* rights, like those of collecting taxes, coining money, maintaining an army and concluding treaties with foreign powers. The German princes took full advantage of such a situation and began exercising their powers in a paternalistic manner (and in some cases even in a despotic way).[66] In particular, with regard to economic policy, they took as a model the political phenomenon of the age, that is, Colbert's Mercantilism (see I.3.1.2). With varying degrees of effectiveness, all the German principalities adopted administrative, tax and regulatory measures which reflected the system of France's Colbert, pursued to an even greater length, which extended to agriculture as well as manufactures, but minus the maritime, colonial, and extra-European aspect of his policy.[67]

Among the German principalities, there was one which progressively distinguished itself for being the most rigorous in the application of the mercantilist doctrine and in the building up of a strong self-sufficient State - the Brandenburg Prussia led by Frederic The Great. Under Frederic The Great and his successors, those industries which were considered necessary and strategic for the growth and wealth of the State were subsidized and controlled by the government through strict regulations.[68] It is particularly worth noticing that a significant part of Prussia's policies consisted of tax measures like the abatement of internal tariffs and the establishment of high – and

[65] The Thirty Years War, from 1618 to 1648, arose out of religious motivations – the fight between Catholics and Protestants, which were both within the Holy Roman Empire. It was a devastating war involving most of the European nations and rulers. The war ended with the signature of a series of treaties which constituted what is known as the Peace of Westphalia.
[66] SECKENDORFF, V.L., THE GERMAN PRINCELY STATE (1655); HORROCKS, J.W., *supra*, 142.
[67] SCHMOLLER, G., THE MERCANTILE SYSTEM AND ITS HISTORICAL SIGNIFICANCE, (New York, Macmillan, 1986) 56-7,81-91.
[68] MOKYR, J., *Mercantilism, the Enlightenment, and the Industrial Revolution*, *supra*.

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sometimes prohibitively high - import tariffs aimed at protecting the said domestic industries.[69]

In 1818, the imposition of internal tariffs in the Prussian principality - which had long obstructed traffic amongst its numerous territorial localities – ended. Internal free trade represented a step "*which though not consciously so intended was the beginning of a movement in the economic sphere which, along with progress in other departments, was ultimately to issue in the unification of Germany under the presidency of the power which had led the way towards fiscal unity*".[70] The fiscal union of Prussia was indeed extended to adjacent German States and similar unions were established in other parts of Germany. Such movement reached its climax in the creation of the Zollverein, which by the middle of the 19th century included basically the whole Germany.[71] Thus, Prussia - and subsequently all of Germany - was able to establish a complete internal free-trade area which, as highlighted multiple times in this chapter, constitutes one of the two conditions for the implementation and the success of mercantile policies.

I.3.2.3 External policy and the 'educational tariff'

Although the German fiscal unions were based on the principle of internal free trade, their external policy was one of protection through tariffs and other restrictive measures. In this, German rulers were strongly influenced by the thoughts of Friedrich List,[72] who - in opposition to the Adam Smith's teaching – advocated the doctrine of the so-called National Economy, characterized by a practical rather than theoretical approach. Indeed, even though international free trade was recognized as an ideal by List, he

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[69] TRIBE, K., *Mercantilism and the Economics of State Formation*, *supra*; HORROCKS, J.W., *supra*, 144.
[70] HORROCKS, J.W., *supra*, 148.
[71] SCHMOLLER, G., *Studien über die wirtschaftliche Politik Friedrich des Großens and Preußens überhaupt von 1680-1786*; HECKSCHER, E.F., MERCANTILISM, (London: Allen & Unwin, 1956).
[72] Friedrich List (1787-1846) was a German professor at the University of Tubingen who also entered the public service. He was the founder of 'scientific protection' and had a strong influence on the German and American protectionist movements. His main work is *The National System of Political Economy* (1841). He also spent part of his life in the United States, where he *published Outlines of American Political Economy* (1827), which contains the main ideas of his theories.

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claimed that economic policies must be based on the concrete context characterizing a country, in particular its stage of development.[73] Therefore, according to List, instead of shaping the economic policy after ideal assumptions which did not exist in concrete, rulers should rather take into account the fact that the various nations were in constant strife and competition with one another and therefore each government had to protect and reinforce its national economy and industry before opening to free trade. Otherwise, nations which, like Germany, had not yet reached a high degree of national industrialization, in terms of size and self-sufficiency, would have been at a disadvantaged position compared to countries like England or France.[74]

Consistent with this doctrine, List proposed an "*educational tariff*" for nascent industries which could only be removed once the country's industrial and commercial development was further developed.[75] List's doctrine manifested all its influence in shaping the German Empire built under the leadership of Prussia. Indeed, following a period of recession and in an attempt to protect the infant nation from the aggressive competition of more industrialized nations like France or England, Chancellor Bismarck proceeded to significantly increase the import custom duties.

The German import tariffs were never as high as those in the Colbert's France's because Bismarck was also interested in collecting additional revenues necessary to satisfy the financial needs of the new imperial administration. Thus, the tariffs rates were sufficiently high to be effectively protective, but not so high as to stop imports altogether and so produce no revenue at all. In light of this tariff strategy, Germany provides an additional example of how tax sovereignty implies the use of taxing power for both revenue-raising and regulatory/public policy purposes. In addition, it clearly demonstrates how essential those two tax sovereignty prerogatives have been for the establishment and

[73] LIST, F., THE NATIONAL SYSTEM OF POLITICAL ECONOMY, (London: Longmans, Green & Co., 1909); HORROCKS, J.W., *supra*, 148-150.
[74] LIST, F., *supra*, at 98-101.
[75] SHIELD NICHOLSON, J., *Introductory Essay*, in LIST, F., THE NATIONAL SYSTEM OF POLITICAL ECONOMY, (London: Longmans, Green & Co., 1909).

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the building of nation-states. The protective tariffs begun by Bismarck dominated Germany's external policy for long time, accentuated with the increases of tariffs in other countries and modified by commercial treaties.[76]

I.3.3. United States

I.3.3.1 British loss of political and tax sovereignty as the leading factor to the Declaration of Independence

The establishment of the United States' federal government taxing power represents one of the most significant cases of interminglement between the regulatory-public policy prerogative of tax sovereignty and the development of full state sovereignty. The process itself which led to the Declaration of Independence by the American colonies arose from a debate concerning tax sovereignty. Indeed, the American colonies' rebellion was fed by the British government's unilateral decision to start imposing taxes on the American colonies without holding full political sovereignty over those territories and without obtaining their representatives' consent.[77] The events described below illustrate the mutual interdependence of tax sovereignty and state sovereignty, as they clearly show that the lack of political and territorial sovereignty affects the exercise of tax sovereignty, and, conversely, how as a result of the incapability of the British government to impose its tax sovereignty over the colonies it lost political control over the colonies' territories.

Since their establishment, Britain had shown little interest in the American

[76] As highlighted by HORROCKS, J.W., *supra*, 154, "*doctrines of free trade and laissez faire have never taken deep root in Germany. The creation of the empire in 1870 was the most conspicuous triumph of the nationalist movement of the nineteenth century, and with the foundation of a strong imperial government the way was prepared for the development of a neo-Mercantilism in which the paternalism that was the persistent tradition of the German States should be applied to the regulation and regimentation of industry and commerce in the interests of German self-sufficiency and power on a scale commensurate with the authority of the new political union*".

[77] MERRILL, J., THE FOUNDING OF A NATION. A HISTORY OF THE AMERICAN REVOLUTION 1763-1776 (New York: Oxford University Press. 1968); POLE, J.R., FOUNDATIONS OF AMERICAN INDEPENDENCE 1763-1815 (Indianapolis: Bobbs-Merrill.1972).

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colonies in terms of political sovereignty and effective administrative control of the territory. The colonies were created not by means of an official and structured initiative of the British government, but they rather stem from the will of private individuals who moved out of their mother country – in which, for various reasons, they lived in unsatisfactory conditions - and successfully created settlements in northern America.[78] Other immigrants, not just from Britain, followed from all over Europe. The British government basically limited itself to the exploitation of the economic and commercial opportunities provided by the colonies. It did so through the control of a limited range of areas of strategic importance like harbors and the consequent enactment of mercantilist measures like navigation regulations at its own advantage,[79] the prohibition of imports or the imposition of high tariffs on imports of certain goods and materials from the colonies.[80] Such mercantilist policies are often referred to as "colonialism".

But it was only after the Seven Years War[81] that the British government, whose financial resources had been drained by that conflict, began requesting that the colonies contribute more substantially to its revenues. It did so initially through the reinforcement of the custom officials' corps so that they could collect existing custom duties strictly according to the letter of the law.[82] In addition, special courts were established to enforce

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[78] THOMAS, P.D.G., BRITISH POLITICS AND THE STAMP ACT CRISIS. THE FIRST PHASE OF THE AMERICAN REVOLUTION 1763-1767 (Oxford: Clarendon Press. 1975); GRAPPERHAUS, F.H.M., TAX TALES FROM THE SECOND MILLENNIUM, *supra*, 78-79.
[79] GRAPPERHAUS, F.H.M., TAX TALES FROM THE SECOND MILLENNIUM, *supra*, 78; THOMAS, P.D.G., *supra*.
[80] As highlighted by GRAPPERHAUS, F.H.M., *id.*, "*for transport to and from the colonies only British ships or ships from the colonies could be used. When a colonial merchant wanted to ship goods he had to guarantee that the goods were shipped to England. If he could not offer this guarantee, or did not want to, the goods were heavily taxed at exportation. In fact England became the sole entrepot for colonial wares, such as rice, sugar, tobacco, cotton, wool, indigo, copper, hemp, tar, pitch, hides, rigging*." In addition exportations of yarns and woolen fabrics, lumber, iron, potash, hides, pelts were prohibited.
[81] The so-called *Seven Years' War* (from 1756–63) was the last major conflict before the French Revolution which involved all of the great European powers. The fighting coalitions were composed by France, Austria, Saxony, Sweden and Russia, on one side, and Great Britain and Prussia, on the other side The war arose out of the attempt of the Austrian Habsburgs to re-conquer the rich province of Silesia from Prussia. However, the Seven Years' War also involved overseas fights between Great Britain and France for control of North American colonies. *Seven Years' War*. In Britannica Escola Online. *Enciclopédia Escolar Britannica*, 2014. Web, 2014. Available at: <http://escola.britannica.com.br/article/66946/Seven-Years-War>, (retrieved on January 2014).
[82] One of the justifications for this measures was the increase of the contraband operations carried out by the colonists. GRAPPERHAUS, F.H.M., TAX TALES FROM THE SECOND MILLENNIUM, *supra*, 81.

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the above regulations, prohibitions and custom duties.[83] These measures perfectly reflect the two-faced nature of taxation, since they were aimed at both increasing the revenues arising from America and protecting British industries and businesses from the colonies' competition.

It is, however, with the enactment of the Sugar Act and the Stamp Act, which respectively raised tariffs on refined sugar products and imposed a new tax on contracts,[84] that the British colonialist tax policy experienced an escalation which provoked the opposition by the colonies. Such opposition, which was headed by many attorneys, was officially based on grounds of legitimacy, and specifically that principles regulating the exercise of the taxing power in Britain itself had been violated. Indeed, since the issuance of the Magna Charta, the British government's power to tax was conditioned on the approval and consent of the population's representatives sitting in Parliament. Hence, according to this argument, the British government should have consulted the American colonies' population, which was not represented in the British Parliament, before imposing any tax.[85]

Such opposition evolved into threatens and boycotts of British goods. Eventually this led the British government to repeal the Stamp Act in 1766. Nevertheless, the attempt of Britain to impose its tax sovereignty over the colonies continued with the enactment, in 1767, of the so-called Townshend Acts, a series of acts which imposed a special tax on tea and other articles such as lead, glass, paper and dye, which were regularly shipped to

[83] GRAPPERHAUS, F.H.M., *supra*.
[84] The *Sugar Act*, enacted in 1764, significantly increased tariffs on refined sugar and coffee, wine, indigo, textile. The revenue raising goal of such measure was expressly indicated in the preamble to the Act, which stated: "*it is expedient that new provisions and regulations should be established for improving the revenue of this Kingdom ... and ... it is just and necessary that a revenue should be raised ... for defraying the expenses of defending, protecting, and securing the same*." Through the *Stamp Act*, enacted in 1765, the British government required that many printed materials (legal documents, magazines, newspapers and many other types of paper) in the colonies be produced on stamped paper produced in London, carrying an embossed revenue stamp. See THOMAS, P.D.G., BRITISH POLITICS AND THE STAMP ACT CRISIS. THE FIRST PHASE OF THE AMERICAN REVOLUTION, *supra*.
[85] LEE, R., *Stamp Act (1765)*, in ENCYCLOPAEDIA OF THE AGES OF POLITICAL REVOLUTIONS AND NEW IDEOLOGIES 1760-1815 (Fremont-Barnes, G. ed.), (Westport, CT: Greenwood Press, 2007) 696-697.

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the colonies.[86] In addition, such measures provoked, again, civil unrest, riots, and boycotts of British goods and led to the creation of the famous Boston Tea Party.[87] This turned into a real popular rebellion against the British officials and government and eventually culminated in the signing of the Declaration of Independence on July 4, 1776.

I.3.3.2 The Articles of Confederation: central government's lack of taxing power as lack of state sovereignty

The United States' political and economic independence and unity, since its embryonic phase, developed from and around the exercise of tax sovereignty for regulatory purposes, and in particular through the use of tariffs.

The 1776 Declaration of Independence was followed by years of war which ended only with the peace treaty with Britain signed in Versailles in 1783. During the war, the colonies decided to join together into a confederation of thirteen states and adopted, in 1777, the first constitutional charter. These states eventually evolved into the United States of America. The charter –which was called Articles of Confederation - became effective in 1781. It reflected that self-determination of each colony was paramount and therefore very few and limited powers were attributed to Congress, the only central governmental body. Indeed, most of the crucial government responsibilities had been left to the individual states. Under the Articles, only the states were entitled to directly control individuals. As a consequence, each time Congress had to pursue a collective goal, it had to rely on the practical implementation of its instructions by the states.[88]

Such a government structure was consistent with the ideals of self-determination and independence which had animated the Revolution, and this was particularly evident

[86] CHAFFIN R.J., The *Townshend Acts* Crisis, 1767-1770, in: BLACKWELL ENCYCLOPAEDIA, (Greene and Pole eds.), (Cambridge, MA: Blackwell Reference, 1991), 126-145: *126*-136.
[87] WOODS, L., THE BOSTON TEA PARTY (New York: Oxford University Press. 1968).
[88] MERRILL, J., THE ARTICLES OF CONFEDERATION. AN INTERPRETATION OF THE SOCIOCONSTITUTIONAL HISTORY OF THE AMERICAN REVOLUTION 1774-1781, 8th ed., (Wisconsin, 1976); THE FOUNDING OF A NATION. A HISTORY OF THE AMERICAN REVOLUTION 1763-1776 (New York, 1968); POLE, J.R., FOUNDATIONS OF AMERICAN INDEPENDENCE 1763-1815, (Indianapolis: Bobbs-Merrill, 1972).

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with regard to the taxing power. As illustrated above, the principle of "*no taxation without representation*" had constituted the leading slogan of the colonies' rebellion against Britain. They had engaged in a war against Britain to protect their right not to be deprived, by means of taxation, of their wealth without their own consent. This principle, and the objective to protect against any external taxing power, made the thirteen states extremely reluctant to attribute to the central governmental institution, the Congress, a complete and effective tax sovereignty. Thus, according to the Articles of Federation, Congress, even though it was formally entitled to establish taxes and apportion them among the states, had to turn to the individual states' governments for the purposes of levying and collecting them from individuals.[89]

Congress was therefore in an extremely weak position with regard to revenue raising activities because it depended on funds requisitioned from the states, which "*usually ignored calls for funds or responded very slowly*".[90] Each state was formally obliged to contribute its share "*in proportion to the value of all land within each State*", but what systematically occurred was that state governments' very often failed to collect funds and free-rided on other states' contributions, with the consequence that very little federal revenue were actually collected.[91] And any attempt to improve the situation, from the central government perspective, by means of the establishment, for example, of national tariffs directly levied and collected by federal officers was vetoed by the states because the Articles required a unanimous vote to make such a change.[92] This scheme, which reflected an orthodox deference to the individual states' autonomy and prerogatives, ended up severely affecting Congress's ability to pay for common expenses and, in particular, to equip troops for the national army, which almost led the nation to

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[89] MERRILL, J., THE ARTICLES OF CONFEDERATION, *supra*, 1774-1781.
[90] BROWNLEE, W.E., FEDERAL TAXATION IN AMERICA, (Cambridge: Cambridge University Press and the Woodrow Wilson Center *Press, 1996*), 15.
[91] BROWNLEE, W.E., *supra*, at 15; COOTER, R.D. & NEIL S. SIEGEL, *Not the Power to Destroy: An Effects Theory of the Tax Power*, 98 VIRGINIA LAW REVIEW (2012), 1195-1253, 1202. For instance, the "*Requisition of 1786, the last before the Constitution, 'mandated' payments by the states of $3.8 million, but collected only $663*". See JOHNSON, C.H., *Righteous Anger at the Wicked States: The Meaning of the Founders' Constitution* (2005) 15-26, 1.
[92] See Articles of Confederation of 1781, Art. XIII.

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lose the Revolutionary War.[93] To sum up, "*the states acted individually when they needed to act collectively*".[94] The Confederation "*necessitated a government with many more powers than were possessed by Congress under the Articles – including the great powers to tax to raise and support armies and to regulate commerce*".[95] And, in particular, it "*necessitated conferring authority to exercise these powers by acting directly on individual citizens*".[96]

I.3.3.3 The New Constitution and the Taxing Clause: empowering the central government with tax sovereignty and setting the conditions for its regulatory use

The portrait of the government structure emerging from the Declaration of Independence from Britain was, therefore, that of a central government lacking of substantial sovereign powers and resources. The lack of a far-reaching taxing power constituted the main issue and the Confederation was on the verge of collapse due to its central government's political and financial weakness.[97] Finally, starting in 1780, a cultural and political movement arose in favor of a more powerful central government and quite quickly spread among all the various states. The national leader of this movement was Robert Morris (1734-1806), a wealthy merchant from Philadelphia, who had also held important federal government positions.[98] Morris' previous government activity had given him the opportunity to understand the problems underlying the operation of the Confederation, particularly from the financial perspective. Specifically,

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[93] See AMAR, A.R., AMERICA'S CONSTITUTION: A BIOGRAPHY (Random House, 2005), at 114, according to whom "*the requisition system failed miserably and came perilously close to handing victory to the British in the Revolutionary War. With inadequate mechanisms to enforce states' obligations, many states held back, hoarding resources for local defense despite more urgent need for them elsewhere on the continent*".

[94] COOTER, R.D., *supra*, at 1203.

[95] KRAMER, L.D., *Madison's Audience*, 112 HARVARD L. REV. (1999), 611, 619.

[96] KRAMER, L.D., *supra*, at 619-20.

[97] GRAPPERHAUS, F.H.M., TAX TALES FROM THE SECOND MILLENNIUM, *supra*, 95; BROWNLEE, W.E., *supra*, 15-16.

[98] Robert Morris, an English-born financier and politician, served as member of various political and representative committees and in 1781 he was appointed as Superintendent of Finance. For a punctual illustration of Morris's life and role in the building of the United States, please see: OBERHOLTZER, E.P., ROBERT MORRIS, PATRIOT AND FINANCIER (London and New York: Macmillan, 1903).

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as Superintendent of Finance, he had to deal with the difficulties of obtaining from the states the funds necessary to cover the military expenses and pay back the huge debt the government had taken from foreign countries and banks in order to fight the Revolutionary war. Hence, his main goal was to release the Union from the financial dependence on individual states. Morris, as all other advocates of this movement, was aware that such a result could only be achieved if Congress was allowed to impose and collect taxes directly.[99] Therefore, Morris and his followers promoted several legislative initiatives aimed at empowering Congress with such power. These attempts mostly consisted in proposals for a federal tax on imports.[100]

Nevertheless, all these attempts were inevitably defeated by the veto power granted to the states by the Articles of Confederation[101] until finally Alexander Hamilton and James Madison, the two main leaders of the Federalist movement,[102] proposed that Congress organize a meeting of all states for aimed at reforming the Articles of Confederation and empowering Congress and federal government with the powers necessary to deal with the current situation. In particular, in his *Vices of the Political System of the United States*, a memorandum in which he included all his proposals for a complete reform of the confederation constitutional charter, Madison expressly pointed at the failure of states to comply with congressional requisitions and the lack of coercive power by the federal government as the main issues a new constitutional convention had to aim at solving. Specifically, he stated that such problems of collective action among the states "*necessitated a government with many more powers than were possessed by*

[99] GRAPPERHAUS, F.H.M., TAX TALES FROM THE SECOND MILLENNIUM, *supra*. 95-96.
[100] COOTER, R.D., SIEGEL, N.S., *Not the Power to Destroy: An Effects Theory of the Tax Power*, 98 VIRGINIA LAW REVIEW (2012) 1195-1253, 1201.
[101] JOHNSON, C.H., *Righteous Anger at the Wicked States: The Meaning of the Founders' Constitution* 15-26 (2005), 18.
[102] The Federalist movement was a political movement which played a leading role in the building of the United States nation and institutions and whose most important exponents were James Madison and Alexander Hamilton, who also were among the Framing Father of the new constitutions and will subsequently hold important offices in the federal government. The Federalists advocated a strong central government and repeatedly named common taxation as a tool to forge the thirteen states together into one single nation. See RATNER, S., AMERICAN TAXATION: ITS HISTORY AS A SOCIAL FORCE IN DEMOCRACY, (New York: Norton & Company, 1942), 23-25.

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Congress under the Articles – including the great power to tax, to raise and support armies, and to regulate commerce".[103] Finally, on February 21, 1787, Congress resolved: "*It is expedient that one the second Monday in May next a Convention of delegates who shall have been appointed by the several States be held at Philadelphia the sole and express purpose of revising the Articles of Confederation*".[104]

On May 25,1787 the Constitutional Convention began its first session. Fifty-five delegates from all states met together with the difficult task of framing a new constitution capable of both being accepted and ratified by all the states and making the federal government stronger and more efficient. During the convention many topics were discussed and important decisions were made. What matters the most for our purposes is that delegates agreed to provide the central government with far greater capacity to tax than it had enjoyed under the Articles of Confederation.[105] Such a position was particularly advocated for and defended by the Federalist movement' exponents, who during the subsequent required ratification process on many occasions expressly proposed federal taxation as a means to create one nation from the thirteen states.[106] Consequently, whereas under the Articles of Confederation the central government had only been able to ask the states to contribute voluntarily to the federal treasury – with the unfruitful results described above – the new constitution provided Congress with a fiscal and tax authority commensurate with the higher level of sovereignty the Framers meant to attribute to it. Article I, Section 8, of the Constitution, indeed, states that Congress has the general power "*to lay and collect taxes, duties, imposts, and excises, to pay the debts and provide for the common defense and general welfare of the United States*", "*subject only to a uniformity requirement (for duties, imposts, and excises), a prohibition on taxing exports,*

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[103] MADISON, J., *Vices of the Political System of the United States*, in JAMES MADISON: WRITINGS 69, (Jack N. Rakove ed.), (1999).
[104] Congress Resolution of February 21, 1787. See also GRAPPERHAUS, F.H.M., TAX TALES FROM THE SECOND MILLENNIUM, *supra*, 99.
[105] Indeed, delegates also conferred to Congress the power to regulate commerce, stimulate economic development and represent American affairs abroad.
[106] RATNER, S., *supra*. 23-25.

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and the need to apportion "direct" taxes".[107]

Even though the repayment of the Revolutionary War debt was the immediate problem which led to the introduction of the Taxing Clause, this clause also opened the way for the federal government to use taxation for regulatory public policy purposes. Professor Sidney Ratner supports this conclusion with his observation that "*the Fathers of the Constitution, as the records show, clearly viewed taxation as a means for shaping the national economy, bringing foreign nations to fair commercial terms, regulating morals, and realizing such social reforms as the abolition of slavery*" and that "*the evidence reveals that the framers of the Constitution agreed without dispute that the taxing power could be used for purposes totally unconnected with revenue, that one of its principal objectives was the regulation of commerce, that taxes could be used to destroy commerce, that they could be used indirectly to regulate morals and that in the absence of a special restriction linking direct taxation and Congressional representation, taxes could be used to destroy the vested property rights in slaves*".[108] The tax legislation and the political debate following the adoption of the Constitution both confirm this insight.[109]

The type of tax system Congress initially opted for was for the most part based on import tariffs.[110] At the beginning, from 1789 to 1816, tariffs were imposed primarily for revenue-raising purposes, as a means to approximately pay back the debt the United States had incurred during the War of Independence. Most of this debt burdened the federal government's treasury after its assumption of all the individual states' debt.[111] For this reason, the tariff rates were kept relatively low and therefore did not affect trade

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[107] U.S. CONST. art. 1, $ 8, cl. 1;. What counted as a "direct tax" was obscure even at the Constitution's drafting. See *Notes of James Madison* (Aug. 20, 1787), in THE RECORDS OF THE FEDERAL CONVENTION OF 1787, 350 (Max Farrand ed., rev. ed. 1966) ("*Mr. King asked what was the precise meaning of direct taxation? No one answered*").
[108] RATNER, S., *supra*, 20.
[109] See COOTER, R.D., SIEGEL, N.S., *supra*, 1205; STORY, J., *Commentaries on the Constitution of the United States*, section 962 (1833); BROWNLEE, W.E., *supra*, 40; AMAR, A.R., *supra*, 94.
[110] It is worth noticing that the Constitution itself forbade duties on exports, due to a compromise reached during the convention between delegates from the Northern states and delegates from the Southern states. The Southern states were, indeed, mainly agricultural and, in particular, their economy heavily relied on the exportation of cotton and tobacco to Europe. Therefore, the Southern states were strongly against the imposition of any burden on export. See GRAPPERHAUS, F.H.M., *supra*, 102.
[111] GRAPPERHAUS, F.H.M., *supra*, 107.

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significantly.

The revenue derived from the imposition of import tariffs generated more than ten times the amount of revenue from internal taxes in the first two decades after the new Constitution was adopted.[112] And between 1789 and 1815 the tariff revenues accounted for about 90% of total federal tax revenues.[113] This was also due to the fact that, according to Section 9 of Article I, direct taxation affecting property was severely limited, since this clause specified that "*no capitation, or other direct tax shall be laid, unless in proportion to census*". In addition, an import tariff–based tax system was also supported by the political consideration that this type of taxation, more than others, was perceived as not discriminating against any social class or category.[114]

Nevertheless, even during this period, Alexander Hamilton - who was the first Treasury Secretary under the new Constitution and, as already mentioned, one of the most influential politicians at the time – repeatedly advanced the use of tariffs not just as a revenue-raising tool but also as a means to foster the development of and to protect the nation's infant industries from European competition. At this time, indeed, some European countries were already engaged in mercantilist policies. The core of Hamilton's proposal is contained in his famous *Report on Manufactures,* in which, in line with the mercantilist doctrine already implemented across the ocean, he supported the federal government's promotion of manufactures as a means to make America self-sufficient in agricultural and industrial markets. He encouraged the adoption of a renewed tariff policy to accomplish the goal to protect American agriculture and industry at the same time. In support of this position, he claimed that the developing modern manufacturing in the United States would be difficult task because of "*fear of want of success in untried*

[112] U.S. BUREAU OF THE CENSUS, Historical Statistics of the United States, Colonial Times to 1970, at 1106 (1975), available at www2.census.gov/prod2/statcomp/documents/CT1970p2-12.pdf. Table Y 352-357 covers 1789-1939 (retrieved on July 2013).
[113] BROWNLEE, W.E., *supra*, fn. 21, at 23.
[114] BROWNLEE, W.E., *supra*, 28.

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enterprises" [115] and competition from European manufacturers, who had largely benefitted from their governments' mercantilist policies. In particular, his proposal required higher tariffs to protect new industries and exemptions from tariffs for raw materials necessary for industrial development.[116]

I.3.3.4 The Tariff Acts to support the development of national manufacturers

Hamilton's proposal for a regulatory protective tariff policy had little effect for the time being, since it only produced a very moderate increase in the tariff rates in 1792.[117] Nevertheless, his ideas were very influential in the protectionist doctrines which shaped the American custom policy starting from 1816.

During the War of 1812, which lasted until February 1815, the interruption of commercial relations with Britain stimulated the development of manufacturers within the United States.[118] After the war, the continuation of such industrial growth was 'threatened' by the return of peace between the two countries, which would have reopened the way for English goods. To prevent this from happening, the Federalists and Republicans brought the teaching of Alexander Hamilton to the forefront and agreed to protect American industry by passing the Tariff Act of 1816. This legislation raised the import tariff rate average to 20%, not prohibitively high but certainly higher than any previous tariff rate average. The rationale for this increase in the import tariff rate made by politicians was "*protecting America's high-wage workers and high-cost industries as*

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[115] HAMILTON, A., REPORT ON MANUFACTURES, quoted in THE REPORTS OF ALEXANDER HAMILTON (Jacob E. Cooke ed.), (New York: Harper & Row, 1964), 140.
[116] BROWNLEE, W.E., *supra*, 22.
[117] As highlighted by Ratner, the moderate tariff policy was retained because at that time the United States' economy was for the most made of agriculture and wanted to be able to acquire manufactured products at the cheapest prices. The manufacturing class did not have sufficient power for several decades to obtain a tariff policy aimed at supporting its growth. Therefore, "*between 1794 and 1816, some twenty-five tariff acts were passed, all modifying the customs duties, but the changes were usually for the purposes of revenue or for continuing previous laws of temporary duration*". RATNER, S., *supra*, 27.
[118] BARNHILL, J.H., PIERPAOLI, P.G., *Second American Revolution*, in THE ENCYCLOPAEDIA OF THE WAR OF 1812, (Spencer E. Tucker ed.), 644-45, 45.

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they learned how to meet their British competition".[119] As highlighted by Professor Ratner, "*for the first time protection was adopted as a primary principle of the fiscal system and revenue were treated as secondary to industrial needs*".[120] This early protection movement reached its culmination in 1824, when Congress enacted a 35% tax on imported wool, cotton goods and iron.[121] [122]

Due to the pressure of southern states, beginning in 1833 Congress started to gradually relax the tariffs' rates until they returned to the levels of 1816. In 1846, with the enactment of the Walker Tariff, rates were reduced even further. The reduction in tariff rates was also influenced by the English new free trade movement inaugurated by the repeal of the Corn Laws[123] and gave rise to what is commonly referred to as the "American free trade regime".[124]

During this period, the advocates of protection were by no means silent, and the most ardent of all American protectionists, Henry Charles Carey, was active during these years.[125] Carey's opposition to the free trade policy was based on the argument that it would have made the United States increasingly dependent upon other countries – a policy which would have led to disaster. Therefore, he urged a policy of national

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[119] BROWNLEE, W.E., *supra*, 29.
[120] RATNER, S., *supra*, p. 35.
[121] BROWNLEE, W.E., *supra*, 29. Counter to Hamilton's original idea, however, such act, which was defined by Southern politicians as the "Tariff of Abominations", also increased tariffs on imported raw materials, including flax, hemp, iron, lead, molasses, and raw wool.
[122] It is worth noting that, despite the strong propagandist use of the protection of "infant industries" argument, authoritative scholars have declared that such protectionist policy did not contribute substantially to the rise of American industry. According to these scholars, the development of American industries was due to their own ability to compete with their English counterparts. HORROCKS J.W., A SHORT HISTORY OF MERCANTILISM, *supra*, 176.
[123] The so-called "Corn Laws", in force between 1689 and 1846, were designed to protect English landholders by encouraging the export and limiting the import of corn when prices fell below a fixed point. They were repealed in 1846 in the face of protests by the Anti-Corn-Law-League, which claimed that the laws increased industrial costs. For further reading on the Corn Laws, please see BARNES, D.G., A HISTORY OF BRITISH CORN LAWS, 1660-1846, (New York: A.M. Kelley. 1961, 2nd ed.).
[124] BROWNLEE, W.E., *supra*, 30; HORROCKS J.W., *supra*, 177.
[125] Henry Charles Carey (1793-1879) was a leading American economist belonging to the American School of Capitalism and also served as a chief economic adviser to U.S. President Abraham Lincoln. He started as a free trader, but ended as an advocate of absolute protection, and was by far the most popular champion of American nationalist protectionism. See HORROCKS J.W., *supra*, 178.

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protection and self-sufficiency, strengthened by trade balance surplus.[126]

These ideas contributed to the rise of the instances for a second wave of protectionism which started during the Civil War (1861-1865)[127] and lasted until the first decade of the 20th century. In particular, the triggering factor for this new movement was the Civil War expenses. Congress had to increase internal taxation (induced by new forms of direct taxation, for the illustration of which see next chapter) and the industrial lobbies, affected by this heavy tax burden, called for relief through protective duties upon their products. As a consequence, Congress enacted the Tariff Act of 1864, which imposed import tariffs with an average rate of almost 50% of the total value of imports.[128]

The end of the Civil War was followed by the repeal of some minor direct taxes (including the first tax on individual income) introduced during the conflict to make the latter more acceptable to the lower classes (such measures will be analyzed in the next Chapter), in response to the demands of the richest classes who had accepted those levies only as emergency measures. In addition to this, industrial lobbies vigorously opposed any attempt to withdraw the protective duties. As a result, high tariffs remained in place and were even increased in subsequent years, based on the justification that such high tariffs were necessary to protect of national industries and the high standard of wages enjoyed by Americans.[129]

This mercantilist/protectionist tax policy based on import tariffs continued for decades because it was defended by industrial lobbies to which the Republican governments (which ruled during those years) were highly sensitive and accountable, since they constituted the majority of voters.[130] As highlighted by Brownlee, "*American*

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[126] For a complete illustration of Carey's economic thought, please see KAPLAN, A.D.H., HENRY CHARLES CAREY: A STUDY IN AMERICAN ECONOMIC THOUGHT, (Baltimore: The John Hopkins Press. 1931).

[127] The American Civil War was fought on the issue of slavery. Specifically, several Southern states were in favor of slavery while the Northern states opposed it. The war terminated with the defeat of Southern states, after four years of huge losses and destruction on both sides of the fighters.

[128] BROWNLEE, W.E., *supra*, 32. For a detailed illustration of American tariff legislation, please see TAUSSIG, F.W., THE TARIFF HISTORY OF THE UNITED STATES, (New York: G.P. Putnam's Sons. 1931).

[129] RATNER, S., *supra*, 135-144.

[130] BROWNLEE, W.E., *supra*, 41.

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business leaders lauded the regulatory effects of the tariff system. Manufacturers welcomed the protection they believed the tariffs afforded them against foreign competitors, and they praised the tendency of a favorable trade balance with Europe to encourage capital formation in America. During the 1870s and 1880s, manufacturers became especially enthusiastic about the high-tariff system because it allowed them to build national marketing organizations, free of worries about disruptions caused by European competitors".[131] And labor also supported high tariffs as a means to increase employment in selected industries by protecting American workers from competition with low-wage workers in other countries.[132] Therefore, although such tariffs contributed significantly to federal revenue, the justification for them was also openly for regulatory purposes.

As a consequence, the high tariff rate remained stable at close to 50% on dutiable goods and on certain manufactured goods at 100%.[133] Together with excise taxes on consumption goods like alcohol and tobacco products, which also served both regulatory and revenue-raising functions, the high tariffs gave rise to what is also referred to as the "consumption tax-based Republicans' tax system". This system, despite frequent changes, substantially remained in place and epitomized the federal fiscal policy until the First World War. Indeed, as it will be discussed in the next chapter, only starting from the First World War, the development of a new tax system based on progressivity and on the taxation of income induced a relaxation of import tariffs.

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[131] BROWNLEE, W.E., *supra*, 41.
[132] COOTER, R.D., SIEGEL, N.S., *supra*, 1207. However, some critiques were risen, according to which the protectionist tariff policies had provoked an increase in the costs of production which in the long-term ended up affecting the same manufacturing industries such policies were aimed at protecting. Such critiques eventually led to the most striking reversal of the American tariff policy when, in 1909, the Payne-Aldrich Tariff significantly lowered the tariff rates on many foreign goods entering the country. See KI, E., RYLEY, T., PRELUDE TO TRADE WARS. AMERICAN TARIFF POLICY 1890-1922, (Westport, CT: Greenwood Press, 1994), 39-52.
[133] KAPLAN, E., RILEY, T., PRELUDE TO TRADE WARS. AMERICAN TARIFF POLICY 1890-1922, *supra*.

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I.4. Conclusions

The analysis conducted in this chapter demonstrated how the use of taxation for regulatory purposes, specifically tariffs aimed at developing national industries and protecting them from foreign competition, certainly played a decisive role in the abatement of that political, fiscal and economic fragmentation which had previously prevented the rise of sovereign centralized national governments. Therefore, such exercise of the taxing power's regulatory function was decisive for the creation and industrialization of modern nation states and largely contributed to the establishment of full state sovereignty over national communities and territories.

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Chapter II

THE SHIFT TO A PROGRESSIVE INCOME TAX SYSTEM AND TAX EXPENDITURES: TAX POLICY TO PURSUE SOCIAL JUSTICE AND THE EXTENSION OF NATIONAL GOVERNMENTS' SIZE

In the previous chapter, this work examined how the use of tax sovereignty for regulatory public policy purposes – in the form of mercantilist tariffs - was strongly associated with and played a decisive role in the creation and the establishment of full state sovereignty over national communities and territories, and in their industrialization.

In the following paragraphs, we will observe how the pursuit of regulatory objectives – i.e. the redistribution of wealth and the achievement of more social justice - laid at the basis of another decisive passages in nation states' tax policy history, *that is, the shift from a regressive tax system mainly based on indirect levies on imports and consumption to a progressive direct tax system relying on income taxes.*

For the purpose of this work, the most important conclusion is the recognition of the link between the shift to a progressive income tax system and the further consolidation of state sovereignty in the form of an extension of national governments' size and area of competence. Indeed, through the enactment of progressive income taxes, national governments indirectly endowed themselves with new pervasive state functions, consisting of the power to correct the shape of the social and economic system spontaneously arising from market dynamics.

Subsequently, it will be illustrated how, during the last decades, the government intervention in social and economic fields through the tax system has been further expanded by means of the inclusion, within the income tax codes, of exceptional rules – the so-called "tax expenditures"- all aimed at the pursuit of regulatory objectives. Such enlargement of government through the enactment of both income taxes and tax expenditures also largely contributed to the development of the modern western welfare states.

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SHIFTING TO A PROGRESSIVE INCOME TAX SYSTEM: TAXATION TO RESTRUCTURE THE ECONOMY AND ACHIEVE SOCIAL JUSTICE

II.1.1 Negative Side Effects of Industrialization: Concentration of Wealth and the Role of Taxation in Favoring It

The instances for the introduction of a progressive tax system based on income taxes are inborn to and consequent to industrialization itself. The debate surrounding the introduction of progressive income taxes, indeed, arose based on two issues as perceived by the newly formed working class and by progressive politicians:

- the concentration of wealth in the hands of few rich individuals and corporations;
- the uneven distribution of the tax burden among the society.

Between the second half of the 19th century and the first half of the 20th century, most industrialized nation states experienced a large campaign against the concentration of personal wealth and industrial power. Industrialization and capitalism, undoubtedly brought growth and prosperity to the society as a whole, but at the same time such wealth was not perceived to be equally distributed among the social classes. Labor organizations as well as progressive political movements denounced the fact that economic power had become too concentrated in the hands of a few wealthy individuals and large corporations and subject to monopolies and/or oligopolies in all the relevant industrial and economic sectors.[134] A campaign against this concentration of economic power lasted for decades until it led to the achievement of significant results in terms of redistribution of wealth within society. Especially in the United States, large corporations were expressly blamed for creating depressions by withholding their earnings from dividend distributions and

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[134] TILLY C. (ED), THE FORMATION OF NATIONAL STATES IN WESTERN EUROPE, (Princeton, New Jersey: Princeton University Press. 1975).

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accumulating excessive investments to form monopolies, and, as a consequence of all of this, to drive small enterprises out of the field.[135]

According to the protesters and to most expert observers, the concentration of wealth power was also due to the fact that in all the industrialized nation states, the burden of taxation was unevenly spread. Indeed, in the United States, as in many European countries, most of the revenues had derived from indirect taxes, like consumption taxes in the form of import tariffs and excise taxes. Such tax systems were naturally regressive, since they ended up taxing less wealthy people relatively at higher rates than wealthier people and corporations. For this reason, for example, in the United States the Democrats opposed the so-called "Republican tax system", which heavily relied on tariffs and excise taxes and described the tariff as the "mother of trusts", denouncing that such import tariffs – which, as illustrated in the previous chapter, at the beginning served the necessary purpose of industrialization and development of economic independence of the country – were a political instrument to subsidize giant corporations.[136] Similar arguments against import tariffs and excise taxes were spread in the industrialized European countries, where the lobbies of merchants, traders and manufacturers had been able to obtain the enactment of favorable indirect tax systems as well.[137]

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[135] See BUEHLER, A.G., *Regulatory Taxation*, HARVARD BUSINESS REVIEW 17 (1939), 138-152, 143. "*Corporations alone are assumed to be guilty of forming or attempting to form monopolies, of excessive investing, of fraudulent and exaggerated advertising and selling claims, of irresponsible and ineffective management, and other evils. But worst of all, the corporate form of organization is well adapted to large-scale enterprises, which is held to be undesirable because the small enterprises are presumably driven out of the field*".

[136] See BROWNLEE, W.E., FEDERAL TAXATION IN AMERICA: A SHORT HISTORY, (Cambridge: Cambridge University Press and the Woodrow Wilson Center *Press, 1996*), 42, who also highlights how in the United States, during the 1880s and 1890s, the two competing political parties, the Republican Party and the Democratic Party, developed two conflicting ideological views of tariffs and taxation in general which lasted and strongly influenced their respective revenue policies until World War II. The Republicans' invocation of high tariffs and the Democrats' response sharply polarized the parties on issues of taxation, which exacerbated class conflict for nearly a century. On this topic, see also TERRIL, T. E., THE TARIFF, POLITICS, AND AMERICAN FOREIGN POLICY, 1874-1901 (Westport, Conn.: Greenwood Press. 1973), especially 210-17. The events and the debates which led to the United States' shift to a progressive will be carefully examined in section II.1.3.4.

[137] WEBBER, C., WILDAVSKY A., A HISTORY OF TAXATION AND EXPENDITURE IN THE WESTERN WORLD (New York: Simon and Shuster, 1986); SELIGMAN, E.R.A., THE INCOME TAX: A STUDY OF THE HISTORY, THEORY AND PRACTICE OF INCOME TAXATION AT HOME AND ABROAD, (New York: The MacMillan Company, 1911), 223-355.

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II.1.2 The Political and Doctrinal Debate on the Proposal for Progressivity in the Tax System

The social and political pressures in favor of tax reform concentrated on creating a tax system based on progressivity: that is, for a tax system suitable to distinguish taxpayers on the basis of their ability-to-pay and to redistribute the wealth in a more equitable way.[138] Progressivity, indeed, means that the tax rate, and so the relative tax burden, increases in accord with the taxpayer's ability-to-pay, which, in turn, means that "*taxes should be levied on a person according to how well that person can shoulder the burden*".[139] Between the second half of the 19th century and the first half of the 20th century, the debate on the progressivity of the tax system was central to political and scholar discourse in many western countries. In particular, the debate centered on two conflicting positions.[140]

One position opposed tax progression based on the belief, derived from the classical finance doctrine, that taxation should be as neutral as possible and thus utilized only for the purpose of raising revenues in the economically less distortive way possible. According to this position, every tax with a social or economic end, including the redistribution of wealth, works poorly. Advocates of this position pointed out that it was not the State's role to interfere with the differences in wealth between citizens, but should instead play a neutral role and let the invisible hand of the market work. Such an argument is summarized by the adage "*leave them as you find them*".[141]

The other position favored progressivity based on the assumption that taxing rich persons and poor persons at the same rate is intrinsically uneven because this implies a

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[138] SELIGMAN, E.R.A., *The Theory of Progressive Taxation*, American Economic Association Quarterly, April 1908, 129-301; THE INCOME TAX. A STUDY OF THE HISTORY, THEORY AND PRACTICE OF THE INCOME TAX AT HOME AND ABROAD (New York, 1911); PEYTON YOUNG, H., *Progressive Taxation and Equal Sacrifice*, THE AMERICAN ECONOMIC REVIEW 3 (1990), 253-266.
[139] MANKIW, N.G., PRINCIPLES OF MICROECONOMICS, 6th edition, (Cengage Learning, 2011), 247.
[140] PEYTON YOUNG, H., *Progressive Taxation and Equal Sacrifice*, The American Economic Review 3 (1990), 253-266.
[141] See GRAPPERHAUS, F.H.M., TAX TALES FROM THE SECOND MILLENNIUM, (Amsterdam: IBFD, 2009). 64. MCCULLOCK, J.R., THE TAXATION AND FUNDING SYSTEM, (London, 1845), 141.

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larger sacrifice for the latter, whose monetary loss due to taxes is relatively bigger compared to that of the rich. Therefore, a rich person should pay relatively more in taxes than a poor person. Such an argument resulted in the doctrine of the so-called "equal sacrifice", whose first authoritative theorist was the English philosopher John Stuart Mill, who stated this doctrine as follows: "*As a government ought to make no distinction of persons or classes in the strength of their claims on it, whatever sacrifices it requires from them should be made to bear as nearly as possible with the same pressure upon all…Equality of taxation, therefore, as a maxim of politics, means equality of sacrifice*".[142]

Although in previous historical periods the debate concerning progressivity had never been as central to political discussion as in the late 19th and early 20th century, progressivity and the two contrasting positions relating to it, certainly on a smaller scale, had previously been debated by policymakers and scholars in past historical moments and societies. For instance, the city of Florence between the 15th and the 16th century enacted and subsequently repealed a progressive levy known as *decima scalata* (multistage tenth).[143] Two speeches, in 1538, by the Florentine statesman and historian Francesco Guicciardini discussed the two conflicting positions regarding progressivity.[144] Nevertheless, these episodes remained isolated and never constituted the center of a political debate.

One of the main reasons why in the past the battle for the establishment of a

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[142] MILL, J.S., PRINCIPLES OF POLITICAL ECONOMY, (1848), (London: Longmans Green, 1917), 804. John Stuart Mill's concept led to much discourse on the "equal sacrifice" theory around the turn of the century (Henry Sidwick, 1883; Arnold Jacob Cohen Stuart, 1889; Gustav Cassel, 1901; F.Y. Edgeworth, 1897, 1919; Arthur Pigou, 1928).
[143] GRAPPERHAUS, F.H.M., *supra*, 64.
[144] Guicciardini was personally in favor of progressivity and, in particular, he wrote:
"*Even a moderately progressive tax… will not suffice to bring about justice and equality, because it would not restrict the rich man in the same degree as the poor man in the satisfaction of his necessities. For since we are all citizens of the same state and each equal of the other, there can be no true equality or justice in taxation unless the taxes reduce us all to the same economic level. For to have too much wealth does not do any one any good, but on the contrary is a dangerous thing not only for the body politic, but for the citizen at large, and even for the owners [of the wealth] themselves. If, then, we introduce the progressive principle we shall become truly equal as we reasonably ought to be*". SELIGMAN, E.R.A., THE INCOME TAX. A STUDY OF THE HISTORY, THEORY AND PRACTICE OF THE INCOME TAX AT HOME AND ABROAD, *supra*, 135-136.

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progressive tax system had not gained the same popularity and dimension as in the late 19th century is because of the lack of representation of the lower classes in decision-making political institutions. Indeed, in the previous centuries only people belonging to the noble class were entitled to hold governmental offices and in the earlier stages of nation states the right to vote was attributed only to a limited portion of the male population; that is, only those who paid a certain amount of taxes.[145] And although the rich did not pay higher rates, due to the existing non-progressive tax systems, they were still the only who, in absolute terms, paid enough taxes to vote. As a consequence, the instances and the proposals of the poorer (and larger) part of the populations – including the request for more equality in the distribution of the tax burden – had no representation and expression in the public policy machine.

Between the 19th and the 20th century, instead, the new features and size of industrialized society produced a large and homogeneous working and middle class, and induced both of them to be more aware of their political situation and needs and to structure themselves in organized groups able to claim and often obtain the concession of more rights, starting from the right to vote. This led, in most industrialized countries, to the achievement of universal suffrage, which inevitably created a class of politicians more sensitive to the needs of the lower classes, which finally were given attention. In addition, unlike in the past, by the end of the 19th century, bookkeeping techniques had become sufficiently developed to enable large-scale inspections by tax officials and, above all, to allow a system of taxation which could take into account the different variables characterizing each taxpayer.[146]

Once it was established that the fight was for more progressivity in the tax system, the choice of the type of taxes to advocate for naturally fell on income taxes to be levied on wealthy individuals' incomes and corporations' profits. That is due to the fact that only direct taxes can be shaped according to a progressivity principle and, among direct

[145] GRAPPERHAUS, F.H.M., *supra*, 65.
[146] GRAPPERHAUS, F.H.M., *supra*, 38.

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taxes, income taxes represent, in principle, the most suitable tool to capture an effective ability-to-pay.[147]

The political crusade to a progressive income tax accelerated and even 'benefitted' from the fact that governments had a substantial need for more revenue since many nation states were fighting wars and experiencing economic depression between the 19th and the 20th century. As a result, national governments were constantly requiring their populations, particularly the lower classes, to increase their sacrifices in terms of contributions to public finances and to the army.[148] In addition, the responsibility for the economic depressions was frequently attributed to large industrialist speculation and lobbying power which conditioned the governments' activity and, often, inactivity.[149] Therefore, in order to reduce the resentment by the lower and middle classes and to make them accept the increased sacrifices required, the governments and the industrialist upper classes themselves had to make some significant concessions in terms of social and economic public policies. Such increased political 'bargaining power' of the lower classes significantly eased the process towards the enactment of income taxes and the shift to progressive tax systems. In sum, while on one side the wars, economic depressions and the increasing governmental expenses certainly resulted in additional sacrifices for the population, on the other side they constituted an opportunity for the reformers to gain more bargaining power and see their proposals (or parts of them) adopted in a relatively short timeframe.

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[147] ESSERS, P.H.I., RIJKERS, A.C., THE NOTION OF INCOME FROM CAPITAL, (Amsterdam: IBFD, 2005), 281; TESAURO, G., DIRITTO TRIBUTARIO, (Milan: UTET, 2006), 68-72.

[148] SELIGMAN, E.R.A. THE INCOME TAX. A STUDY OF THE HISTORY, THEORY AND PRACTICE OF THE INCOME TAX AT HOME AND ABROAD, *supra*.

[149] BUEHLER, A.G., *Regulatory Taxation*, HARVARD BUSINESS REVIEW 17 (1939), 138-152, 143

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II.1.3 The Most Significant Shifts

In the following sections, this work will review the most significant shifts to a progressive income tax system among western nation states in history. Among these, the United States experience stands out, since it most effectively illustrates the social and economic significance of this epochal passage in the history of taxation and nation states. Indeed, in the United States the concentration of wealth in the hands of a few subjects and the phenomenon of large corporations were more accentuated. Therefore, the events and the debates which led to the United States' shift to a progressive income tax system will be given more attention.

II.1.3.1 The first (non-progressive) income tax: England

England enacted the world's first income tax, although it was not progressive initially. The traditional British tax system, as the systems in other European nation states at the time, was an indirect tax system mainly relying on tariffs and excises.[150] In 1799, under the initiative of the Treasury ministry William Pitt, a proportional income tax was adopted in order to provide the government with an additional source of revenue to face the costs imposed by the war against Napoleon's France. All of the taxpayers' incomes exceeding £60 were subject to a 10% tax.[151] This tax, however, was considered by the legislature itself as temporary and indeed, in May 1802, right after the end of the war - and in consideration of the evident disapproval by the voting taxpayers –, it was repealed.[152]

Nevertheless, in the same year, due to new revenue needs imposed by the

[150] As reported by GRAPPERHAUS F.H.M., *supra*, at 73, "*more than 80% of British revenue came from custom duties and excise taxes from which the poor suffered, comparatively, the most*". See also WEBBER C., WILDAVSKY A., A HISTORY OF TAXATION AND EXPENDITURE IN THE WESTERN WORLD (New York, 1986); DOWELL, S., HISTORY OF TAXATION AND TAXES IN ENGLAND, (London, 1884).
[151] DOWELL, S., *supra*, 222.
[152] DOWELL, S., *supra*, 230.

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reopening of the conflict with France, Henry Addington, Pitt's successor, had to reintroduce the tax, with some amendments, the most important of which consisted of the partition of incomes into schedules, a feature which still characterizes the British personal income tax today and was adopted also by foreign governments, and the reduction of the rate to 5%.[153] The temporary and extraordinary nature of such a tax, which was repealed again after the Waterloo victory of the British army in 1815, was appropriately described as "*the tax which beat Napoleon*".[154] As a result, the British tax system turned again to rely mainly on consumption and excise taxes.[155]

The increasing debt of the Crown, however, induced Robert Peel – prime minister between 1841 and 1846 – to reintroduce an income tax with the same substantial features as the previous income tax enacted in 1842.[156] According to Peel's intentions, the tax would be temporary and last for only four years - the amount of time considered necessary to fix the government's finances.[157] Nevertheless, the size of the revenue collected through it – 50% more than expected – turned the tax into an irreplaceable tool. Since then, the income tax became a traditional element of the British tax system, despite the open disapproval by all of the succeeding prime ministers.[158]

By the end of the 19th century, populist movements and labor associations started

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[153] As highlighted by DOWELL, S., *supra*, 230-231, one of the main reasons for the unpopularity of the previous income tax previously adopted had been the necessity of filing a general declaration of income from all sources. Therefore, the new income tax was "*split up and parceled out in schedules, so as to form, as regards the returns require, so many separate taxes. Schedule A contained the tax on owners of land, including houses, in respect of the ownership; schedule B, the tax on farmers in respect of land and houses attached to farms, and included the additional benefit to persons in occupation of lands of their own; schedule C, the tax on dividends and annuities from public revenue; schedule D, the tax on income derived by residents in Great Britain from property or business abroad, and the tax on professions, trades employments, or calling exercised in Great Britani; while schedule E contained the charge on public offices or employments of profit, including the army, navy, and civil service*".

[154] ADAMS, C., FOR GOOD AND EVIL. THE IMPACT OF TAXES ON THE COURSE OF CIVILIZATION (London, New York: Madison Books, 1993), 349. It is also reported that after the repeal of the tax, the government ordered the destruction of all the files concerning it. See DOWELL, S., *supra*, 144.

[155] In this period, however, the British tax system also included some non-progressive direct taxes, like taxes on houses, taxes on property on its devolution, and small taxes on salaries and pensions. Nevertheless, the contribute of such levies to the general revenue was much smaller than that of consumption and excise taxes. See DOWELL, S., *supra*, 257-59.

[156] *Income Tax Act*, 1842.

[157] DOWELL, S., *supra*, 325.

[158] REES, J.F., A SHORT FISCAL AND FINANCIAL HISTORY OF ENGLAND 1815-1918, 32.

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lobbying the government to turn such a proportional income tax into a progressive income tax, in order to make the contribution from higher classes larger compared to that of lower working and middle classes. All of the attempts in this direction failed, until 1910, when the government led by Lloyd George introduced a surtax on incomes above £ 5,000. The tax rates increased significantly the following years, and during World War II the highest rate reached the record of 83%. In 1973, the surtax was repealed and replaced by a more structured range of tax rates (25%, 33%, and an additional rate between 40% and 83%).[159] Although most government statements formally justified the shift to a progressive income tax on grounds of revenue-raising needs, scholars and historians agree on recognizing the social public policy purposes of such a measure. In particular, Seligman highlights that "*this change is due in part to the evolution that has occurred in England, as elsewhere in Europe, in the general attitude with regard to the social functions of taxation*".[160]

The tax structure remained substantially unmodified until the late 1980s, when Margaret Thatcher's government, in an attempt to discourage tax avoidance, decided to significantly reduce the rates (25% was the average rate and 40% the maximum rate).[161] It is important to highlight that the current income tax structure is characterized by rates ranging between 10% and 45%, a no-tax bracket (income under approximately £10,000 is tax exempt) and various deductions in consideration of criteria like age, number of household members and their income etc., which make the tax even more progressive.[162]

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[159] SELIGMAN, E.R.A., THE INCOME TAX, *supra*, 207-213.
[160] SELIGMAN, E.R.A., THE INCOME TAX, *supra*, at 213.
[161] UK 1988 Budget, available at http://www.margaretthatcher.org/archive/displaydocument.asp?docid=111449 (retried from January 2014).
[162] HM REVENUE & CUSTOMS, Income Tax Rates and allowances, available at http://www.hmrc.gov.uk/rates/it.htm (retrieved on January 2014).

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II.1.3.2 The first progressive income tax: the Prussian-German case

The country which took the lead with respect to the enactment of a progressive income tax based on modern-day views was Germany. In 1891, indeed, Prussia the most important State of the German Empire, enacted some progressive tax policy.

After the decline of the guild system, in 1869, Prussia had experienced vigorous economic development and industrialization. The new and flourishing industrial class used all of its influence to release itself from substantial taxation. The industrial class justified this position by arguing that substantial taxation would harm the future development of industry. The industrial class, therefore, proposed that the government finance its expenses mainly through the collection of consumption taxes, which in fact burdened the lower classes of the population most significantly.[163]

Nevertheless, a reformist movement in favor of a tax system based on the progressivity principle started to grow and, when the government found itself in need of consensus and more revenue to pay for the military expenses it was incurring, it took the progressive principles into account. In 1847, two attempts by the government to enact a progressive income tax failed due to the vigorous opposition from the industrial and proprietary classes. These bills were aimed at imposing a progressive income tax on the higher incomes and it was clear that the "*main end in view had been a more equitable distribution of the burden of taxation*".[164] Specifically, the proposed tax rate was 3% on the so-called "funded incomes" – i.e. incomes from property or invested capital, including profits, interests and rent – and 2% on the so-called "unfunded incomes", consisting of wages, salaries, professional fees and other similar sources of income.[165] A third attempt, in 1849, one year after the tumultuous revolution year 1848, failed again. Finally, in 1850, the government succeeded in introducing an income tax, the so-called

[163] GRAPPERHAUS, F.H.M., *supra*, 65. As highlighted by SELIGMAN, E.R.A., *supra*, 224, at this time "*the consumption taxes played the greater role*".
[164] HILL, J.A., *The Prussian Income Tax*, 6 THE QUARTERLY JOURNAL OF ECONOMICS 2 (Jan. 1982), 207-226, 213.
[165] For a detailed description of these two proposals, see HILL, J.A., *The Prussian Income Tax*, 6 THE QUARTERLY JOURNAL OF ECONOMICS 2 (Jan. 1982), 207-226, 213. See also SELIGMAN, E.R.A., THE INCOME TAX, *supra*, 230-50.

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Klassensteuer und klassifizirte Einkommensteuer, which became effective in 1851.[166] Such tax divided taxpayers into many classes on the basis of their income and each of them was subject to a different rate. However, because of its administrative structure, this tax did not constitute the redistributive tool asked for by advocates of a progressive tax system. In fact, "*nobody had to fill in tax forms, assessments were settled by means of assessment committees, selected by taxpayers, without any power, and there was a maximum yearly amount (i.e. 7.200 Thaler)*".[167] These features made the tax unfit to distinguish taxpayers according to their relative effective ability-to-pay.

A progressive income tax worthy of such a title – the first modern progressive income tax adopted by a nation state - was enacted three decades later, in 1891, when the government, through the activity of the Ministry of Treasure Johannes Von Miguel, was finally successful at enacting a tax whose rates ranged from 0.62% to 3% income above 9,500 marks. Besides the application of two different rates, the most important innovation of this tax was the introduction of tax forms to be filled for the determination of the payable tax. This mechanism, the first version of what has later become known as 'tax return', allowed the personal circumstances of taxpayers – such as the number of children, maintenance liabilities of next of kin and chronic illness – to be taken into account and therefore to better identify a more precise ability-to-pay.[168] To reduce avoidance and elusion, the tax form-mechanism was complemented by more pervasive investigative powers attributed to tax officials. This new progressive income tax and the administrative system related to it gave rise to significant results in terms of both perceived social justice and revenue collection. As a consequence, such tax policy laws

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[166] Gesetz, betreffend die Einfuhrung einer Classen- und classificirten Einkommensteuer vom 1 Mai, 1851. The text is given in Zeitschrift des Koniglich-preussischen statistischen Bureaus, Bd. 8 (1868), p.. 25. The so-called *Klassensteuer und klassifizirte Einkommensteuer*. See WINIKER, R., DIE *KLASSENSTEUER UND KLASSIFIZIRTE EINKOMMENSTEUER* IN PREUSSEN, 1877.
[167] GRAPPERHAUS, F.H.M., *supra*, 66.
[168] HILL, J.A., *supra*, 210-226; SELIGMAN, E.R.A., THE INCOME TAX. A STUDY OF THE HISTORY, THEORY AND PRACTICE OF THE INCOME TAX AT HOME AND ABROAD, *supra*; SCHMÖLDERS, G., ALLGEMEINE STEUERLEHRE, 5th ed. (Berlin, 1980).

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were enacted and implemented in the other states of the German empire.[169]

Since then, a national income tax modeled after the Prussian tax has remained in place in Germany. However, the need for more revenue due to the cost of World War I, the subsequent economic depression, and social pressures for a more equitable distribution of the tax burden led to a significant increase in the tax rates and an enlargement of the tax basis through an enlargement of the definition of income. Currently individual income tax rates range from 15% to 45% and no income tax is assessed for income under approximately €8,000.[170]

II.1.3.3 The French "slow revolution"

The fight for a more just tax system was one of the primary motives for the French Revolution between the eighteenth and the 19th century. Indeed, during the Ancient Regime, the ruling aristocracy and the clergy enjoyed tax immunities and privileges.[171] Therefore, the burden of taxation, consisting mostly of excise taxes and tariffs, fell on farmers and merchants. This burden became intolerable for the latter and led to some revolts which, together with other social and economic claims, gave rise to the Revolution.[172] Also, the most notable intellectuals of the time discussed the injustice of the tax system, as reflected in Diderot's *Encyclopedie*.[173]

The first revolutionary governments, influenced by the illuminist theories, initially seemed willing to immediately shift to a tax system entirely reliant on direct taxes

[169] GRAPPERHAUS, F.H.M., *supra*, at 66; SELIGMAN, E.R.A., THE INCOME TAX *supra*, 258-261.
[170] SCHÖN, W., *Germany*, in COMPARATIVE INCOME TAXATION: A STRUCTURAL ANALYSIS (Hault, H.J., Arnold, B.J. eds), (Amsterdam: Kluwer Law International, 2010) 65-92, 68.
[171] For a detailed description of the tax privileges the French aristocracy benefitted from, please see BEHRENS, B., *Nobles, Privileges and Taxes in France at the End of the Ancien Regime*, 10(3) ECONOMIC HISTORY REVIEW, (1963), 451-475.
[172] SELIGMAN, E.R.A., THE INCOME TAX, *supra*, 304.
[173] See DIDEROT D., D'ALEMBERT J.B., ENCYCLOPEDIE, OU DICTIONNAIRE RAISONNÉ DES SCIENCES ET DES ARTS ET MÉTIERS, where, in particular, it is reported how the salt tax, an excise levied on the consumption of tax, was afflicting the lower classes.

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(including income taxes).[174] Nevertheless, political resistance and feasibility issues impeded such a shift and revolutionary governments opted for a system still based on taxation of products rather than personal incomes or properties.[175] The governments however attempted to make such an indirect taxation system – which was, like any indirect tax system, regressive by nature - more sustainable for the lower classes by introducing certain exemptions for necessary products.[176] In fact, during its first decades of implementation, the revolutionary governments' indirect tax system was quite well tolerated and also produced good results in terms of revenue collected.[177]

However, by the middle of the 19th century, the French economy had experienced significant industrial development which resulted in the concentration of wealth in the hands of the new "bourgeois aristocracy", made of a minority of businessmen, corporations and merchants. As a consequence, the newly established working and middle classes started to perceive the indirect tax system as one of the tools through which this *status quo* was kept intact in the interest of industrialists and the merchant class, who enjoyed a relatively lower tax burden and benefitted from the protective import tariffs they had lobbied for.[178] Supported by intellectuals, academics and socialist political movements and parties, the working and middle classes asked for the repeal of a large part of the existing tax system and for the enactment of a more equal system based on a progressive income tax.[179]

The reluctance of the re-established monarchic government to accept these policies certainly constituted one of the triggering factors in France of the 1848 Revolution, which gave rise to the so-called Second Republic.[180] During the Second Republic, governments and socialist-inspired parties introduced many bills containing the proposal for the

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[174] SELIGMAN, E.R.A., THE INCOME TAX, *supra*, 304.
[175] CLAMAGERAN, J.J., L'HISTOIRE DE L'IMPOT EN FRANCE, 2.vol., (1867), 458-60; SELIGMAN, E.R.A., *supra*, 273.
[176] SELIGMAN, E.R.A., THE INCOME TAX, *supra*, 304
[177] CLAMAGERAN, J.J., *supra*, 460.
[178] CLAMAGERAN, J.J., *supra*, 461.
[179] SELIGMAN, E.R.A., *supra*, 308.
[180] VIGIER, P., LA SECOND REPUBLIQUE, (Paris: Presses Universitaires Françaises, 1967), 88.

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adoption of an income tax.[181] Nevertheless, divisions within the socialist movement between the agricultural and the urban proletariat ended up benefitting the industrialists and other higher classes, who exploited such division. And the subseequent conservative governments (supported by industrialists and higher classes) were also reluctant to enact any significant tax reform in a progressive direction.[182] As stated by Seligman, the earlier history of the income tax projects in France is well summed up by a French writer in the statement that "*The Revolution did not want to establish it, and the government which succeeded either would not or could not*".[183]

The time for the introduction of a progressive income tax became ripe only in 1909, when, after a two-year debate, the General Assembly approved the income tax proposal formulated by the Ministry of Finance Cailleux. The income tax (*Impôt sur le revenue*) was structured in the following way:

- the partition of individual income into various categories each of them taxed at a different rate;
- the addition of a supplementary tax on incomes above a specified amount.[184]

Nevertheless, the Senate, where the conservatives could still rely on a relative majority, rejected this proposal. Three years later, the Senate enacted an income tax (*Impôt sur le revenue*) significantly different and much less effective than the tax proposed by Cailleux.[185]

Only in 1917, due to the need to raise more revenue to finance the World War I and to make the sacrifices imposed by the latter acceptable to the lower class, France amended the income tax to make it more similar to that endorsed by the General

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[181] SELIGMAN, E.R.A., THE INCOME TAX, *supra*, 278-283.
[182] SELIGMAN, E.R.A., THE INCOME TAX*, supra*, 306.
[183] SELIGMAN, E.R.A., THE INCOME TAX, *supra*, 278, quoting Joseph Chailley, L'IMPOT SUR LE REVENU; LEGISLATION COMPAREE ET ECONOMIE POLITIQUE (1884), 483.
[184] HARISTOY, J., *L'Impôt sur le revenue*, FinanzArchiv/Public Finance Analysis, 28 Jahrg., H. 1 (1911), 416-419.
[185] CLAMAGERAN, J.J., *supra*, 464.

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Assembly eight years before.[186] Regulatory redistributive objectives, additional and prevailing over the revenue-raising purposes, were certainly at the basis of the adoption of the income tax. The social justice goals to be reached through a progressive distribution of the tax burden were expressly declared by Cailleaux himself during one of the appeals he made to the Parliament. In such speech, he defined the tax regime which would result from the adoption of his proposal for the progressive income tax, as a "*regime of progress and of justice, a regime which will lighten the burden of the small man and which will put a moderate, although by no means exaggerated, charge on the richer classes*".[187]

During the following years the *Impôt sur le revenue* was deeply modified: in particular, the supplementary tax was repealed and all incomes became subject to the same progressive rates.[188] An important regulatory innovation in the French income tax's structure, subsequently copied by other countries, was the implementation, in 1945, of the so-called "family quotient" income tax splitting (*quotient familial*), according to which the tax base includes the income of the whole household but such income is then allocated to each family member in accordance a specific formula. As a consequence, the more are the household's members, the lower is the tax rate.[189]

II.1.3.4 An American "arm wrestling": the U.S. shift to a progressive income tax system

As anticipated, the United States process towards the enactment of a progressive income tax is certainly the most significant illustration of the regulatory goals pursued through the shift in nation states' tax system. This is due to two reasons. First, in the

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[186] SELIGMAN, E.R.A., THE INCOME TAX, *supra*, 308.
187 CAILLAUX, J., L'IMPOT SUR LE REVENUE, (Paris: Berger-Levrault & Cie, 1910), 103.
[188] SELIGMAN, E.R.A., THE INCOME TAX, *supra*, 309.
[189] GEST, G., *France*, in COMPARATIVE INCOME TAXATION: A STRUCTURAL ANALYSIS (Halt, H.J., Arnold, B.J. eds.), (Amsterdam: Kluwer Law International, 2010) 65-92, 68.

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United States, the juxtaposition between advocates of progressive income taxes and their opponents reached the highest level of political and doctrinal confrontation, largely due to the exceptionally rapid and large-scale industrialization and the resulting concentration of wealth in the hands of a few individuals and big corporations. Second, the definitive shift to a progressive income tax system happened within the context of so-called New Deal policies, whose ultimate inspiring vision was the recovery from the deep economic and financial crisis in which the country had fallen by means of an unprecedented national government's intervention in the economy.

II.1.3.4.1 The Republican regressive consumption-based tax system and the first temporary progressive individual income tax

As already discussed in the previous chapter, the American federal tax system which was enacted after the enactment of the new Constitution was firmly based on tariffs as the main source of revenue, supplemented by a limited number of excise taxes, in particular the excise tax on alcohol and tobacco. Indeed, some federalist governments' attempts, in the late 18th century, to enact federal direct taxes failed due to lack of support in Congress and among the most influential part of the public. Another major obstacle to the adoption of a federal direct tax system was the previously mentioned restriction provided by Article 1, Section 9, of the Constitution, according to which any direct tax imposed by the federal government had to be allocated among states on the basis of their relative population (see Chapter I, section *I.3.3.3*).

As mentioned in section *I.3.3.4* an opportunity to make a change to American federal tax policy came about during the Civil War (1861-65), the fight of which required the payment of an enormous quantity of military expenses and therefore required an unprecedented increase in federal revenue.[190] Such a national emergency was managed by

[190] The war costs provoked an increased in government spending from less than 2% of the gross national product to about 15%. See BROWNLEE, W.E., FEDERAL TAXATION IN AMERICA: A SHORT HISTORY, 2nd ed., (Cambridge University Press, 2004), 31.

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a Republican Party-led government, which introduced a tax system composed primarily of high tariffs and excise taxes on virtually all consumer goods.[191] This consumption taxation system was regressive, since, as any indirect tax system,[192] it resulted in people with lower incomes incurring a relatively larger effective tax burden compared to that of higher income people.

Although the Republican government unquestionably preferred this wartime tax system – due to the fact that it was favorable to the interests of the government's most influential and powerful supporters and voters (that is, individuals belonging to the business lobbies) -, the Republican Party's leaders believed that in order not to undermine the lower classes' and border states' confidence in the war effort, they had to introduce some elements of fairness, in terms of distribution of the burden. After analyzing and discussing a series of options,[193] the Republican government opted for the enactment, in 1863, of the first federal income tax, which was formally qualified by the Congressional leaders as an indirect tax to limit as much as possible the risk of conflict with the Constitution.[194] In its original version, this tax was ungraduated, simply imposing a basic rate of 3% on individual incomes over a personal exemption of $800.[195] However, immediately after the war years, the tax was amended and became graduated. At the end of the war, in fact, it imposed a 5% rate on incomes between $600 and $5,000 and a 10% rate on incomes over $5,000. Even if these rates may nowadays appear low, such income tax reached the goal of making the wealthier population pay relatively higher taxes than the poor. As highlighted by a tax historian, "*the tax reached well into the affluent upper*

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[191] BROWNLEE, W.E., *supra*, 31.
[192] See section II.1.1.
[193] In particular, a frequently discussed option was constituted by the enactment of a property tax modeled after those already implemented at the state level. See BROWNLEE, *supra*, 33.
[194] The argument congressmen relied on for the qualification of such tax as an indirect tax was that it did not directly tax properties. SEE BROWNLEE, W.E., *supra*, 34.
[195] BLAKEY, R.G. AND BLAKEY, G.C., THE FEDERAL INCOME TAX, (London: Longmans Green, 1940), 1-103; SELIGMAN, E.R.A., THE INCOME TAX: A STUDY OF THE HISTORY THEORY, AND PRACTICE OF INCOME TAXATION AT HOME AND ABROAD (New York: Macmillan, 1914); RATNER, S., AMERICAN TAXATION: ITS HISTORY AS A SOCIAL FORCE IN DEMOCRACY (New York: W.W. Norton, 1942).

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middle classes of the nation's commercial and industrial centers".[196] By the end of the war, indeed, it is estimated that more than 10% of the households were paying the income tax.[197]

It must, however, be noted that some authoritative commentators, in explaining the adoption of this first federal income tax, emphasize the Republicans' desire to provide temporary political protection for the consumption-based tax regime as a motive for establishing the federal income tax.[198] A confirmation of such insight may be supported by the fact that, although this income tax provided successful results in terms of both fairness of the tax system and raising revenue, it ended up being repealed a few years after the end of the Civil War. Republican congressmen bowed to the lobbying pressure of extremely wealthy businessmen and industrialists who had accepted the imposition of the federal income tax only as a temporary measure.[199] As a result, the tax system through the beginning of the 20th century remained one of indirect levies heavily based on import tariffs and excise taxes.[200]

II.1.3.4.2 The popular pressure for progressivity and the resistance by the Supreme Court

At the end of the 19th century, however, the United States' political discourse saw the rise of critiques pertaining to the Republican indirect tax regime and support for tax reform proposals aimed at re-establishing social justice through the reallocation of the tax burden in accordance with an effective ability-to-pay. Non-revenue rationales were at the core of such critiques. Indeed, in connection with the resumption of a serious two-party competition, the Democratic Party decided to endorse the middle class' growing resistance against the concentration of economic power in a small wealthy population and

[196] BROWNLEE, W.E., *supra*, 35.
[197] BROWNLEE, W.E., *supra*, 35.
[198] STANLEY, R., DIMENSIONS OF LAW IN THE SERVICE OF ORDER: ORIGINS OF THE FEDERAL INCOME TAX, 1861-1913 (New York: Oxford University Press, 1993).
[199] BROWNLEE, W.E., *supra*, 36-37.
[200] The benefits of such an indirect tax system to American business leaders have been discussed in Chapter 1.

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the burden of a regressive tax system. Democrats' attention was therefore directed to the parts of the population which had been the most adversely affected by the tariffs (that is, farmers, middle-class consumers, small businesses through the whole nation and Southerners, since their economies were not as industrialized as that of the Northerns but were still based on agriculture and therefore did not benefit from restrictions on the import of consumption goods).[201]

The Democratic Party's tax battle began with an unprecedented critique of the most central element of the consumption-tax system – the tariff, which it described as the "*'mother of trusts' and, more generally, as the primary engine of a Republican program of subsidizing giant corporations*".[202] The economic depression of the mid 1890s exacerbated the popular pressure for a radical reform of the tax system in a progressive way. Eventually, the popular resentment against the Republicans for failing to correct the unequal distribution of wealth and tax burden led the Democrats to take control of both the houses of Congress in 1893 and promote the enactment, in 1894, of the Wilson-Gorman Act containing a new income tax.[203] Even though it resembled the Civil War income tax, the progressivity of the 1894 tax was more limited due to the opposition of Republicans and Northern Democrats responding to large businesses' interests and lobbies. Indeed, it was imposed at a uniform 2% rate and progressivity arose exclusively from an higher personal exemption for incomes under $4,000.[204]

A simplistic justification provided by some commentators for the reestablishment of the progressive income tax is that it was mainly due to the federal government's need for a new source of revenue to make up for the decrease of tariff revenues generated by a

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[201] As reported by BROWNLEE, W.E., *supra*, 43, "*In fact, during the 1880s and the 1890s, the two competing political parties came to base their economic appeals on sharply conflicting ideological views of the tariff and of taxation in general. In a kind of path-dependent politics initiated by the Civil War crisis, these parties identities would have a major influence on revenue policy until World War II. The Republican invocation of high tariffs and the Democrats' response had sharply polarized the parties on issues of taxation, which would exacerbate class conflict for nearly a century*".

[202] BROWNLEE, W.E., *supra*, 42.

[203] As part of the Wilson-Gorman Tariff. The enactment of such a tax was also favored by the decrease in tariff revenue due to the decline in foreign trade.

[204] GRAPPERHAUS, F.H.M., TAXES THROUGH THE AGES, (IBFD: Amsterdam, 2009), 42.

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decline in foreign trade. Nevertheless, more authoritative commentators and evidence at the time of relevant political debates demonstrate that "*the support for a radical progressive income tax had far more to do with the search for social justice in an industrializing nation than with the quest for an elastic source of revenue. The tax became an integral part of democratic statism – a radical program of invoking instruments of government power to create a more democratic social order*".[205] This point is extremely important for our purpose to demonstrate how regulatory and social policy goals often direct tax policy choices.

It is important to highlight that such tax was the first income tax directly levied also on corporations' income. The Civil War tax, indeed, had been levied on corporate income only indirectly, that is, it had been imposed only on that part of corporate income in the hands of shareholders – that is, dividends - and was withheld at the corporate level just as a collection device. Nevertheless, the Congressional debate demonstrates that, although the new tax was a tax on all of the income of the corporation (both distributed and not-distributed income), it was still mainly viewed as a way of better taxing the income of rich individual shareholders – who were able to escape the state-level personal property tax - rather than a tax to reach the corporations themselves.[206]

However, the 1894 income tax did not remain in force for long. In 1895, the Supreme Court struck down the provision of the Wilson-Gorman Tariff on the grounds that it was inconsistent with Art. 1, Section 8 of the Constitution, according to which any federal direct tax should have been allocated among states on the basis of their relative population.[207] The Supreme Court, therefore, created a serious institutional barrier to progressive taxation. But, at the same time, the Court's decision stimulated even more

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[205] BROWNLEE, W.E., *supra*, p. 45. In regard to the support of Democrats to the adoption of a progressive income tax system, see also BROWNLEE, W.E., *Economists and the Formation of the Modern Tax System in the United States: The World War I Crisis*, in THE STATE AND ECONOMIC KNOWLEDGE: THE AMERICAN AND BRITISH EXPERIENCE, (Mary O. Furner and Barry E. Supple eds.) (Washington D.C.: Woodrow Wilson Center Press, and Cambridge: Cambridge University Press, 1990), 401-35.

[206] AVI-YONAH, R., *Corporations, Society, and the State: A Defense of the Corporate Tax*, VA. L. REV. 90, no. 5 (2004), 1193-255, 1215.

[207] *Pollock v. Farmers' Loan and Trust Co*.

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political and popular support for income taxation, as demonstrated by the many attempts of Democratic congressmen to introduce constitutional amendments that would permit it.[208]

II.1.3.4.3 The new bipartisan support for the income tax: the 1909 corporate income tax, the Sixteen Amendment and the 1913 income tax

Even though Democrats lost the control of Congress in 1896, during the following fifteen years the support for income taxation grew so much among the population that even Republican leaders felt they had to accept the introduction in the tax system of a certain degree of progressivity. In particular, Republicans realized that progressivity and income taxation had become appealing to an increasing part of their constituents.[209] In addition, some influential conservatives thought that the introduction of a modest income tax at the federal level could help take the wind out of the sails of more radical popular pressures and tax measures.[210] Three events prove such newly established bipartisan support for the income tax.

The first event is represented by the bipartisan approval, in 1909, of an Act including what is considered the first corporate income tax in history.[211] Through the 1909 Act, passed under the Taft Republican Presidency, "*a special excise tax with respect to the carrying on or doing business*" of 1% of net income over $5,000 of "*every corporation, joint stock company or association, organized for profit*" was adopted. As with the Civil Law income tax, also the 1909 corporate income tax was formally labeled

[208] JENSEN, E.M., THE TAXING POWER: A REFERENCE GUIDE TO THE UNITED STATES CONSTITUTION, (London: Praeger. 2005), 56.
[209] RATNER, S., AMERICAN TAXATION, *supra*, 285-286.
[210] The most influential among these conservatives was a group of urban economists and attorneys who were tax experts. Edwin R.A. Seligman of Columbia University and Charles J. Bullock of Harvard University led them in advocating income taxation, on the one hand, and in moderating the rhetoric used to justify the tax, on the other. In particular, Seligman argued that the point of the tax was to "*round out the existing tax system in the direction of greater justice*". Such language helped shift the discourse over taxation from a focus on the salvation of industrial America to an emphasis on a moderate redistribution of the tax burden. See SELIGMAN, E. R.A., *The Income Tax*, POLITICAL SCIENCE QUARTERLY (1894) 610-648.
[211] 44 Cong. Rec 3929 (1909).

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as an "excise tax" to limit the risk of unconstitutionality, which was, however, expressly excluded by the Supreme Court in a 1911 decision.[212]

At the basis of the introduction of the corporate income tax there were regulatory arguments. In particular, the main drafters of the tax expressly described the tax as a tool to limit the excessive accumulation of wealth and power in the hands of corporations. Indeed, between the last decade of the nineteenth and the first decade of the 20th century, the American business scene had turned from being characterized by the presence of many small-sized enterprises and companies to being dominated by few large-size corporations consolidated through opaque trusts and the holding company structures. Populist and Progressive movements and politicians looked at such a scene as dangerously leading to the creation of monopolies and an unprecedented concentration of wealth and power in the hands of a few large corporations whose controlling shareholders´ identity was not clear. This situation, therefore, called for more regulation. The first regulation the government, led by Democratic President Roosevelt, tried to introduce was federal incorporation. This attempt was ended, however, by firm Republican opposition claiming that such a measure would amount to an intolerable interference by the government in the business industry. Therefore, the debate shifted to an indirect and smoother instrument of regulation, that is, taxation, specifically a tax on corporate income. Indeed, for the purposes of this work and as a confirmation of the correctness of the thesis here defended, it is important to highlight that the Congressional debate documents demonstrate how advocates and drafters of the 1909 corporate income tax justified its introduction under two main regulatory purposes: (i) reducing the amount of wealth and power concentrated in the hands of corporations and their managers, and (ii) eliminating the opacity of the trust and holding structures through the disclosure of relevant information concerning the accounts and the business transactions of corporations.[213]

[212] *Flint v. Stone Tracy Company* 220 US 107 (1911).
[213] AVI-YONAH, R., *Corporations, Society, and the State: A Defense of the Corporate Tax*, *supra*, 1218-1220.

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The second decisive events resulting from the new bipartisan support for the income tax was the ratification by all the States of the Sixteenth Amendment to the Constitution, empowering Congress to levy taxes on income from whichever source and without the requirement of repartition among the States on the basis of their relative population. A third consequence was the enactment of a new bipartisan income tax.[214] Both of these events happened in 1913.

Compared to the Civil War and the 1894 income taxes, the 1913 tax was quite modest – in terms of progressivity and revenue goals - due to the many compromises such a bipartisan measure had to withstand.[215] The 'normal' rate was 1% on almost all personal and corporate income. It is important to note that the middle class was substantially excluded from the scope of the tax due to the high $3,000 income exemption and an exemption for dividends up to $20,000 from personal income (which therefore limited the double taxation of corporate earnings to the portion received as dividends by the richest Americans). There was also a graduated surtax up to 6% on income over $20,000. The wealthiest Americans were subject to marginal rates ranging between 1 and 7% – substantially lower than those they had faced during the Civil War. In the first years of application of such income tax, it is estimated that only about 2% of American households were subject to it and therefore tariffs[216] and the excise taxes on tobacco and alcohol remained the most productive sources of federal revenue. These data serve to confirm that the revenue goals of the income tax were far less important than the desire to use it to advance social and economic justice. As a confirmation of this, it is important to mention that the primary drafter of the 1913 legislation, Cordell Hull, and other champions of it expressly referred to the tax's redistributive role as the primary

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[214] Underwood- Simmons Tariff Act of 1913. See BUENKER, J.D., THE INCOME TAX AND THE PROGRESSIVE ERA (New York: Garland, 1985).
[215] As highlighted in BROWNLEE, W.E., *supra*, 56, the new tax was "*less progressive and less ambitious in its revenue goals than the Civil War legislation or even the legislation of 1894*"
[216] The tariffs, indeed, became even more productive for raising revenue, because the 1913 reduction of tariff rates stimulated trade and increased revenues.

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objective.[217]

II.1.3.4.4 World War I and the shift to a progressive income tax-based system

As highlighted by Brownlee, "*if it had not been for the mobilization for World War I, the major consequence of the passage of the income tax in 1913 might have been the protection of the regime of consumption taxation inherited from the Civil War*".[218] Indeed, the entrance of the United States in World War I significantly accelerated the development of federal taxation towards a progressive income tax system. The costs of the war and the sacrifices it imposed on the population – always relatively higher for the middle and lower classes compared to those of the higher business classes – prompted popular democratic pressures for more equality in the distribution of wealth and gave the lower classes more "bargaining power" and more of an audience from the politicians. During World War I, in fact, Harry Wilson's Democratic government embraced taxation as a fundamental redistributive tool to counter the concentration of wealth and the privileges associated with it, and therefore to achieve more social justice. Therefore, Wilson and the Democratic Party took the opportunity to radically turn the American tax system, whose fundamental structure was still based on tariffs and consumption taxes, into a progressive tax system based on income taxes lying on the richest individuals and on the largest corporations. Such a new tax regime was also referred to as "soak-the-rich" income taxation.

In practice, this reform of the tax system consisted in the transformation, through the wartime Revenue Acts, of the income tax into the "spinal column" of federal taxation. The Revenue Act of 1916 adopted the first personal income tax heavily falling on

[217] See HULL, C., MEMOIRS OF CORDELL HULL, 45-74; BAACK & RAY, *The Political Economy of the Origin and Development of the Federal Income Tax*, in EMERGENCE OF THE MODERN POLITICAL ECONOMY: RESEARCH IN ECONOMIC HISTORY SUPPLEMENT 4, (Robert Higgs ed.), (Greenwich, Conn.: JAI Press, 1985), 12.
[218] BROWNLEE, W.E., *supra*, 57.

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wealthy individuals,[219] doubled the tax on corporate income to 2%, and also enacted an excess profits tax of 12.5% on the ammunition industry.[220] These measures were further expanded by increasing the rates and scope, through the Revenue Acts enacted in the following war years. The regulatory public policy goals pursued through these measure has been on many occasions highlighted by politicians and scholars. In particular, it has been reported how the main goal of the architects of the Revenue Act of 1916 was the implementation, through the personal income tax, of an "ability-to-pay" philosophy.[221]

The so-called *excess profits tax* is a special tax, additional to the income tax, levied on profits above a standard level commonly referred to as 'economic rent' or 'supernormal profit'. Such type of tax has been frequently proposed as a business stabilizer, to slow down booms and discourage businesses in runaway periods.[222] Initially, the excess profits tax was imposed only on the ammunition industry, but the Revenue Act of 1917 extended the scope of the tax to all business profits above a 'normal' rate of return. The rates of the excess profits tax were graduated progressively by rates of return on invested capital. The tax rates established by the Revenue Act of 1917 ranged from 20% to 60% according to the amount of the supernormal profits. The Revenue Act of 1918 further increased the burden of the excess profits tax by setting the lowest rate at 30% and the highest rate at 65%. During the war years, the revenues raised through the excess profits tax constituted almost two thirds of the total federal revenues.[223] Democrats never hid that the enactment of the excess profit tax was driven by the political willingness to tackle the "monopoly problem" and its negative effects on the United States' economy.[224]

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[219] The Democrats opposed a broadly based income tax because it would have fallen mostly on salaries and wages, the types of incomes earned by the lower and middle classes. See BROWNLEE, W.E., *supra*, p. 62.
[220] RATNER, S., *supra*, 347 and 358-361.
[221] RATNER, S., *supra*, 341-399. BROWNLEE, W.E., *Wilson and Financing the Modern State: The Revenue Act of 1916*, in PROCEEDINGS OF THE AMERICAN PHILOSOPHICAL SOCIETY 129 (1985): 173-210.
[222] BUEHLER, A.G., *Regulatory Taxation*, HARVARD BUSINESS REVIEW 17 (1939), 138, 148.
[223] BROWNLEE, W.E., *supra*, 64-65.
[224] CUFF, R.D., THE WAR INDUSTRIES' BOARD: BUSINESS-GOVERNMENT RELATIONS DURING WORLD WAR I (Baltimore: Johns Hopkins University Press, 1973).

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It appears clear that with the 1916 taxes the Democrats made a step further compared to the Civil War income tax and the 1894 tax, because by making the federal government's finances completely dependent on the above income taxes, the Democrats substantially turned the income tax into a permanent element of the American tax system. From this, we can observe that the revenue-raising element of the income taxes acted mainly as an instrument for the achievement of the real primary social goal of their enactment, that is, the restructuring of the American economic and social structures in a more equal way.[225]

Business leaders were obviously irritated by these tax policies and built up an unprecedented anti-tax campaign against Wilson and his Democratic government, which helped Republicans win the 1921 election and regain control of Congress and the government. Under the pressure of the business lobbies, the new Republican government attempted to mitigate the redistribution effects of the previous legislature. They repealed the excess profits tax and made both the individual and the corporate income tax less burdensome and progressive.[226] In addition, and most importantly, they introduced many loopholes in the income tax system, by providing businesses with a wide range of targeted deductions, exemptions and credits. As a result, the effective tax rates of the richest individuals and corporations fell drastically.[227] Andrew Mellon, the Secretary of the Treasury, formally justified the enactment of such measures as necessary to promote and safeguard the growth of the economy, which was therefore considered as alternative (and not complementary) to progressivity.[228]

It is important to highlight how the adoption of such measures also increased the

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[225] CUFF, R.D., *supra*.
[226] In particular, within seven years, Republicans lowered the marginal rate on the richest taxpayers from 73% to 25%. See BROWNLEE, *supra*, 73
[227] By 1923, the effective rate on the richest 1% of American families dropped to less than 8%. BROWNLEE, W.E., *supra*, 74
[228] For Mellon's pro-growth arguments, see MELLON, A.W., TAXATION: THE PEOPLE'S BUSINESS (New York: Macmillan, 1924), 93-107 and 127-38; KING, R.F., *From Redistributive to Hegemonic Logic: The Transformation of American Tax Politics*, 1894-1963, POLITICS AND SOCIETY 12, no. 1 91983), 1-52, and MONEY, TIME & POLITICS: INVESTMENT TAX SUBSIDIES IN AMERICAN DEMOCRACY (New Haven, Conn.: Yale University Press, 1993), 104-111.

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power of the Congress's tax-writing committees, since they amounted to and provided the same political benefits of direct spending programs without the budget controls and transparency requirements which were required to direct spending programs. Tax-writing committee's members, indeed, often used this power to favor (and in turn obtain the support of) the wealthiest groups while avoiding the costs associated with raising taxes. During these years, the Joint Committee on Internal Revenue Taxation (JCIRT) – the current Joint Committee on Taxation - was created, officially with the intention of providing Congress with further technical tax assistance.[229] In practice, the JCIRT became a critical point of the American federal tax policy-making process and "*a vehicle for enhancing the influence of the committees' senior members*".[230] As it will be illustrated with regard to the so-called tax expenditures, this phenomenon increased during the years in tendency with the expansion of the income tax system model to mostly all industrialized nation states. The income tax systems currently represent the most significant use of tax policy for regulatory social and economic purposes within the OECD countries, which will be deeply analyzed in the next chapter concerning the so-called 'tax-expenditures".

Despite the enactment of such countermeasures, however, the Republican government was not politically able to completely roll back the progressive income tax system designed by the Democrats, because it had already become a fundamental and irreplaceable element of the federal tax system in terms of both revenue and social justice. Such circumstances were extremely important for President Roosevelt's New Deal radical tax regime of the late 1930s.

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[229] On the formation of the JCIRT, see BLAKEY, R.G, BLAKEY, G.C., THE FEDERAL INCOME TAX (London: Longmans, Green, 1940), 542-43, 546-48; KENNON, D.R., ROGERS, R.M., THE COMMITTEE ON WAYS AND MEANS: A BICENTENNIAL HISTORY, 1789-1989 (Washington D.C.: U.S. Government Printing Office, 1989), 330-33; REESE, T.J., THE POLITICS OF TAXATION (Westport, Conn.: Quorum, 1980), 61-88.
[230] BROWNLEE, W.E., *supra*, 76.

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II.1.3.4.5 Roosevelt's New Deal and income taxation as a method of regulating larger corporations

Facing the United States' worst economic collapse, indeed, Democratic President Frank Delano Roosevelt and its Treasury Secretary Henry Morgenthau determined that the concentration of wealth and concentration of corporate power were still major obstacles to the country's economic and social recovery.[231] Roosevelt officially stated that the accumulation of wealth meant "*great and undesirable concentration of control in relatively few individuals over the employment and welfare of many, many others*".[232] Moreover, "*whether it be wealth achieved through the cooperation of the entire community or riches gained by speculation – in either case the ownership of such wealth or riches represents a great public interest and a great ability to pay*".[233] This is why, in order to tackle the concentration of wealth, Roosevelt's Administration made a large use of the taxing power. As highlighted by contemporary commentators, Roosevelt advocated "*taxation as a method of regulating the larger corporations, preventing monopoly, and preserving the smaller enterprises*".[234]

In particular, Roosevelt, Morgenthau and their economic advisors focused their tax policies on holding companies and corporate surpluses. They assumed that the corporation form was intrinsically prone to particular weaknesses and abuses, and these peculiar evils demand punitive taxation. Indeed, Roosevelt's government proposed to the Congress the enactment of a graduated tax on corporations to check the growth of monopolies, the revival of the excess profits tax to strike at monopoly profits while raising additional revenue, a tax on the dividends that holding companies received from corporations they controlled, and surtaxes to raise the maximum income-tax rate on

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[231] See RATNER, S., AMERICAN TAXATION, *supra*, 451-490.
[232] SCHLESINGER, A.M. JR, THE AGE OF ROOSEVELT: THE POLITICS OF UPHEAVAL (Boston: Houghton Mifflin, 1960), 328.
[233] LAMBERT W.K., NEW DEAL REVENUE ACTS: THE POLITICS OF TAXATION, (University of Microfilms, 1970), 259-60.
[234] BUEHLER, A.G., *Regulatory Taxation*, HARVARD BUSINESS REVIEW 17 (1939), 138-152, 138.

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individuals from 63% to 79%.[235]

Such proposals were in large part approved by Congress. With the Revenue Act of 1933, indeed, the excess profits tax was reestablished and with the Revenue Act of 1935 the rates of the normal corporate income tax were graduated so that the larger income corporations would pay a higher tax rate than the smaller income corporations. Congress put the richest into higher tax brackets and as a consequence raised their effective tax rates by almost 50%.[236]

II.1.3.4.6 The undistributed-profits tax

The most important innovation of the Roosevelt administration was, however, the introduction of an additional tax imposed on the profits that corporations did not distributed to their shareholders, the so-called undistributed-profits tax. Indeed, Morgenthau and his advisors were persuaded that large corporations deliberately retained profits to escape the taxation of dividends under the already existing individual income tax. This behavior, besides depriving the federal government of a significant amount of revenue, also favored the concentration of wealth in the hands of large corporations and a lack of circulation of such resources within society which could be used for new investments. Therefore, this new tax was thought to induce large corporations to distribute their profits in excess and therefore put them into circulation.[237]

In its initial proposal, the undistributed-profits tax should have replaced both the corporate tax income and the excess profits tax, and therefore its rates should have been very high.[238] Nevertheless, the large corporations' lobbying pressure on Congress and

[235] BROWNLEE, W.E., *supra*, 90.
[236] BROWNLEE, W.E., *supra*, 92. In 1936, the effective tax rate paid by the richest 1% of taxpayers increased to 16.4%, higher than during any year of World War I.
[237] It has been noted that Roosevelt's Administration also saw in such a tax a tool to transfer corporate control to small stockholders and the federal government, and also as a means to stabilize the economic conditions. See BUEHLER, A.G., *supra*; the messages of the President of the Congress on June 19, 1935, March 3, 1936, and November 16, 1937.
[238] BROWNLEE, W.E., *supra*, 95.

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some divergence among Democratic congressmen led to the enactment of a graduated tax on undistributed earnings, characterized by moderate rates ranging from 7% to 27%.[239]

Large corporations' lobbies and organizations protested against this use of taxation, which they clearly saw "*as a threat to their control over capital and their latitude for financial planning*".[240] Scholars and experts close to the business community depicted the New Deal radical tax measures as the result of political calculations rather than a genuine intent of fixing the economy. They, indeed, claimed that the Roosevelt's campaign against big corporation was part of a political strategy mainly aimed at seeking support from the "little fellows".[241] Small enterprises were certainly more numerous than large corporations, and thus politically more appealing in terms of votes.

To support the claim of large companies, conservative representatives, observers and experts highlighted that such a regulatory taxation failed to single out the "bad corporations", and unjustifiably rested on the assumption that all large companies are antisocial and pander to the preferences of society and, therefore, should be eliminated via increasing tax burden. In fact, they continued, "*one cannot measure the injury to social welfares from business activity by the size of the investment, the amount of the net income, the rate of return on the investment, or any other mechanical or objective factor, since business abuses do not vary in any definite ratio with such factors, but are relative to the particular and changing circumstances of business enterprise. They depend largely upon the type of management and the individual characteristics of each undertaking, large or small, corporate or noncorporate*".[242] Such a regulatory taxation, instead, ended up hurting the desirable and the undesirable corporations alike and penalizing the efficient large corporation along with the inefficient, the responsible management along with the irresponsible management. Thus, it punished the good and the bad

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[239] U.S. DEPARTMENT OF THE TREASURY, OFFICE OF TAX ANALYSIS, *Tax Revision Studies*, 1937, vol. 4, Undistributed Profits Tax, National Archives.
[240] BROWNLEE, W.E., *supra*, 98.
[241] BUEHLER, A.G., *supra*,143.
[242] BUEHLER, A.G., *supra*,144.

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indiscriminately. In light of these considerations, they concluded, taxation is not a selective agency of regulation.[243]

These critiques, in addition to the lobbying pressures exercised by large corporations and the depression, led conservative Democrats to join Republicans in a coalition aimed at curtailing the measures already adopted and blocking any more New Deal tax reform. In 1938, indeed, the tax on undistributed profits was gutted and the graduated corporate income tax was discarded. Furthermore, in 1939, Congress abolished the undistributed-profits tax. Roosevelt refused to sign the laws through which such measures were enacted and depicted them as the "*abandonment of an important principle of American taxation*" – taxation according to ability-to-pay.[244]

However, even if the passing of this measure sounded like a defeat for the Roosevelt Administration's tax policy, the federal tax system had already changed its perspective on taxation – taxation according to ability-to-pay had become the basic-line principle and any deviation from this principle had at least to be justified. In addition, at this time, the Roosevelt Administration had increased the federal government's revenue capacity and size (in terms of involvement in the economic and social aspects of the country), and this, in turn, corresponded to an increase in the political sovereignty of central government at the expense of the single states and also of private players.

II.1.4 Conclusions

In the paragraphs above, we have seen how tax policy was used again as a fundamental regulatory instrument in another decisive passage of the history of nation states. With the introduction of progressive income taxes, nation states' governments, under the numerous pressures arising from working and middle class citizens and from

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[243] *Id*.
[244] BROWNLEE, W.E., *supra*, 99.

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progressive movements, shifted to a progressive income tax system in order to correct the uneven distribution of wealth resulting from industrialization and consequently achieve more equity within society.

This very incisive and intrusive governmental intervention, aimed at partially correcting the shape of society and the economic system arising spontaneously from market dynamics, contributed to the significant increase in the national governments' size and area of competence and, in turn, of the legitimacy and dimension of state sovereignty. This was especially true in federal countries like the United States, where the authority and power of the national government was expanded at the expense of States' power.

Despite numerous libertarian initiatives for a more limited involvement of the central government in the adjustment of economy, which have been raised in the subsequent decades, the promotion and the guarantee of an adequate redistribution of wealth through the tax system today is, at least in principle, an unquestioned prerogative of modern social states. Indeed, income taxation according to the ability-to-pay principle is today a landmark of the tax systems in all of the industrialized countries. In some countries, the ability-to-pay principle has even been explicitly recognized in constitutional charters. This is the case, for example, in Italy, where Art. 53 of the Constitution states that "*every person shall contribute to public expenditure in accordance with their capability*" and also that "*the tax system shall be progressive*", in Spain, where Art. 31 states that "*everyone shall contribute to sustain public expenditure in proportion to his or her financial means, through a just and progressive system of taxation based on principles of equality, which shall in no case be confiscatory in nature*", and in Hungary, where Art. 70/I of the Constitution states that "*every citizen of the Republic of Hungary bears the obligation to contribute to rates and taxes in accordance to income and wealth*". However, in most industrialized and developed countries the ability-to-pay principle is not written in the Constitution but is an underlying principle imbedded in the country's legal system, arising from the principle of equality.

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This is the case, for example, of Germany,[245] the United States,[246] Austria,[247] and The Netherlands.[248]

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[245] Art. 3 par 1 German Basic Law.
[246] BARKER, W.B., *The three faces of equality: Constitutional requirements in taxation*, 57 CASE W. RES., (2006) 24.
[247] See GASSNER, W., LANG, M., *Das Leistungsfähigkeitsprinzip im Einkommens_- und_Körperschaftssteuerrecht*, GUTACHTEN ZUM 14. ÖSTERREICHISCHEN JURISTENTAG, ÖJT III/1, (2000). 62-64.
[248] TIPKE, DIE STEUERRECHTSORDNUNG, (Köln: 2000), 552.

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II.2 TAX EXPENDITURES AND THEIR ONGOING SUCCESS

II.2.1 Regulatory Tax Policies Within the Income Tax System

In the first part of this chapter, we have seen how the shift from a regressive tax system based on indirect taxes to a tax system based on progressive income taxation was mainly driven by social justice and economic reform ideals and rather than just by revenue-raising purposes. After this important historical passage, nation states' governments have continued to use their tax sovereignty for regulatory public policy purposes. However, they have done so without entirely reforming their tax system again. They, rather, have acted from within the current tax system – that is, the income tax-based system - or by integrating it with separate specific taxes. Such regulatory tax measures have consisted of the introduction into the existing tax system of special benefits or penalties aimed, respectively, at promoting, rewarding or punishing certain targeted non-tax behaviors undertaken by certain groups of individual taxpayers or categories of industries.

Such measures have taken various forms. In the case of policies aimed at rewarding or promoting the undertaking of certain behaviors or transactions, the regulatory use of taxation has consisted mainly of tax credits, deductions, exemptions, special lower rates or deferral of tax payments. All of these types of tax tools fall within the definition of "*tax expenditures*" and they are the subject of the so-called "*tax expenditure analysis*", an area of tax and budget policy research aimed at highlighting the financial impact of such tax breaks in terms of revenue losses, analyzing their pros and cons, and eventually comparing their effectiveness to that of alternative direct spending programs. As for the tax policies set forth to punish conducts considered deleterious by governments, they have been largely made up of the denial of tax credits, deductions, exemptions or by "customized special purpose" taxes. Such measures – which are directly

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opposite to tax expenditures – are generally defined as “negative tax expenditures” or “tax penalties”. The following paragraphs will analyze the main features of the most important category, in numerical terms and for the doctrinal debate it has given rise to, of such regulatory measures, that is, tax expenditures. It is not our goal to illustrate in detail the single measures enacted in the various countries. Our goal is rather to explain how and why governments have continued to make substantial use of the regulatory function of their tax sovereignty instead of relying on direct spending programs and direct regulations in pursuing regulatory social and economic goals. At the same time, from such analysis it will emerge how this form of regulatory tax policy has contributed to the consolidation and the extension of state sovereignty by facilitating national governments’ ability to control and design a social economic order, that is, the ultimate goal of the power to govern as defined in the introductory section of this work.

II.2.2 Tax Expenditures: An Overview

As highlighted above, the most important structural use of tax sovereignty for regulatory purposes made by national governments since the end of World War II is undoubtedly constituted by so-called “*tax expenditures*”. Tax expenditures can be defined as governmental subsidies provided through the tax system in the form of special treatment for particular transactions or activities.[249] Special treatment may consist of, in fact, deductions, exclusions, exemptions, credits, preferential rates or deferral of tax liability. Tax expenditures are, in fact, aimed at providing financial advantages for their recipients in the form of tax breaks.

These measures are referred to as ‘expenditures’ because, despite the fact that they do not involve actual money transfers from the government to taxpayers, they

[249] SURREY, S., PATHWAYS TO TAX REFORMS: THE CONCEPT OF TAX EXPENDITURES, (Cambridge: Harvard University Press, 1973), vii; THURANYI, V., *Tax Expenditures: A Reassessment*, DUKE L. J., (1988), 1155-1206, 1164.

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nevertheless give rise to an (indirect) increase in government spending. Indeed, all the measures falling within the definition of tax expenditures share the feature that the reduction in tax liability for taxpayers necessarily results in a loss of revenue equivalent to the amount of direct spending that would be required to support such a regulatory purpose (i.e. the subsidy amount).[250]

Various policy reasons lie behind such measures. In many cases they are genuine contributions to the general welfare while in many other cases they simply constitute a sacrifice of the general welfare to the interests of particular groups. Such measures are inherent in any tax system and any tax. Governments have always set forth tax breaks to pursue public policy objectives or to advance certain private activities considered - whether right or wrong – to be of public interest or strategic for the national interest.[251] What is new here is their systematic and unprecedented use within the income tax system of such measures starting from the second half of the 20th century. Indirect spending through tax expenditures within the income tax systems has indeed become pervasive and grown across all the main developed nation states. Its use has reached unprecedented levels.[252] In most industrialized countries, indeed, as the income tax increased its economic and financial relevance, so did the tax subsidies provided through special deductions, exemptions, exclusions, credits, rates etc. set forth in the tax codes. What especially matters for our purposes is highlighting that through such measures nation states governments have been able to pursue and achieve various social and economic public policy goals.[253] And in many cases such measures have been preferred to the enactment of direct regulation or direct spending programs.

Unsurprisingly, therefore, many scholars and policy-makers have commented and

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[250] SCHICK, A., *Off-budget Expenditure: An Economic and Political Framework*, 7(3) OECD JOURNAL ON BUDGETING, 3.
[251] KAYE, T., *Sheltering Social Policy in the Tax Code: The Low-Income Housing Credit*, 38, VILL. LAW R., (1993) 871, 872 .
[252] See the data reported in OECD, TAX EXPENDITURES IN OECD COUNTRIES, (Paris: OECD, 2010). See also section II.2.6 of this work.
[253] HUNGERFORD, T., *Tax Expenditures and the Federal Budget*, (June 2011), Congressional Research Service 7-5700, 2. KAYE, T., *supra,* 872.

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debated the nature, the costs and the benefits of tax expenditures. At the same time, they have also investigated the tax policy background underlying the adoption of tax expenditures. This latter part of the tax expenditure analysis is mostly important for the purposes of this work, since through it we will be able, in a comparative perspective, to examine the advantages and the disadvantages in regard to the adoption of regulatory social policies in the form of tax subsidies as opposed to direct spending programs.

II.2.3 The Earliest Attention on Tax Expenditures: The German Experience

Although, as we will see in the next paragraphs, the creation of tax expenditure analysis is historically attributed to the United States' internal tax policy debate, the first country which officially focused on the phenomenon of financial subsidies provided through the tax system was Germany, where as early as 1954, the literature recognized the "*equivalence between special tax deductions, credits, and other allowances and government subsidies*".[254] And, even more important for the purposes of this work, German authors and jurisprudence agree that "*the tax system furnishes a useful instrument for implementing economic and social policy and acknowledges that it is often used for such 'nonfiscal' purposes*".[255]

In light of the above mentioned equivalence between direct spending programs and indirect subsidies granted through the tax system, the German government has been particularly sensitive to the need to track and account in the budgetary process for these

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[254] SHANNON, H.A., *The Tax Expenditure Concept in The United States and Germany: A Comparison*, 33 TAX NOTES 2 (1986), 201-213, 203. See HUBER, WIRTSCHALTSVERWALTUNGSRECHT, 2nd Ed., Vol. 2, 259 (1954).

[255] SHANNON, H.A., *supra*, 203. See HUBER, *supra*, 258-59. In particular, the German Federal Constitutional Court has confirmed that tax law is a legitimate means to implement social and economic policy. See BVerfGE 16, 147, 161. The German Federal Tax Court and the German Federal Administrative Court have also followed this view. See BFH BStBI, 62, 376; BFHE 75, 302; 89, 422, 440; 92, 495; BVerwGE 10, 3, 8. For the German literature attempt to establish a constitutional basis for such regulatory use of taxation, see VOGEL, W., BONNER KOMMENTAR, Art. 105, Para. 45 ff; and also VOGEL, W., *Die Abschichtung von Rechtsfolgen im Steuerrecht*, 54 STEUER UND WIRTSCHAFT 97, 107 (1977).

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tax subsidies. In 1959, the German Federal Ministry of Finance, in response to a parliamentary inquiry, issued a report of all of the subsidies in the federal budget which also included a list of the subsidies indirectly furnished through tax measures related not just to the income tax but to all federal taxes. This document also reflected the costs of tax subsidies in terms of foregone revenue.[256] In 1966 the federal parliament passed a resolution which made the issuance of a separate report listing the direct and the indirect subsidies (thus including the tax subsidies) mandatory and instructed the Federal Government to attempt to reduce such measures, especially those "*hidden subsidies in the form of tax benefits*".[257] Finally, the Law to Promote Economic Stability and Growth (*Gesetz zur Forderung der Stabilitat und des Wachstums der Wirtschaft*),[258] enacted in 1967, required the Federal Government to submit to the parliament, on a biennial basis, a statistical survey of all government subsidies, including a survey of tax subsidies together with their corresponding revenue loss estimates.[259]It is worth noting that such report is not limited to subsidies provided through income taxes, but includes also those subsidies arising from measures concerning other types of taxes.[260] However, despite the fact that Germany took the lead in giving attention to and reporting the number and the amount of subsidies provided through the tax system in the government budget, tax subsidies never constituted a pivotal issue in the German tax policy debate. This is likely to be due to the fact that the reporting of tax subsidies in Germany – unlike in the United States - was considered to be an exclusive matter of budgetary policy, and not of tax policy.[261]

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[256] Bericht des Finanzministeriums vom 28.7.1959, Bundestag Drucksache III/1229 at I; SHANNON, H.A., *supra*, 204;
[257] *Id*.
[258] See *Gesetz zur Forderung der Stabilitat und des Wachstums der Wirtschaft vom 8 Juni 1967, Bundesgesetzbiatt I* at 582.
[259] This biennial report is known as "*Subventionsberichte*", which literally means "Subsidy Reports".
[260] SHANNON, H.A., *supra*, 204.
[261] BABU, J., *The Tax Expenditure Budget: What the U.S. Can Learn from Germany*, 27 SETON HALL LEGIS J. (2002), 163-189.

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II.2.4 The U.S. Debate: Surrey and the Inception of Tax Expenditure Analysis

A discussion of tax subsidies and their equivalence to direct spending have been at the core of both the budget and the tax policy debate for almost five decades in the United States, from which it subsequently spread to the other industrialized nation states. The first chapter of this story can be traced a few years after Germany's discourse on tax subsidies began, that is, when, in 1967, the late Harvard professor Stanley Surrey,[262] at the time serving as Assistant Secretary of the Treasury for Tax Policy for Lyndon Johnson's administration, used his prestige and political influence to 'open the eyes' of politicians and experts on the use – and abuse, in his point of view – of subsidies and privileges provided through the income tax system.

At that time, indeed, budget officials, consultants and fiscal experts were trying to portray President Johnson's proposal to impose a 10% surcharge on income taxes to fund the President's "Great Society" programs and to make the Vietnam War more acceptable to Congress.[263] In this attempt to temper the proposed surcharge, the House Ways and Means Committee meetings were focused on the identification of direct spending programs suitable to be cut. Upon a close review of the discussion within the Committee, Professor Surrey realized that none of its members ever considered the voluminous tax incentives and subsides as part of government expenditures and therefore as a potential target for the budget cuts. As Surrey reported in his renown monograph *Pathways to Tax Reform* - considered as the "bible" of the tax expenditure analysis:

"*for the moment the committee, in its desire to see expenditures controlled and thus make a tax increase more palatable if it must be voted, became an Apportions Committee. But in its scrutiny of the expenditures listed in the budget, the committee had*

[262] Stanley S. Surrey (1910-1984) was Professor of Law at Berkeley and then at Harvard Law School. Before starting his academic career he had hold federal government positions during the New Deal. Between 1961 and 1969 he served as Assistant Secretary of the Treasury for Tax Policy under President Johnson presidency.
[263] SURREY, S., MCDANIEL, P., TAX EXPENDITURES, (Cambridge, MA: Harvard University Press 1985), *Introduction*.

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forgotten what it knew as a tax committee. Never once in its examination of the direct expenditures listed in the budget did the committee pause to consider the dollars involved in the tax incentives and tax subsides contained in the Internal Revenue Code. It was not for lack of knowledge. The committee members were fully aware that through tax benefits the income tax law provided financial assistance to this or that business [as well as to state and local governments and to such groups as the aged, the sick, and the blind]…. But the committee kept the financial assistance furnished by these special tax provisions completely separate and isolated in its mind from the task at hand".[264]

Surrey concluded that the Internal Revenue Code included various tax incentives and subsidies which resembled direct expenditures, and offered a multitude of potential spending cuts.[265] Therefore, these code provisions – for which Surrey coined the term "*tax expenditures*"[266] - deserved the same analysis and evaluation provided to direct spending programs. For this reason, Surrey officially called for a "*tax expenditure budget*" reporting the revenue cost of "*deliberate departures from accepted concept of net income…[through which] our tax system does operate to affect the private economy in ways that are usually accomplished by expenditures – in effect to produce an expenditure system described in tax language*".[267]

The Treasury embraced the proposal for a tax expenditure budget when Surrey was still serving as Secretary Assistant and therefore leading the Tax Policy Department. In 1969, the first tax expenditure budget was published, even though formally it was only an estimate as it did not obtain an official status in the President's budget. This practice of having the Treasury issuing a yearly estimate of measures considered tax expenditures within the income tax system continued during the subsequent years under the Nixon

[264] SURREY, S., PATHWAYS TO TAX REFORMS: THE CONCEPT OF TAX EXPENDITURES, (Cambridge, MA: Harvard University Press, 1973), 1-2.
[265] SURREY, S., *supra*, 1-2.
[266] SURREY, S., *supra*, 3-4.
[267] SURREY, S., *supra*, fn. 2, at 3 (quoting Surrey's speech at *Money Marketers*, a New York financial group).

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administration. In 1974, finally, with the enactment of the Congressional Budget and Impoundment Control Act the inclusion of tax expenditure estimates in the President's budget was made mandatory and tax expenditures were officially defined as "*those revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability*".[268]

Currently, two separate tax expenditures budget are issued in the United States. Indeed, both the Department of Treasury and the Congress's Joint Committee on Taxation (JCT) issue their own annual lists and estimates of tax expenditures.[269]

II.2.5 The Goals of Tax Expenditure Analysis and the Failure at Achieving Them: Why Regulatory Taxation Is Still Alive And Healthy

The tax expenditure analysis, as theorized and proposed by Surrey and other advocates, had two goals, one direct and the other indirect. The first direct goal was, through the issuance of tax expenditures budgets, to provide governments with a more clear and realistic picture of the effective public spending and its beneficiaries.[270] This, on its own, would have constituted an important step in the direction of more transparency and accountability in the management and administration of public finances. But, in the opinion of its advocates, the issuance of the tax expenditures reports and budgets could have also led to the realization of a more important second and indirect goal - that is,

[268] *Congressional Budget and Impoundment Control Act of 1974*, section (3), codified at 2 U.S.C., Section 622. Pub. L. No. 93-344 (1974).

[269] The Treasury's tax expenditure budget accompanies the Federal Budget, while the JCT budget is delivered to each of the congressional tax committees – the House Committee on Ways and Means and the Senate Committee on Finance. Congress of the United States, Congressional Budget Office, The Effects of Tax Reform on Tax Expenditures – A CBO Study, March 1988 (on file).

[270] See SURREY, S., *supra*, 129. See also THURANYI, V., *Tax Expenditures: A Reassessment*, DUKE L. J., (1988) 1155, 1164; SHAVIRO, D., *Rethinking Tax Expenditures and Fiscal Language*, 57 TAX L. REV. (2003-2004) 187, and 201-02, where the author highlights that the ultimate goal of Surrey was to preserve the progressivity of the tax system, which is affected by the "upside-down" effect of many tax expenditures provided in the form of tax deductions.

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inducing the governments to proceed to more efficiently review their spending by repealing those tax expenditures not justified by general public interest or whose regulatory goals could have been achieved through direct regulation or direct subsidies. Indeed, in the tax expenditure analysis advocates' opinion, the disclosure of such reports would have inevitably increased the attention of policy-makers, scholars and public to government subsidies provided in the form of tax measures and their costs in absolute and relative terms. Such forms of spending would have, therefore, gained full consideration in the debate over spending cuts and many tax expenditures enacted simply under powerful lobbyist pressures would have lost their disguise and eventually been repealed unless supported by serious justifications in terms of contribution to the general welfare and lack of alternative and financially more efficient programs.

Nevertheless, among scholars and policy-makers there is large consensus on the substantial failure of tax expenditure analysis to fully achieve the above-mentioned goals. Two different reasons may justify the 'failure' of the tax expenditures analysis.[271] First, there is an intrinsic weakness of tax expenditure analysis, itself, because of the lack of universal agreement over its foundations and effectiveness. Second, as it is widely believed among politicians and policy-makers, tax expenditures often constitute, in practical terms, a more feasible, effective and incisive instrument for national government to impact and regulate economy and society – and therefore exercise state functions - as opposed to direct spending programs and direct regulation.

II.2.5.1 Lack of agreement over the foundations of tax expenditure analysis: the issue concerning the identification of the normative tax base

Following the advice provided by scholars, many countries which heavily engaged in tax expenditures have drafted tax expenditure lists and/or budgets in order to more

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[271] See KAHN, D.A., *A Proposed Replacement of the Tax Expenditure Concept and a Different Perspective on Accelerated Depreciation*, UNIVERSITY OF MICHIGAN LAW&ECON RESEARCH PAPER No. 13-001 (2013).

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effectively control their budgets and fiscal policies. As illustrated above, the first two countries which gave attention to this issue and published official government documents were Germany and the Uni2ted States, respectively in 1959 and 1969, in order to provide an account of the amount of the spending indirectly provided through the tax system. They were followed, in 1979, by the Canadian and the British governments: Canada published a comprehensive list and conceptual analysis of tax preferences in its federal income tax system, while the United Kingdom added a table of tax expenditures to its *Expenditure Plans Paper*.[272] During the last three decades, the reporting techniques have been refined and a number of other countries adopted formal tax expenditure budgets, as is reflected in the OECD publication *Tax Expenditures in OECD countries*, which provides an updated overview of the main reporting practices regarding tax expenditures adopted by OECD members.[273]

Although this OECD publication represents the most recent proof of the long-lasting engagement of governments and international organizations in comparative studies aimed at developing uniform guidelines for the identification, measurement and reporting of tax expenditures in an attempt to improve tax and budget policies, the identification of tax expenditures is still characterized by considerable subjective judgment, a circumstance which has raised persistent negative critiques to the credibility and the effectiveness of the tax expenditure analysis.

Indeed, since tax expenditures, as already pointed out, are meant to provide special treatment to some activities, this, in itself, implies the existence of a benchmark with respect to which tax expenditures necessarily constitute a deviation.[274] Therefore, in order to identify and properly control tax expenditures for budgetary and tax policy purposes, governments and scholars need to previously determine such a benchmark, that is, the

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[272] SURREY, S., MCDANIEL, P., TAX EXPENDITURES, (Cambridge, MA: Harvard University Press 1985), 2.
[273] The beginning of the involvement of international institutions in tax expenditure analysis dates back to 1976 and 1977, when the International Fiscal Association and the International Institute of Public Finance dedicated their annual meetings to the discussion of the concept of tax expenditures. Subsequently, in 1984, the OECD published its first study on tax expenditures, which was followed by updated works in 1996 and, finally, in 2010.
[274] OECD, TAX EXPENDITURES IN OECD COUNTRIES, (Paris: OECD, 2010), 15-16.

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standard tax regime.

With specific regard to tax expenditures within the income tax system, it is fundamental to evoke the distinction made by Surrey, the 'father' of the tax expenditure analysis. According to Surrey, the income tax system can be divided into two parts. One part consists of the so-called "*normative structure of the tax*"[275] - that is, the structural provisions necessary to implement a normal income tax on individual and corporate income -, while the second part consists of "*departures from the normal tax structure (...) designed to favor a particular industry, activity, or class of persons*".[276] Tax expenditures belong to the second category. Tax expenditure analysis, therefore, requires the understanding of the normative structure of the income tax in order to determine whether a provision is structural to the implementation of the tax or represents a deviation from said normative structure and constitutes a tax subsidy. [277]

Even though the identification of the structural provisions of the income tax system may seem theoretically easy, there are many practical circumstances in which the concrete qualification of a measure as a standard provision or as a tax expenditure is extremely debatable. In particular, it is important, in the process of identification of tax expenditures, to distinguish them from provisions which may have their same form and functioning but instead of being aimed at favoring certain industries or groups of taxpayers are simply part of the basic structure of an income tax system and thus are integral to having an income tax at all.[278]

Indeed, while certain provisions are quite evidently disguised spending programs and therefore can be easily classified as tax expenditures, in fact, the tax codes also contain provisions whose role in the tax system is not so clear. There are provisions which - although they take the form of exclusions, deductions, accelerated deductions,

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[275] SURREY, S., MCDANIEL, P., *supra*, fn. 6, at 186.
[276] SURREY, S., MCDANIEL, P., *supra,* 3. See also THURANYI, V., *Tax Expenditures: A Reassessment*, *supra*, 1164.
[277] As highlighted by Surrey - who, as already illustrated, is unanimously credited as the creator of the tax expenditures doctrine and analysis – "*tax expenditure analysis requires the understanding of the normative structure of the tax in order to determine whether a provision is a part of the structural or the tax expenditure component*".
[278] SURREY, S., PATHWAYS TO TAX REFORMS, fn. 1, at 15.

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credits, rules deferring recognition of an item of income – may not actually be aimed at subsidizing certain activities or industries for particular purposes but may be, instead, structural provisions necessary to the correct implementation of the income tax. Two examples of these types of provisions are the "business expenses deduction" and the "foreign tax credit": despite their form, they do not constitute preferential provisions but are simply instruments necessary to the determination of a proper tax base.[279] The problem is that there are many other provisions whose nature is not as clear and therefore their inclusion into the normative structure of the income tax is the object of ongoing analysis and debate.

Aware of this problem, Surrey proposed a formulation of the normative income tax suitable – in his opinion - to achieve the largest consensus among scholars and policy-makers. Surrey's normative income tax was based on a refinement of the Haig-Simmons economic definition of income achieved through the combination of such theory with widely accepted practices. According to the Haig-Simmons definition, income consists of the taxpayer's consumption plus the increase in his/her net economic wealth during each tax year.[280] However, Surrey recognized that the rigid application of the Haig-Simmons definition could not provide a workable foundation for the identification of tax expenditures, since it does not realistically take into consideration some basic features of the tax system. Indeed, "*aside from the many ambiguities that become apparent as soon as one attempts to apply the Haig-Simmons definition to the protean stream of economic life, any system of income taxation is an aggregation of decision about a host of structural issues that the Haig-Simmons definition does not even purport to settle. Under*

[279] By recognizing the primary tax jurisdiction of the source of income's country, the foreign tax credit avoids the double taxation of that income. As for the business expense deduction, it enables the tax system to identify and tax a proper net income, since it allows the taxpayer to deduct those expenses incurred in the production of that income (as opposed to the consumption of the income).
[280] This concept was articulated in SIMONS, H., PERSONAL INCOME TAXATION (Chicago: University of Chicago Press, 1938), 50 ("*Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question*"). Simon's definition constituted a more explicit and detailed definition of Haig's earlier definition of income as "*the money value of the net accretion to one's economic power between two points of time*". HAIG, R.M., THE FEDERAL INCOME TAX (New York: Columbia University Press, 1921), 7.

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a street interpretation of the Haig-Simmons base, numerous items not traditionally taxed would be made includable in income, such as imputed income on an owner-occupied home, imputed income from household work by a nonworking spouse, personal exemptions, and even the graduated tax rate schedule".[281] Therefore, Surrey altered the Haig-Simmons definition by requiring the identification of the normative income tax to take into account the "*widely accepted standards of business accounting*"[282] and, above all, "*the generally accepted structure of an income tax*".[283] As a result, he proposed the adoption of a normative income tax based on the Haig-Simmons definition of income but at the same time suitable to take into consideration *"the historical treatment of various items under the U.S. income tax, as well as the consensus of economists and other tax analysts about a politically and administratively realistic tax base*".[284]

Despite Surrey's guidance, disagreement about what the "generally accepted" tax structure is still has constituted a never-ending source of critiques to Surrey's proposal and effectiveness of tax expenditures analysis. Such critiques have been fueled by the actual results of the tax expenditure analysis's practical implementation, characterized by vast uncertainty and disagreement as to whether many items should be qualified as normal tax provisions or as tax expenditures.[285] Many prominent scholars have therefore claimed that the actual identification of the normative income tax according to the criteria set forth by Surrey – which required the combined application of economic principles with administrative practices – was too subjective and based on the individual judgment

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[281] BABU, J., *The Tax Expenditure Budget: What the U.S. Can Learn from Germany*, in 27 SETON HALL LEGIS. J, 163-189, at 175. BITTKER, B.I., *Accounting for Federal Tax Subsidies in the National Budget*, 22 NAT'L TAX J. 244 (1969), 260.
[282] SURREY, S., MCDANIEL, P., *supra*, 189.
[283] SURREY, S., MCDANIEL, P., *supra*, 4.
[284] THURONYI, V., *Tax Expenditures: A Reassessment*, *supra*, 1166.
[285] For example, according to some scholars, all personal deductions, such as charitable contributions and medical expenses, clearly are tax expenditures. Conversely, a number of commentators have concluded that some personal deductions are consistent with a normal tax system. See CHIRELSTEIN M., AND ZELENAK, L., FEDERAL INCOME TAXATION (12th ed. 2012), 206; ANDREWS, W., *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. (1972) 309; KAHN, J., *Personal Deductions - A Tax "Ideal" or Just Another "Deal"?*, L.REV. MSU-DCL 1 (2002); TURNIER, W., *The High Road and the Low Road, Personal Deductions and Tax Reform,"* 31 VILL. L. REV. (1986) 1703; NEWMAN, J., *Of Taxes and Other Casualties*, 34 HASTINGS L.J. (1983) 941.

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and ambiguity. In particular, the most radical critique was that a consensus on the definition of a normative tax base is simply impossible. According to this position, whose first advocate was Professor Bittker, the tax expenditure concept as defined by Surrey – that is, relying on an identification of an objective normative income tax as a benchmark – is inherently ambiguous because "*every man can create his own set of "tax expenditures" but it will be no more than his collection of disparities between the income tax law as it is, and as he thinks it ought to be*".[286] [287]

Despite various attempts to develop a normative income tax capable of attracting a general consensus,[288] the criticisms based on the ambiguity and relativity of the benchmark has continuously weakened the scientific foundation of the tax expenditure analysis[289]and, as a consequence, the administrative usability of it by governments, scholars and organizations is limited. More recently, international organizations also tried to facilitate the achievement of international agreement over the definition of the normative income tax. In particular, the OECD and the World Bank defined the benchmark for tax expenditure analysis as a norm including "*the rate structure, accounting conventions, deductibility of compulsory payments, provisions to facilitate tax*

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[286] BITTKER, B.I., *Accounting for Federal Tax Subsidies in the National Budget*, 22 NAT'L TAX J. (1969) 244, 260. Besides this radical critique, other critiques were raised against the Surrey's tax expenditure concept and analysis by other authoritative scholars. In particular, see ANDREWS, W.D.,*supra*, 312; BLUM, *Book Review*, 1 J. CORP. TAX'N (1975) 486, 488 (reviewing SURREY, S., PATHWAYS TO TAX REFORM (1973). For an exhaustive analysis of these positions see THURONYI, V., *supra*, 1167-1170.

[287] BITTKER, B.I., *The Tax Expenditure Budget – A Reply to Professors Surrey and Helmuth*, 22 NAT'L TAX J. 538, (1970), 539.

[288] In particular, the most notable attempt was made by the US Joint Committee on Taxation in 2008, which published a report offering an alternative framework to overcome the main criticism of tax expenditure analysis as developed by the US Treasury following the Surrey's indications. In this report, the Joint Committee proposed a normative income tax based on a comprehensive tax base which many related to the adoption of a consumption tax approach. See JOINT COMMITTEE ON TAXATION (2008), *A Reconsideration of Tax Expenditure Analysis* (JCX-37-08), United States Congress, Washington DC.

[289] More recently, an authoritative tax scholar, Michigan Law Professor Douglas A. Kahn, stated that the main reason for the weakness and the unsuccessful practical implementation of the tax expenditure analysis is that "*the underlying premise of the expenditure concept is unsound*". In particular, Kahn contests the traditional "*binary approach*" under which, starting from the assumption that it is possible to identify a normative tax structure, an item either is consistent with normal tax provisions or is inconsistent. On the contrary, Kahn claims that a normative tax structure simply does not exists. See KAHN, D.A., *A Proposed Replacement of the Tax Expenditure Concept and a Different Perspective on Accelerated Depreciation*, UNIVERSITY OF MICHIGAN LAW&ECON RESEARCH PAPER NO. 13-001 (2013).

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administration, and international fiscal obligations".[290] Nevertheless, this definition also - probably as a result of its excessive vagueness – has not had a serious impact on countries' individual practices. As admitted by the OECD in its most recent publication on this topic, the choice of a benchmark still varies significantly from country to country and thus identification of tax expenditures is still characterized by considerable subjective judgment. Significant differences among country reports in measuring the number and the amount of tax expenditures within their respective tax systems make any serious attempt of comparative analysis of tax expenditure data and statistics extremely difficult, if not impossible.[291]

II.2.5.2 Practical reasons behind the ongoing "success" of tax expenditures

As anticipated, the second reason for the failure of tax expenditure analysis to result in what advocates hoped for (i.e., the repeal of many tax expenditures) is related to the belief that, despite the questions casted about their efficiency under a purely economic and fiscal perspective, tax expenditures often constitute, in practical terms, a more feasible, effective and affordable instrument for national government to implement regulatory social and economic public policies as opposed to direct spending programs and direct regulation. The arguments supporting such a belief about tax expenditures are as follows:

- their higher administrative efficiency;
- their higher political feasibility.

The administrative efficiency argument is based on the assertion that "*because tax*

[290] SWIFT, POLOCKOVA BRIXI, AND VALENDUC, TAX EXPENDITURES – SHEDDING LIGHT ON GOVERNMENT SPENDING THROUGH THE TAX SYSTEM, (Washington DC: The World Bank, 2004), 1-3. See also KRAAN, D.J., *Off-Budget and Tax Expenditures*, 4 (1) OECD JOURNAL ON BUDGETING, (2004), 121-42.
[291] POLACKOVA BRIXI, *supra*, 1-3.

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expenditures usually deliver their reward through a reduction of tax that would be paid in any event, government spending agencies need not engage in the administrative effort to manage a program and deliver payments".[292] Unlike direct spending programs, subsidies provided through tax breaks generally do not involve substantial start-up and program-management costs. This is mainly due to the fact that tax expenditure programs can take advantage of the already existing tax apparatus. In particular, the already existing reporting relationship between taxpayers and tax authorities can give rise to significant administrative economies of scale. Indeed, if a subsidy is provided through the income tax system, the tax authority can identify the eligible subjects and the amount of the actual tax breaks to be granted to each entitled taxpayer by simply using the information it already holds and therefore without duplication of the reporting to a spending agency. In addition, it has been noted that, even if a specific subsidy program requires the communication of information not already held by the government, the cost of such additional communication is often lower with respect to tax incentives than direct subsidies because the tax authority can take advantage of a communication channel – i.e., the annual tax filing requirement – which is already in use.[293] Conversely, if a subsidy is provided through a direct spending program, the government department in charge of implementing the program must set up a new application, certification, audit and money-handling out process. As a result, the implementation of direct spending programs may end up being very complex and impose a significant administrative burden within the government department, which has limited internal resources that will be taken from other important activities.[294]

The feature of tax expenditures which, together with the above illustrated administrative efficiency, is allegedly at the foundation of growing use of tax expenditures by legislatures and governments - despite the warnings of the tax

[292] OECD, TAX EXPENDITURES IN OECD COUNTRIES, (Paris: OECD, 2010), 24.
[293] ZELINSKY, *Efficiency and Income Tax: The Rehabilitation of Tax Incentives*, 64 Tex. L. Rev (1985) 973.
[294] WEISBACH, D.A., NUSSIM, J., *The Integration of Tax and Spending Programs*, 113 YALE LAW JOURNAL (2004), 955–1028, 962.

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expenditure analysis's advocates - is the higher political feasibility of providing subsidies through the tax system as opposed to direct spending programs. Political feasibility manifests itself, for instance, in regard to the enactment advantages generally associated with the implementation of tax measures. Indeed, in most nation states' legal systems, tax laws have to pass through less procedural review than direct spending programs.[295] Additionally, tax laws are generally permanent, while laws entailing direct spending programs are regularly subject to periodical reauthorization or review.[296] Therefore, tax expenditures, once enacted, are less likely to be reformed or repealed. It is undeniable that such a circumstance may represent a problem under the fiscal perspective because it allows tax expenditures to grow continuously, under lobby pressures and for electoral interests of politicians, as often highlighted by tax expenditure analysis's advocates. But, under the political perspective, such a circumstance inevitably contributes to the characterization of tax measures as more stable and reliable - and not temporary – instruments of regulation and policy-making for nation states' governments.

Another feature of tax expenditures, traditionally stigmatized by the tax expenditure analysis doctrine as one of the main reasons for reducing the use of tax subsidies (but which certainly contributes to their political feasibility) is their lower level of transparency. As noted by the OECD in its last report on tax expenditures, tax breaks are normally not properly displayed side-by-side with direct spending programs having similar goals.[297] And, as seen above, the reporting efforts made by governments in the last decades have proven not to be very effective and reliable. This results in reduced visibility of tax expenditures compared to direct spending programs. Therefore, it is unlikely that public attention will be captured by the enactment of new tax expenditures. This turns into a political advantage, in particular, with regard to those measures aimed at

[295] HOWARD, C., THE HIDDEN WELFARE STATE, (Princeton University Press, 1999).
[296] OECD, TAX EXPENDITURES IN OECD COUNTRIES, (Paris: OECD, 2010), 33.
[297] *Id*.

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financially assisting small groups of taxpayers who incur the risk of appearing to receive privileges at the expenses of the larger community.

A last argument in favor of the higher political feasibility characterizing tax expenditures is related to taxpayer psychology. Regardless of the level of transparency and visibility characterizing the single tax expenditures, it has been asserted that under a public perception perspective - a factor which is not taken into account by efficiency economic and fiscal evaluations -, "*some social goals cannot be achieved through an explicit spending program as well or better than they can be through a tax expenditure*".[298] Such conclusion is based on the assumption that while market interventions in the form of direct subsidies may be easily perceived by taxpayers as an appropriation by government coming out of their taxes, tax expenditures operate to reduce government confiscation of their income. This concept has been effectively illustrated by Professor Robert Musgrave, who stated that "[P]*eople may well perceive declines in disposable income due to taxes as more burdensome than similar losses due to declines in earnings. It hurts more 'to lose what you have', than not 'to get what you don't have'*".[299]

II.2.6 Tax expenditures Today: Some Data

The arguments illustrated above explain the ongoing "success" of tax expenditures as governmental policy-making instruments. And the same reasons can lead one to predict that, without much risk of being contradicted, the massive use of spending programs implemented through the tax system is not likely to be reduced, despite the tax expenditure analysis theories and the tax neutrality arguments often officially endorsed by

[298] WIEDENBECK, P.J., *Paternalism and Income Tax Reform*, 33 U. KAN. L. REV. (1984-1985) 675-700, 679.
[299] See MUSGRAVE, R.A., *Leviathan Cometh – Or Does He?*, in TAX AND EXPENDITURE LIMITATIONS 77, 99, (H. Ladd & T. Tideman eds.), (Washington, DC: Urban Institute, 1981).

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governments.[300] A certain reduction in tax expenditures may have happened in the last three or four years, but the global financial and economic crisis must be credited for that, rather than a structural and thoughtful move away from the use of tax policy to implement spending programs.

The areas and activities in relation to which tax expenditures are enacted are the most varied and depend on the discretionary decisions of governments and legislatures, influenced by the contextual circumstances characterizing each country's economy and society and often influenced by lobbying pressures (above all with respect to tax expenditures under the corporate income tax). Potentially, tax expenditures, just like taxes, can be issued with regard to any area of human activities. It is therefore impossible to draft an exhaustive list of tax expenditures' categories. Nevertheless, from an examination of existing tax expenditures reported by various countries, the OECD was able to derive a set of areas in which such tax policy measures are more often adopted:

- low-income, non-work-related;
- make work pay;
- retirement;
- employee benefits (non-health, non-retirement);
- education;
- health;
- housing;
- general business investment;
- research and development;

[300] For example, in its report anticipating and setting the guidelines for the 1986 tax reform, the United States Treasury officially endorsed tax neutrality by stating that: "*An ideal tax system would be as neutral as possible toward private decisions. Any deviation from this principle represents implicit endorsement of governmental intervention in the economy – an insidious form of industrial policy based on the belief that those responsible for tax policy can judge better than the marketplace what consumers want, how goods and services should be produced, and how business should be organized and financed*". U.S. DEPARTMENT OF THE TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH (1984), reprinted in 1984 FEDERAL TAXES (P-H) Bulletin 12 Extra, and in 1984 STAND. FED. TAX REP. (CCH) Extra Ed. Nos. 52, 53 & 56.

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- specific industry support;
- capital income relief;
- intergovernmental relations;
- charity'
- other.[301]

Among these categories, those which certainly account for the largest part are those in the areas of retirement, housing and health. Every country, indeed, spends billions of euros in the form of tax deductions or exclusions granted to taxpayers and aimed at providing incentives to the development and acquisition of employer-provided and individual pension plans and health insurance plans (in those countries not characterized by a fully socialized healthcare system), and at favoring the ownership of residential houses.[302]

As already illustrated in II.2.5.1 due to the subjectivity inherent in the definition of a normative tax structure, it is extremely difficult to identify and have a clear picture of all the tax expenditures in force within an income tax system and above all, of their amount. This problem increases exponentially with regard to comparative analysis between different countries' recourse to tax expenditures, considering that, where implemented, reporting techniques vary significantly from country to country. The OECD itself admits that the differences between the single countries' data reported in its last publication on the use of tax expenditures may be largely and simply due to differences in the reporting and calculation techniques adopted by each government.

Taking this into consideration, it still may be worthwhile to review and analyze some of the data included in the OECD report. Such data, even if not reliable under a

[301] OECD, *supra*, 73.
[302] For example, according to official data from 2009, in the United States the largest tax expenditure is the exclusion of employers' contribution for medical insurance premiums and medical care, which amounts for over $130 billion; the second largest deduction is the combined net-exclusion of contributions to and earnings from employer-provided and individual pension plans, which accounts for over $115 billion; the third most expensive tax expenditure, the deduction for mortgage interest on owner occupied homes, account for over $88 billion.

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scientific perspective, can give a general idea of the quantitative significance of spending tax policies implemented under the various countries' income tax system. According to the OECD report, the tax expenditures under income taxes-GDP ratio is the following:

- Canada: 5.4% (data from 2004). The largest part of such measures is constituted by tax expenditures for retirement.
- Germany: 0.29% (data from 2006).
- Korea: 1.76%. More than one third of reported tax expenditures consists of general business incentives and the second most important category is made of tax expenditures for health (less than one third);
- The Netherlands: 1,1%;
- Spain: 2.3% (data from 2009). The so-called 'mark-work-pay' measures constitute the largest part of reported tax expenditures (0.7%); the other main areas in which tax expenditures have been implemented are housing (0.5%) and health (0.4%);
- United Kingdom: 8.1% (data from 2008). 2.3% of reported tax expenditures are for retirement and another 1.2% for housing;
- United States: 6% (data from 2008). Housing and retirement purposes each individually account for more than 1% of GDP.[303]

II.2.7 Conclusions

The most important insight arising from the analysis conducted above is that the administrative and political feasibility of such regulatory tax measures certainly allowed national governments to continue to exercise a pervasive role in the control of various

[303] Source: OECD, *supra*, 75-140.

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fields of social and economic life and therefore implement the ultimate function of complete state sovereignty, namely the design, the implementation and the protection of a specific social and economic order within a specific territorial area (see Introduction).

Another important consideration which may be identified from the analysis above is that although tax expenditure analysis may have failed in its attempt to induce a drastic reduction in the amount of subsidies hidden in the tax codes, especially within the income tax codes, tax expenditures analysis and its advocates must certainly be credited for identifying and focusing scholars' and policy-makers' attention on the most important regulatory use of tax sovereignty since the end of World War II.

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Part B

TAX SOVEREIGNTY'S REGULATORY FUNCTION AND GLOBALIZATION

From Sovereign Autonomy Over Taxation To Multilateral Exercise of Tax Sovereignty

The traditional concept of state sovereignty prescribes that each nation state has "*supreme…and exclusive rule*" within its own territorial borders and over its own people.[304] According to this view, therefore, sovereignty coincides with the power and the ability of nation states´ governments to determine and implement policies unilaterally, without being subject to any external influence.[305]

Nevertheless, in the last few years, the largest part of international law scholarship has recognized that the traditional view of state sovereignty as absolute and exclusive autonomy from the external environment is outdated. Globalization, indeed, has given rise to a new reality in which financial and economic national markets are constantly engaged in cross-border contacts and exchanges and, as a result, regulatory relationships among nation states have been reshaped as well. Given the growing interconnection of national economies and financial markets, indeed, the national governments' policy-making activity is now significantly influenced and driven by external factors and, at the same time, states cannot ignore the potential implications its conduct may have on the global market.[306]

The scenario that emerges from globalization is therefore that of a necessary

[304] SCHOLTE, J. A., GLOBALIZATION: A CRITICAL INTRODUCTION, (London: Palgrave MacMillan, 2000), 135-37.
[305] CHRISTIANS, A., *Sovereignty, Taxation and Social Contract*, 18 MINN. J., INT'L L. 99 (2009), 106.
[306] TRACHTMAN, J.P., *Welcome to Cosmopolis, World of Boundless Opportunity*, 39 CORNELL INT'L L.J. (2006) 477, 479.

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change in the concept of state sovereignty. Although some international scholars have even contended that state sovereignty is dead, or is dying,[307] it is probably more appropriate to speak of a new dimension of state sovereignty. What may, at a first look, appear as a loss of state sovereignty is, in fact, a necessary new way of exercising it. In light of the changed scenario imposed by economic globalization as described above, nation states are not able to unilaterally pursue efficient policies in many areas – not just economic and financial policies but also social, environmental, labor policies, to mention the most visible of them – since "*there is a danger that political communities will be unable to reach a desired goal owing to conditions outside their jurisdiction*".[308] As a result, the only way for nation states to pursue effective policies in the areas impacted by globalization is to devise and implement them at a supranational level, which may take two forms: (i) transferring some power or decision-making authority to a broader international body, such as international organizations or special purpose institutions; and (ii) engaging in multilateralism, that is, the design of policies and their implementation though coordination and cooperation among several nation states.[309]

The same transformation has undeniably taken place in regard to tax sovereignty. All of the regulatory tax legislation reviewed in the first part of this work - which demonstrated how the regulatory prerogative of taxing power has been strictly intermingled with the establishment of full state sovereignty and how, on certain occasions, it played a pivotal role in the building and development of nation states themselves - reflected the traditional view of sovereign autonomy over taxation, according to which tax policies should be adopted by national governments without

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[307] JAMES, A., SOVEREIGN STATEHOOD: THE BASIS OF INTERNATIONAL SOCIETY (London: Allen & Unwin, 1986), 3.
[308] ZURN, M., *Democratic Governance: Beyond the Nation State*, in DEMOCRACY BEYOND THE STATE: THE EUROPEAN DILEMMA AND THE EMERGING GLOBAL ORDER, 91, (Michale Th. Greven & Louis W. Pauly eds.). (Toronto: University of Toronto Press. 2000), 93 "*No transfer or dilution of state sovereignty … there is necessary re-characterization involved ..*", as observed by SLAUGHTER, A.M., *Security, Solidarity, and Sovereignty: The Grand Themes of UN Reform*, 99 AM. J. INT'L L. (2005) 619, 628.
[309] RING, D., *International Tax Relations: Theory and Implications*, 60 TAX L. REV. (2007) 83, 145-46 and 152-53.

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regard to external influence.[310] Even those policies which were, by nature, directed to international activities, like mercantilist tariffs, were indeed driven by the idea that goals could be achieved unilaterally.

However, just like the traditional concept of state sovereignty, the traditional view of tax sovereignty has proved obsolete in light of the new global economic reality. From a taxing power perspective, the growing global economic integration and interdependence has given rise to new issues and problems whose common feature is their global scale, which are not manageable by single states individually. As a result, the exercise of both of the tax sovereignty prerogatives – the revenue-raising and the regulatory function – necessarily turned from being limited to a purely national perspective to being, in many situations, the subject of supranational design and implementation, either through the attribution of decision-making powers to international organization or by means of cooperation and coordination between various nation states.[311]

[310] TANZI, V., *The Impact of Economic Globalization on Taxation*, 52 BULLETIN FOR INTERNATIONAL FISCAL DOCUMENTATION 8/9 (1998) 338, at 339. CHRISTIANS, A., *supra*, at 99; MCLURE, C.E.JR., *Globalization, Tax Rules and National Sovereignty*, BULLETIN FOR INTERNATIONAL FISCAL DOCUMENTATION 8/9 (2001), 328.

[311] RING, D., *What's at Stake In The Sovereignty Debate? International Tax and The Nation-State*, BOSTON COLLEGE LAW SCHOOL, RESEARCH PAPER NO. 153, 7-13; TANZI, V., *supra*, 339. CHRISTIANS, A., *supra*, 99-102.

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Chapter III

COORDINATED TAX POLICIES TO REGULATE GLOBAL ISSUES: THREE ILLUSTRATIVE CASES

In this chapter, the supranational design and implementation of regulatory tax policies with regard to three specific international issues posed by globalization - harmful tax competition, multinational enterprises' base erosion and profit shifting strategies, and financial sector's speculative behaviors – will be examined. These issues represent, indeed, the cases of international negative externalities arising from globalization on which nation states, scholars and policy-makers have focused the most to study and develop internationally-coordinated regulatory tax measures. For the specific purposes of this work, this chapter will show how, even in their new dimension, the strict relationship between tax sovereignty' regulatory function and state sovereignty has not been altered in its substance. Specifically, this chapter will demonstrate that the supranational and international design and implementation of certain regulatory tax policies, rather than representing a reduction of the original nation states' tax sovereignty, is actually playing an essential role in the preservation of state sovereignty as it evolves in light of the issues posed by the current age of globalization.

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III.1 THE CONTRAST OF HARMFUL TAX COMPETITION

III.1.1 Tax Competition and Its Effects on National Tax Sovereignty's Prerogatives

The first illustrative example of the transformation of tax sovereignty, and its impact on both the revenue-raising and the regulatory function, is certainly represented by the policies adopted by nation states to counteract the phenomenon commonly referred to as "tax competition" among jurisdictions.

The unprecedented mobility of capital characterizing the current age of globalization induced an equally unprecedented "fight" among countries to attract both portfolio and direct investment by lowering their tax rates on income earned by foreign investors. Such competition resulted, in part, in a shift of the income tax burden from capital to less mobile items of income such as labor, and, in part, reduced the revenue necessary to fund government activities, which has made it more difficult for modern welfare states to continue to provide the same level of social insurance.[312] It is therefore clear how the tax sovereignty of national governments, and in turn state sovereignty, has been affected not only in its capability to collect revenue, but also in its ability to promote progressivity in the tax system (and therefore substantial equality in the distribution of wealth), that is, one of the most important regulatory uses of the taxing power in the history of nation states, as illustrated in Chapter 2.

In order to protect their tax sovereignty from such deplorable consequences, nation states engaged in a new set of tax policies aimed at counteracting the part of tax competition they considered excessively harmful to the general welfare. Specifically,

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[312] See, AVI-YONAH, R., *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 HARV. L.REV. (2000), 1573, 1576, who explains how "*tax competition, in turn, threatens to undermine the individual and corporate income taxes, which traditionally have generated the largest share of revenue for modern welfare states. The developed countries have responded in two ways: first by shifting the tax burden from (mobile) capital to (less mobile) labor, and second, when increased taxation of labor has become politically and economically problematic, by reducing social safety net*".

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their efforts have focused on identifying and limiting the existence of so-called "tax havens" - that is, those jurisdictions characterized by an extremely low or zero taxation of certain categories of income earned by foreigners and which assure a high level of banking and/or commercial confidentiality – and, in general, of privileged tax regimes offered to foreigners by several jurisdictions. Due to their goal of protecting nation states' tax sovereignty in both its functions, the measures against tax havens can be qualified, as well, as an exercise of both revenue-raising and regulatory tax sovereignty. As the following paragraphs will illustrate, nation states initially recurred to unilateral measures, but subsequently, in light of the insufficiency of the latter, turned to a multilateral exercise of tax sovereignty, therefore confirming the insight above regarding the new dimension of tax sovereignty.

III.1.2 Unilateral Reactions and Respective Limits: CFC Regulations, Black and White Lists, Departure and Exit Taxes

Among the measures unilaterally taken by nation states to contrast the use of tax havens, the first and most important one is certainly represented by the so-called '*controlled foreign company"* legislation (hereinafter 'CFC regulation'). Such legislation provides a tool to prevent individuals or multinational enterprises from deferring their tax obligations by shifting their mobile income (i.e. capital income) to foreign entities established in territories characterized by privileged tax regimes. Specifically, the CFC regulation makes the profits generated by the offshore companies directly taxable as part of the resident controlling shareholders' individual or corporation income.[313]

[313] For a complete illustration of the design and implementation of CFC regulation in the various countries, please see ARNOLD, B., THE TAXATION OF THE CONTROLLED FOREIGN CORPORATIONS: THE INTERNATIONAL COMPARISON, (Toronto: Canadian Tax Foundation, 1986); OECD, *Controlled Foreign Company Legislation: Studies in Taxation of Foreign Source Income*, (Paris: 1996), ARNALD, B.J., DIBOUT, P., *General Report, in Limits on the use of low-tax regimes by multinational business: current measures and emerging treads*, 86b CAHIERS DE DROIT FISCAL INTERNATIONAL (2001).

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The United States were the first country to adopt a CFC regulation, in 1962.[314] Since then, many other industrialized countries decided to introduce a CFC regulation. As of today, twenty-five countries have passed a CFC regulation. [315][316]

Despite significant differences arising from the various domestic contexts and tax policy perspectives, an overview of the CFC regulations shows that their application is generally triggered by three events, which will be referred to as '*triggering factors*' throughout the chapter. The first triggering factor occurs where one or more residents (individuals or legal entities) controls or has a substantial interest in a foreign entity. This standard is referred to as the '*control test*'. The definition of 'control' and 'substantial interest' varies among the regulations even though a certain consistency can be found.[317] The second triggering factor concerns the *nature* of the controlled foreign entities' income. The amount of income derived by non-genuine business activities either

[314] Also known as "Subpart F" (Sections 951 to 960 of the I.R.C.) of part N, which is the international section of the Internal Revenue Code.

[315] Argentina, Australia, Brazil, Canada, China, South Korea, Estonia, Finland, France, Germany, Israel, Japan, Italy, Lithuania, Mexico, Norway, New Zeeland, Portugal, United Kingdom, Spain, Sweden, South Africa, Hungary, United States, Venezuela.

[316] One of the main issues which arise from the adoption of the CFC Legislation in European countries concerns their compatibility with EC Law. It has been pointed out that the national CFC rules could represent a violation of the principle of freedom of establishment and of movement sanctioned by articles from 43 to 48. Indeed, articles from 43 to 48 prescribe that member States must guarantee to their citizens and their residents the freedom of movement and the freedom of establishment in other member States[316].

The European Court of Justice (hereinafter ECJ) very often has stated that Treaty provisions regarding the freedom of establishment applies also to the national provisions that regulate the detention of so many shares that give the legal control of a company[316], wherever it is located. In general, the Court clarified that national provisions can not improperly restrict the freedom of establishment of companies in the form of:

- legislative obstacles to the detention of so many shares that give the legal control of a company which is located in another member State; or
- discriminatory tax treatment based upon the nationality of the controlling company or individual.

As concerns the topic of our interest, the Court of Justice, being required to a pronouncement on the compatibility of the British CFC Legislation, pointed out that such type of discipline could constitute a potential obstacle to the freedom of establishment when applicable not only to purely artificial structures whose unique aim is a fiscal advantage (i.e. fiscal saving - see *Cadbury Schweppes* and *Cadbury Schweppes Overseas* ECJ cases). Therefore, the freedom of establishment cannot be generally limited in cases of intercompany transnational linkages bearing (also) fiscal advantages. Indeed, the principle stated by the Court is that the freedom of establishment can be limited by national provisions only if the decision of incorporating a company and investing in a foreign State is driven by no economic reasons but only fiscal advantages[316]. This decision has a crucial importance for the future of the application and interpretation of the various CFC Legislations enacted by the single member States. See MEUSSEN, G.T.K., *Cadbury Schweppes: The ECJ Significantly Limits the Application of CFC Rules in the Member States*, EUROPEAN TAXATION (2007), 13.

[317] MAISTO, G., PISTONE, P., *A European Model for Member States' Legislation on the Taxation of Controlled Foreign Subsidiaries (CFSs)*, 48 EUROPEAN TAXATION 2008, 503-570, 507.

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determines the amount of income that is subject to the CFC rules or is, by itself, a condition for the application of the latter. The third and last triggering factor occurs where the income earned by the controlled foreign companies are subject, according to the country of incorporation's rules, to a *tax burden* markedly lower than the one imposed by the shareholders' country of residence.

While the first triggering factor is necessarily implicated in all the CFC regulations as a prerequisite for their application, the simultaneous adoption of the second and third factors does not constitute, theoretically, a 'Hobson's choice'. Indeed, the second and the third triggering factors represent, respectively, the fulcrum of the *transactional* and the *jurisdictional* approaches, which traditionally inspired the designing of the CFC legislation.[318]

In its basic form, a CFC regulation based on the *transactional approach* focuses on the nature of the controlled foreign companies' income (i.e., the second triggering factor, see above), irrespective of the tax burden imposed in the foreign countries. According to this approach, only the part of income that is considered a potential result of unacceptable tax deferral (the so called '*tainted income'*) shall be included in the resident shareholders' income, regardless of the foreign tax level. Income, other than the income that is "tainted," is not subject to the CFC rules and therefore is not taxed by the controlling shareholders' residence country.

Under a pure *jurisdictional approach* the attention shifts, instead, to foreign taxation. The application of the CFC rules is triggered when the foreign country's level of taxation is zero or considered too low compared to that of the country of the controlling shareholders' residence (i.e. the third triggering factor, see above). Moreover, once the level of taxation levied by the foreign country is qualified as too low, the *entire* controlled company's income, irrespective of its nature, is included in the resident

[318] GARBARINO, C., MANUALE DI TASSAZIONE INTERNAZIONALE, (Milan: Ipsoa, 2008), 1601-03.

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controlling shareholders' income and therefore subject to their residence country's tax jurisdiction.

Given the difference of perspective, each approach, in order to be implemented, calls for different specific *legislative tools*. In particular, the transactional regime requires a detailed legislative *description of the so-called 'tainted income'*, that is, that part of the controlled foreign companies' income to which the CFC rules are exclusively targeted. Tainted income usually embraces the so-called '*passive income*' and certain types of business income generally referred to as '*base company income'*. As for the passive income, although its definition differs in the various CFC legislations, it generally includes all of the income not generated by an active economic activity exercised by the recipient. Therefore, passive income is generally identified with interests, dividends, rents, royalties and capital gains.[319] The base company income category usually refers to any income other than passive income that is considered to be tainted income for the purposes of CFC rules. The most important component of base company income is income derived by a controlled foreign company from selling property or rendering services outside the country in which the CFC is established or to related parties.[320]

On the other hand, for CFC regulations based on the jurisdictional approach, the legislative tools generally includes a broad general *definition of a low-tax country or tax haven*, which typically involves a comparison between the residence country tax and the foreign tax.[321] Such a definition is almost always supplemented and accompanied by a

[319] In general, this definition is formulated as follows: a) positively, through a list that usually includes dividends, interests, royalties and gains or b) negatively, by means of an exclusion from the concept of income derived by a genuine economic activity. In any case, the definition of passive income excludes financial income derived by banking, insurance or financial businesses to the extent that it represents the income from the characteristic activity. (Such an exclusion is, however, sometimes denied to income derived from financial activities addressed to subjects belonging to the same group of companies). See MAISTO, G., PISTONE, P., *A European Model for Member States' Legislation on the Taxation of Controlled Foreign Subsidiaries (CFSs)*, *supra*.

[320] ARNALD, B.J., DIBOUT, P., *General Report*, *supra*, 50-57.

[321] This comparison may be based on nominal or effective tax rates or on the actual foreign taxes paid by a particular CFC.

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list of countries that are expressly considered as low-tax country (*black list*)[322] or a list of countries that are not low-tax countries (*white list*).

Another type of unilateral measure deserves to be mentioned, that is, the establishment of tax penalties aimed at affecting the individuals' change of residence to tax havens. Many countries have established a specific *departure tax* or *exit tax* for those who stop being a resident in their territories.[323] *Departure* or *exit taxes* are levied on the latent surplus values of the transferring individual's assets.[324]

III.1.3 The Shift to Multilateralism

However, even if national tax authorities have implemented the above-mentioned measures very strictly, the reality revealed that a unilateral approach to an issue that, as already explained, is essentially global in its nature tends to be intrinsically weak. The reason for such conclusion can be illustrated as follows.

First of all, physiological jurisdictional limits to the power of each country's tax authorities inevitably restrict their ability to counter some forms of harmful tax competition. Second, since a country may believe that taxing its residents in a way that

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[322] In general, the various *black lists* differentiate among countries where:
- there is an income tax, but its rate is too low if compared to the rate of the country that has issued the black list;
- there is an income tax, but some types of companies are exempted from it;
- there is an income tax, but it is levied only on profits generated in their territory, while the profits whose source is abroad are exempted.

[323] For an analysis of the main issues related to the enactment and implementation of exit and departure taxes, please see RAMMELOO, S., CORPORATIONS IN PRIVATE INTERNATIONAL LAW: A EUROPEAN PERSPECTIVE (Oxford: Oxford University Press, 2001), Chap. 4, Part II. See also GARCIA-RIESTRA, M., *The transfer of seat of the European company v Free establishment case-law*, EUROPEAN BUSINESS LAW REVIEW (2004), 1295-1323; DRURY, R.R., *The regulation and recognition of foreign corporations: The 'Delaware syndrome'*, 57(1) CAMBRIDGE LAW JOURNAL (1998), 165-194 and *Migrating companies*, 24(4)EUROPEAN LAW REVIEW 24(4) (1999), 354-372; and EBKE, W.F., *The 'Real Seat' Doctrine in the Conflict of Corporate Laws*, 36 INTERNATIONAL LAWYER (2002), 1015-1037.

[324] It is interesting to highlight that the European Court of Justice, being required to pronounce itself on the compatibility of the Dutch *exit tax*, pointed out that such type of regulation does not constitute an obstacle to the freedom of establishment. See ECJ C-470/04, better known as *N* case. See VAN DEN HURK H., KORVING J., *The ECJ's Judgment in the N Case against the Netherlands and its Consequences for Exit Taxes in the European Union*, 61(4) BULLETIN FOR INTERNATIONAL TAXATION 2007, 150-158.

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neutralises the benefits they get from certain tax haven policies will put them in a competitive disadvantage should its action not be followed by other countries provisions, it is highly probable that the mentioned State will pursue a *lasseiz faire* policy instead of a true anti-tax haven policy. Third, the necessity of monitoring all forms of harmful tax competition and enforce countermeasures necessarily imposes significant administrative costs on countries adversely affected by such competition. Fourth, uncoordinated unilateral measures may increase compliance costs on taxpayers.

For the aforesaid reasons, in the last years, most developed countries have shifted to an internationally coordinated and cooperative approach to the fight against harmful tax competition.[325] The forthcoming description of the process towards the establishment of common policies to fight harmful tax competition is extremely important and illustrative for the purpose of our work, since it confirms the insight according to which the supranational design and implementation of tax policies, rather than implying a loss of nation states' tax sovereignty, must be considered as a new way to effectively exercise it (in regard to both its revenue-raising and regulatory functions) in consideration of the international issues and problems posed by globalization. As the following paragraphs will show, such multilateral policy-making activity aimed at the establishment of a general duty to comply with global community standards as the only practical way to effectively preserve each country sovereign prerogative to structure its own tax system in the way it considers as the most appropriate to its social, economic and political scenario.

III.1.3.1 The UE Code of Conduct

The first relevant initiative seriously aimed at an internationally coordinated action plan to curb harmful tax competition was taken by the Economic and Financial Affairs

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[325] See OECD, HARMFUL TAX COMPETITION: AN EMERGING GLOBAL ISSUE, (Paris: OECD, 1998), 37-38.

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Council of the European Union, which, on 1 December 1997, approved the Code of Conduct for Business Taxation,[326] with the purpose of providing disincentives for member States willing to adopt fiscal measures that could influence the location of business activities within the territory of the Union.

The Council, when adopting the Code, acknowledged the positive effects of fair competition, which can indeed be beneficial. Mindful of this, the Code was specifically designed to detect only such measures which unduly affect the location of business activity in the Community by being targeted merely at non-residents and by providing them with a more favourable tax treatment than that which is generally available in the Member State concerned.[327]

The Code of Conduct is not a legally binding act, but it belongs to the category of the so-called soft law. It requires Member States to abstain from introducing any new harmful tax measures and amend any laws or practices that are deemed to be harmful in respect of the principles of the Code itself. Within the scope of the Code are all those tax measures (legislative, regulatory and administrative) which have, or may have, a significant impact on the location of business in the Union.

The Code set the criteria for identifying potentially harmful measures, which include:

- an effective level of taxation which is significantly lower than the general level of taxation in the country concerned;
- tax benefits reserved for non-residents;
- tax incentives for activities which are isolated from the domestic economy and therefore have no
  impact on the national tax base;

[326] See ECOFIN, *Conclusion of the Ecofin meeting on 1 December 1997 concerning tax policy*, in OFFICIAL JOURNAL OF THE EUROPEAN COMMUNITIES, 6.1.98, C.2/1, Brussels.
[327] See TERRA, B.J.M., WATTEL, P.J., EUROPEAN TAX LAW, (London: Walters Kluwer International, 1997), 112.

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- granting of tax advantages even in the absence of any real economic activity;
- the basis of profit determination for companies in a multinational group departs from internationally accepted rules, in particular those approved by the OECD;
- lack of transparency.

In addition, in 1998, the European Council established the Code of Conduct Group, in charge of assessing the tax measures that may fall within the scope of the Code of Conduct in regard to business taxation.

In a report of November 1999 the Group identified 66 tax measures with harmful features (40 in EU Member States, 3 in Gibraltar and 23 in dependent or associated territories) and in the subsequent years other practisec were added to the list.[328]

Since then, the Code of Conduct Group has been monitoring standstill and the implementation of rollback and reported regularly to the Council. In order to guarantee a proper and effective implementation of the Code of Conduct, the European Commission issues a periodic report to the Ecofin.[329]

III.1.3.2 The 1998 OECD Report

The above-described Code of Conduct expressed – at a European level – a broader international need for the establishment and implementation of common policies aimed at avoiding the erosion of the national tax bases carried out through preferential tax regimes and preserving the progressivity of their tax systems.

At a global level, developed countries have tried to satisfy this need within the framework of an international organization, that is, the Organization for Economic Co-operation and Development (hereinafter, OECD). In Summer 1996, an OECD Ministerial

[328] EU COUNCIL, CODE OF CONDUCT GROUP'S REPORT, November 23, 1999, available at http://ec.europa.eu/taxation_customs/resources/documents/primarolo_en.pdf (retrieved from January 2014).
[329] PANAYI, C.H.J.I., *Corporate mobility in the European Union and Exit Taxes*, BULLETIN FOR INTERNATIONAL TAXATION, (2009), 459-473.

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Communiqué', indeed, called upon the organization to study and develop measures to curb the distorting effects of harmful tax competition on investment and financing decisions and their consequences for national tax bases and progressivity of the tax systems.[330] A few weeks later, in September 1996, the G7 Ministers also invested the OECD of the task to analyse the issue of harmful tax competition and formulate proposals for the contrast of it.[331]

Two years later, on 9 April 1998 the OECD's Council approved the report *Harmful Tax Competition: An Emerging global Issue*.[332] The analysis conducted by the OECD was mainly focused on "*geographically mobile activities, such as financial and other service activities*",[333] that is, those assets which can be easily transferred from a jurisdiction to another one. In line with our insight about the fact that the shift to a supranational development of tax policies does not imply a reduction of tax sovereignty but is, instead, a new necessary way of preserving and exercising it, the OECD itself, in the Report, expressly premised that *"[c]ountries should remain free to design their own tax systems as long as they abide to internationally accepted standards*".[334]

In the OECD Report two types of harmful practices are identified: tax havens and harmful preferential tax regimes. The report then discussed "harmful tax practices". Essentially, according to the OECD, harmful tax practices exist when tax regimes are tailored to erode the tax bases of other countries. This can occur when tax regimes attract investment or savings originating elsewhere, and when they facilitate the avoidance of other countries' taxes. The report distinguished the two types of practices.

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330 COUNCIL OF THE OECD, *Ministerial Communiqué*, OECD OBSERVER, June/July 1996, at 1, IV.
[331] Statement of G7 Finance Ministers and Central Bank Governors (Sept 20, 1996).
[332] OECD, Committee on Fiscal Affairs, HARMFUL TAX COMPETITION: AN EMERGING GLOBAL ISSUE, (Paris: OECD, 1998).
[333] OECD, HARMFUL TAX COMPETITION, *supra*, 8.
[334] OECD, HARMFUL TAX COMPETITION, *supra*, 15.

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The key factors to identify *tax havens* are the following:

a) no or merely nominal taxation on the relevant income;
b) lack of policies for effective exchange of information with other countries' tax authorities;
c) lack of transparency of the jurisdiction's financial service regime;
d) the absence of a requirement that the activity be substantial.

The key factors to identify preferential tax regimes are the following:

a) no or merely nominal taxation on the relevant income
b) lack of policies for effective exchange of information with other countries' tax authorities;
c) the tax system is "ring-fenced" from the domestic economy – i.e., the low tax rates offered to the foreign investors do not apply to residents' income;
d) lack of transparency of the jurisdiction's financial service regime;

Although some criteria for identifying both practices are similar, specific provisions vary enough to allow a jurisdiction to be classified as either a tax haven[335] or a harmful preferential tax regime.[336]

But besides the description and the analysis of the harmful competitive practices and their consequences, the Report contains the Recommendations, which constitute the guidelines for the achievement of the ultimate goal of the OECD work, that is, the coordinated contrast to harmful tax competition practices. Such Recommendations are,

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[335] OECD, HARMFUL TAX COMPETITION, *supra*, 22-23.
[336] OECD, *id*, at 26. See JAMES, V., *Twenty-first Century Pirates of the Caribbean: How the Organization for Economic Cooperation and Development Robbed Fourteen Caricom Countries of their Tax and Economic Policy Sovereignty*, in 34 INTERAMERICAN LAW REVIEW (2002), 1.

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indeed, based on the OECD awareness of the scarce effectiveness of unilateral and even bilateral measures carried out until 1998, and contain proposals for amendments of the already existing domestic measures and bilateral agreements and for the development of stronger international cooperation based on multilateral agreements involving the largest possible number of countries. The Recommendations can be divided into three main categories:

- recommendations concerning internal tax legislations and practices;
- recommendations concerning international double taxation agreements;
- recommendations aimed at intensifying international cooperation against harmful fiscal competition.

The first group of Recommendations aimed at improving the effectiveness of the already existing domestic tax measures, in particular the CFC regulations, the transfer pricing and participation exemption rules. The second group of Recommendations essentially aimed at improving the implementation of the rules contained in international agreements by increasing the exchange of information between countries' tax authorities and making the conditions to benefit from the advantages (in terms of tax credits) provided by such conventions stricter. The third group of Recommendations aimed at making all the principles affirmed in the Report effective and implementing the guidelines set out in the Report.

In order to comply with the Recommendations, a specific Forum, today known as *Global Forum on transparency and Exchange of Information*, was established and charged with the identification of those jurisdictions which constitute tax havens in light of the above illustrated factors and the analysis of the effectiveness of counteracting measures. In addition, the Global Forum was also in charge with the preparation of new guidelines and proposals.[337]

[337] OECD, HARMFUL TAX COMPETITION: AN EMERGING GLOBAL ISSUE, (Paris: OECD, 1998), 54 (qualifying the Forum as a subsidiary body, created to focus on remedial work against harmful tax competition).

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III.1.3.3 The OECD standard of transparency and exchange of information

The conclusions reached in the 1998 OECD Report were confirmed and further developed in the 2000 OECD Report entitled *Toward Global Tax Co-operation, Progressing in Identifying and Eliminating Harmful Tax Practice*, whose main innovation was the inclusion of a list of OECD and non-OECD countries whose tax regimes had to be considered harmful or potentially harmful in terms of improper tax competition.[338]

This list was compiled following an extensive study carried out by experts appointed by the OECD countries gathered in the *Global Forum on transparency and Exchange of Information*, and issued after a thorough dialogue with the concerned jurisdictions.[339] Thirty-five jurisdictions were initially identified: Andorra, Anguilla, Antigua and Barbuda, Netherlands Antilles, Aruba, Bahamas, Bahrain, Barbados, Belize, British Virgin Islands, Cook Islands, Dominica, Gibraltar, Grenada, Guernsey, Isle of Man, Jersey, Liberia, Liechtenstein, Maldives, Marshall Islands, Mauritius, Monaco, Montserrat, Niue, Panama, Samoa, Seychelles, Saint Kitts and Nevis, Saint Lucia, Saint Vincent and the Grenadines, Tonga, Turks and Caicos Islands, Vanuatu, US Virgin Islands.[340]

In the Report it was stated that if these countries had not modified their tax regimes by the end of 2001, "defensive measures" would have been taken collectively against them by the OECD countries.[341] However, despite this apparently strict "ultimatum", the OECD conduct was in practice much more conciliatory. Indeed, the deadline was postponed to February 2002 and the identified jurisdictions, instead of being asked to directly eliminate any harmful tax measure, were given another opportunity to make just

[338] OECD, TOWARD GLOBAL TAX CO-OPERATION, PROGRESSING IN IDENTIFYING AND ELIMINATING HARMFUL TAX PRACTICE, (Paris: OECD, 2000).

[339] All the jurisdictions were invited to Paris to discuss the experts' preliminary findings and only when the majority of jurisdictions had in fact done so, the OECD reached its conclusions and drew up the final list. In addition, the OECD gave all the jurisdictions the opportunity to make a commitment to the OECD to end tax practices that were classified as harmful. Only six of the concerned jurisdictions took the plunge: Bermuda, the Cayman Islands, Cyprus, Malta, Mauritius and San Marino. These six were therefore not included in the initial list of tax havens.

[340] OECD, TOWARD GLOBAL TAX CO-OPERATION, *supra*, *(2000)*, 17.

[341] CHRISTIANS, A., *Sovereignty, Taxation and Social Contract*, 18 MINN. J., INT'L L. (2009) 9, fn. 65, 118.

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a commitment to temporally satisfy the requests put forward by the non-tax heaven countries. After making the commitment, the jurisdiction could be granted additional time and then decide whether to cooperate or not with the OECD to reach a general agreement on which to base subsequent negotiations. This inclusive and cooperative approach adopted by the OECD materialized in bilateral and multilateral confrontations with the vast majority of the countries included in the 2000 list and was confirmed in the 2001 OECD Report.[342]

A general consensus was reached that the jurisdictions' commitment be focused on transparency and effective exchange of information. With regard to transparency, it is commonly recognized that this condition is not fulfilled when a jurisdiction grants the possibility of obtaining, through simple tax rulings, more favourable fiscal treatments than those ordinary provided. Another criterion to assess a jurisdiction's level of transparency is represented by the existence of the legal obligation to draw up the accounting books according to the internationally accepted accounting standards (Generally Accepted Accounting Principles, GAAP) as well as the obligation to certify and file the balance sheets with the local financial authorities. Moreover, in order to fulfil these conditions, the local authorities must demonstrate that they are in the position to obtain at any moment, the relevant information on the companies' ownership, as well as any banking information.

The second requirement on which the commitment has to be focused is represented by the possibility of an effective exchange of information. As already mentioned, secrecy and non-disclosure of taxpayers' information play a pivotal role in attracting capital to tax havens and facilitating tax evasion on earnings from passive investments by foreign individuals and companies. Therefore, commitment by "cooperative tax havens" for effective exchange of information became the main goal of the OECD in contrasting harmful tax competition.

[342] OECD, PROJECT ON HARMFUL TAX PRACTICE: THE 2001 PROGRESS REPORT, (Paris: OECD, 2001).

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As a result of confrontations, many countries initially included in the OECD tax havens-list officially committed themselves to curbing their harmful tax practices by respecting the aforesaid standards of transparency and exchange of information. Between 2000 and 2002, twenty-five declarations of intent had been delivered to the OECD, which, in consideration of these commitments decided to remove such jurisdictions them from the list of *Unco-operative Tax Havens*. As a result, in 2003, only five countries were identified in the OECD list: Andorra, Liberia, Liechtenstein, Marshall Islands and Monaco.[343]

III.1.3.4 The issuance of the Model Agreement on Exchange of Information on Tax Matters

In an attempt to have the concerned jurisdictions not only commit themselves to the standards of transparency and exchange of information but also effectively implement them, the OECD decided to focus its work on the development of a common "*model vehicle for exchange of information which would require a multilateral framework (...) for consultation with cooperative jurisdictions, on exchange of information*".[344] For this purpose, on June 2000, the OECD Committee on Fiscal Affairs entrusted an *ad hoc* Special Project Team. Out of this group, a much smaller OECD delegation was selected attend negotiations with the concerned jurisdictions' delegates within another group known as the *Global Forum Working Group on Effective Exchange of Information*, which consisted of an equal number of representatives of OECD and non-OECD countries.[345]

After several meetings and consultations, in April 2002 the Global Forum finally approved the *Model Agreement on Exchange of Information on Tax Matters*, which has been drafted in both a bilateral and a multilateral version. The Model contains the OECD

[343] OECD, PROJECT ON HARMFUL TAX PRACTICE: THE 2004 PROGRESS REPORT, (Paris: OECD, 2004).
[344] OECD, Committee on Fiscal Affairs, TOWARD TAX GLOBAL TAX COOPERATION: PROGRESS IN IDENTIFYING AND ELIMINATING HARMFUL TAX PRACTICES, (Paris: OECD, 2000), 26.
[345] The non-OECD countries were Aruba, Bermuda, Bahrain, Cayman Islands, Cyprus, Isle of Man, Malta, Mauritius, the Netherlands Antilles, the Seychelles and San Marino.

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main standards of transparency on which the international cooperation aimed at eliminating harmful tax measures should be based. It is driven by the following principles:

- the exchange of information is not spontaneous or automatic, but it is only upon request, that is, the information on a taxpayer can be provided only if the other State's Authorities expressly ask for them;[346]
- the requested State cannot refuse to provide information solely on the grounds that it does not need the information for its own tax purposes;[347]
- the requested State must provide the information even if the conduct under investigation is not considered as illegal under its laws;
- the information may concern:
    a) relations between the taxpayer and the requested State's financial institutions (i.e. bank accounts, fiduciary registrations etc.);
    b) information regarding the ownership of companies, trusts' beneficiaries, settlors and protectors and interposed third parties (except those that would give rise to disproportionate difficulties);
- the exchange of information must be respectful of the taxpayers' rights;[348]
- the information exchanged must be kept strictly confidential.

The Model Agreement consists of three parts. The first is a general introduction setting out the basic concepts and terms. The second part consists of the articles, with the

[346] In this respect, the Model Agreement is narrower than other instruments, such as the Joint OECD/Council of Europe Convention on Mutual Administrative Assistance in Tax Matters and the EU Directive on Mutual Assistance in Tax Matters. It is also narrower than the practice under the Art. 26 provisions (Exchange of Information) of most Double Taxation bilateral treaties, which typically include spontaneous and/or automatic exchange of information.
[347] This has subsequently been reflected in Article 26 (Exchange of Information) of the OECD and UN Model Tax Conventions, which previously allowed a country to refuse a request for exchange of information if the information would not be obtainable in the normal course of tax administration.
[348] The OECD reports state that an essential element to be considered in the arrangement of international agreements is the provision that all information exchanged must be used only for the scope for which they have been requested.

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multilateral version presented alongside the bilateral version. The third part is a detailed article-by-article Commentary.

The Model represents a crucial instrument above all with regard to the bank secrecy, which, as already illustrated, is the other important advantage of investing in a tax haven jurisdiction and makes it extremely difficult for residence States' tax authorities to access relevant information concerning their taxpayers' income. It is worth highlighting that the unlike the original version, the Model Agreement (as amended in 2005) expressly lifts bank secrecy not only for criminal tax matters but also for ordinary tax investigations.[349] Whether or not something is a criminal tax matter depends on the definition provided in Art. 4 of the Model, which refers to the law of the Applicant State. Strictly speaking, this definition also requires the conduct to be intentional.[350]

The approval of the *Model Agreement on Exchange of Information on Tax Matters* unquestionably represented a great step forward in the creation of a fair tax competition and, as a consequence, in the protection of nation states' tax sovereignty with regard to both its revenue-raising and regulatory functions. Indeed, as illustrated in the previous paragraph, it established common rules and procedures aimed at enabling nation states to obtain all the necessary information for the proper determination of their taxpayers income and therefore to avoid a decrease in both revenue and progressivity of their tax system.

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[349] Art. 5(4): "*Each Contracting Party shall ensure that its competent authorities for the purposes specified in Article 1 of the Agreement, have the authority to obtain and provide upon request:*
a) information held by banks, other financial institutions, and any person acting in an agency or fiduciary capacity including nominees and trustees;..."
[350] *Art. 4(1):*"*For the purposes of this Agreement, unless otherwise defined:*
[a).....
b).....
......]
o) the term "criminal tax matters" means tax matters involving intentional conduct which is liable to prosecution under the criminal laws of the applicant Party;
p) the term " criminal laws" means all criminal laws designated as such under domestic law irrespective of whether contained in the tax laws, the criminal code or other statutes". See BARNARD, J., *Former Tax Havens Prepared to Lift Bank Secrecy*, in IBFD BULLETIN – TAX TREATY MONITOR, January 2003, 11.

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Nevertheless, the reality showed that a fair tax competition was still far from being achieved. Indeed, since, as already explained, a simple press release stating their commitment to effective exchange of information and transparency (and not actually signing an agreement) was considered enough to have a jurisdiction removed from the OECD's list of uncooperative tax havens, most countries were able to continue their harmfully competitive tax policies without concretely signing any exchange of information agreements and therefore they had absolutely no incentives to do it.[351] This is the main reason why from 2002 to 2006 only a few exchange of information agreements (just seven) were signed and, above all, none of the countries endowed with a preferential tax regime was involved.[352]

III.1.3.5 The financial and economic crisis as a renewed stimulus to an effective implementation of the OECD standards

Starting from the beginning of 2008, the trend changed. In particular, due to the financial crisis and the consequent decrease in tax revenue, the G20 governments heavily focused their attention on the issues of international tax evasion, bank secrecy and the real implementation of high standard of transparency and exchange of information. The "war to tax havens" was put on the agenda of the G20 Summits held in Washington, London and Pittsburgh.[353] After the meeting held in Washington on November 2008 where the strategies to cope with the financial crisis were discussed, the G20 leaders identified fight to international tax evasion as a priority and issued a common press release stating that there was unanimous consensus on the need for a collective action against non-

[351] By early August 2004, only five jurisdictions (Andorra, Liberia, Liechtenstein, the Marshall Islands and Monaco) remained in the *black list* issued by the OECD which at the beginning included more than thirty countries. Moreover, it was noted that tax haven commitment were conditional upon the OECD countries making equivalent commitments (or else being subject to defensive measures) and that the OECD countries, as explained in the previous paragraph, focus the content of the Model Agreement only on exchange of information for geographically mobile services, that is, not for interest paid to individuals. See EASSON, A., *Harmful Tax Competition: An Evaluation of the OECD Initiative*, in TAX NOTES INTERNATIONAL, June 2004, 1071.
[352] Most of the agreement signed in this period involved the United States.
[353] Available at http://www.whitehouse.gov/the-press-office/g-20-toronto-summit-declaration

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cooperative jurisdictions.[354] Moreover, the G20 leaders expressly referred to the standards developed by the OECD as a benchmark for the levels of transparency and exchange of information to reach in international fiscal relations and they also expressly asked the OECD to "*continue efforts to promote tax information exchange*" because "*lack of transparency and a failure to exchange tax information should be vigorously addressed*".[355]

According to this request, the OECD immediately started working on the issuance of a new list based on stricter criteria than the previous *black list*. Indeed, in addition to indicating the jurisdictions which had not committed to its standards, the new list, better known as *Progress Report*, set forth and highlighted also those countries which have not yet substantially implemented their commitment, those which instead partially have done so and their respective number of exchange of information agreement signed. The reason for this change is that such a more detailed list gives "*a complete picture of all countries' ability to exchange information to the standard*".[356]

According to the Progress Report's "reading guide", provided by the OECD in its 2009 Report (*Tax Co-operation 2009: Towards a level playing field*), a country is considered to have substantially implemented the standards of transparency and exchange of information if it has signed agreements that provide for exchange of information with at least 12 OECD countries.[357] Such a proved being successful from the very beginning. Indeed, many surveyed countries, concerned about the consequences of being listed in the Progress Report as non-compliant with the OECD standards, officially entered the Global Forum (i.e. Malaysia and Philippines, which were not member yet, like) and declared

[354] G20 Declaration of the Summit on Financial Markets and the World Economy, Washington D.C. 15 November 2008

[355] G20 Declaration of the Summit on Financial Markets and the World Economy, Washington D.C. 15 November 2008.

[356] OECD, TAX CO-OPERATION 2009: TOWARDS A LEVEL PLAYING FIELD, (Paris: OECD, 2009), 21.

[357] This benchmark was agreed in November 2008 by the OECD *Global Forum on transparency and Exchange of Information* as an appropriating dividing line.

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their availability to start cooperating with the OECD just before the official submission of the Progress Report to the G20 meeting of 2 April 2009.[358]

When the list was published for the first time, just four countries (Costa Rica, Malaysia, Philippines and Uruguay) were classified as jurisdictions which had not committed to the internationally agreed standards.[359] These four jurisdictions, however, committed to implement the OECD standards few days later. Thanks to the pressure arising from the G20 and the G8,[360] progress toward full effective exchange of information continued during all 2009: as highlighted by the OECD, in one year "*has been made more than in the past decade*".[361] Indeed, not only the OECD standards of transparency and exchange of information have been universally endorsed, so that none of the surveyed countries is currently indicated in the Progress Report as a "*jurisdiction that have not committed to the internationally agreed tax standard*" but they have also been implemented. Up to November 2013, over 1,500 bilateral agreements for the exchange of information have been concluded, and the large majority of them have been signed by jurisdictions which had previously been identified by the OECD as not substantially implementing the standard in the Progress Report published on 2 April 2009.[362]

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[358] In particular, Switzerland, Austria, Belgium, Luxemburg, Andorra, Lichtenstein, Monaco withdrew their reservation to the OECD rules on the exchange of (bank) information and declared that since then they would have started negotiations with their treaty partners to update, by the conclusion of specific protocols, their existing Double Taxation treaties, including the new Art. 26 of the OECD *Double Taxation Model Agreement*, which, as modified in 2006, substantially reproduce the main contents of the OECD *Model Agreement on Exchange of Information on Tax Matters*.

[359] See OECD, A PROGRESS REPORT ON THE JURISDICTIONS SURVEYED BY THE OECD GLOBAL FORUM IN IMPLEMENTING THE INTERNATIONALLY AGREED TAX STANDARD, 2nd, (Paris: OECD, 2009), available at http://www.oecd.org/ctp/42497950.pdf (retrieved on January 2014).

[360] For instance, in July 2009, the G8 Governments urged "*all Countries that have not yet fully implemented the OECD standards of transparency and effective exchange of information in tax matters to do so without further delay*" and encouraged the OECD "*to strengthen its work on tax evasion and report back in 2010*". See G8 and G20 joint final statement at the end of the Hokkaido Toyako Summit, available at http://www.mofa.go.jp/policy/economy/summit/2008/doc/doc080709_01_en.html

[361] OECD, PROMOTING TRANSPARENCY AND EXCHANGE OF INFORMATION FOR TAX PURPOSES: A BACKGROUND INFORMATION BRIEF, (Paris: OECD February 2010), 2.

[362] OECD Global Forum on Transparency and Exchange of Information, TAX TRANSPARENCY 2013, (Paris: OECD, 2013), 30.

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To better monitor the actual implementation of effective exchange of information, the Global Forum on Transparency and Exchange of Information for Tax Purpose decided, at its Mexico meeting on 1- 2 September 2009, to renew its structure and its membership. Currently, the Global Forum includes delegates of all G20 members, all OECD countries and all offshore jurisdictions and has a three-year mandate to peer review all the members and other jurisdictions which may require particular attention.[363] The peer reviews encompasses two phases: Phase 1 is dedicated to review the legal and regulatory frameworks while Phase 2 is aimed at assessing the practical implementation of the standards[364]. As of November 2013, 100 jurisdictions have been reviewed, fifty of which have completed both Phase 1 and Phase 2.[365] Out of these, eighteen jurisdictions are rated *Compliant* with the OECD standards, twenty-six jurisdictions are rated *Largely Compliant*, two jurisdictions are rated *Partially Compliant* and four jurisdictions are rated *Non-Compliant*. Fourteen additional jurisdictions [v] were not given compliance ratings, pending further improvements to their legal and regulatory frameworks for exchange of information in tax matters.[366]

III.1.4 Conclusions

In the sections above, the main passages of the development and implementation, at the supranational level, of tax policy standards aimed at contrasting harmful tax

[363] In 2012, the mandate was renewed for another three years.
[364] OECD, PROMOTING TRANSPARENCY AND EXCHANGE OF INFORMATION FOR TAX PURPOSES: A BACKGROUND INFORMATION BRIEF, (Paris: OECD, February 2010), 3.
[365] OECD GLOBAL FORUM ON TRANSPARENCY AND EXCHANGE OF INFORMATION, TAX TRANSPARENCY 2013, *supra*, 30.
[366] Members of the OECD Global Forum on Transparency and Exchange of Information for Tax Purposes have continued to steps towards the achievement of full cooperation among nation states. In particular, during the last Global Forum Meeting in Jakarta, they officially declared their commitment to the Establishment of a new Automatic Exchange of Information (AEOI). See, OECD GLOBAL FORUM ON TRANSPARENCY AND EXCHANGE OF INFORMATION FOR TAX PURPOSES, Final statement, Jakarta meeting, 21-22 November 2013. Available at http://www.oecd.org/tax/transparency/ENG% 20Jakarta% 20Statement% 20of% 20Outcomes.pdf (retrieve from December 2013).

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competition between countries have been described. Such policies represent the most illustrative example of how economic globalization has changed the concept and the nature of tax sovereignty. The amplification of harmfully competitive tax practices conducted by some jurisdictions at expenses of others, boosted by economic globalization, has posed serious obstacles to the traditional exercise of both the functions of tax sovereignty - the revenue-raising function and the regulatory function. After attempting to cope with it through unilateral measures, nation states realized that the only effective way to counter harmful tax competition is to cooperate with each other to set common strategies and policies under the coordination of an international body, the OECD.

As already stated at the beginning of this chapter, such a shift to a supranational design and implementation of regulatory tax policies should not be read as a reduction or a loss in national tax sovereignty. It is instead a new way of exercising and protecting the latter consistently with the change in the reality of international relationships due to economic globalization. As the analysis above demonstrated, in fact, the policy standards devised within the OECD framework have been aimed at preserving, on one hand, the national tax bases and tax revenue – that is, the revenue-raising function of tax sovereignty - but, on the other hand, also the progressivity of national tax systems, one of the main public policy achievements of the regulatory use of the taxing power by nation states.

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III.2 THE BEPS PHENOMENON

III.2.1 The Rise of Multinational Enterprises and the "double non-taxation" issue

Another issue related to economic globalization is the phenomenon of the so-called "base erosion and profit shifting" (hereinafter "BEPS", which is also how it is referred to within the international tax community). The phenomenon is the result of multinational enterprises´ tax planning which legally exploits the opportunities for minimizing taxes by taking advantage of the gaps and the inconsistencies under the current international tax system.

Beginning in the 1920s, the largest part of international tax policy-making and regulations has been focused on avoiding double-taxation on income arising from international and cross-border activities. This was due to the fact that double taxation constitutes an additional non-economic cost which may alter and therefore distort investment and location decisions. Thus, individuals and legal entities operating and deriving income at the international level, supported by tax scholars and experts, correctly required governments to cooperate with each other and structure their domestic tax systems and international treaties in a way that prevents international double taxation. This cooperative effort resulted in significant improvements, so that, today, double taxation represents a very minimal concern for international investors and enterprises.

However, the recent developments of economic globalization show that another issue, as important as double taxation, has been disregarded for too long and urges for coordinated actions by national governments, namely "double non-taxation". Indeed, while - due to the above-mentioned coordinated efforts made by national governments in the last decades - not much risk of double taxation remains within the current international tax panorama, now the interaction between the various domestic tax rules and between the domestic tax rules and tax treaty rules gives rise to gaps which may

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result in very low or no tax on certain items of income.

As already pointed out in this work, today´s economic environment is characterized by an unprecedented economic integration across borders. Such economic integration has been recently bolstered by the increasing development and importance of the digital economy, of intangibles and of new communication technologies. In light of this, it is today possible to do business and be heavily involved in the economic life of another country without being considered to have a taxable presence in that country or in the country of residence, or in any other country which imposes a tax on the type of income derived by such economic activity. Such a result can be achieved through hybrid mismatch arrangements,[367] transfer pricing policies regarding intangibles,[368] intra-group financial transactions[369] and other arbitrage techniques, all of which are not in violation of the law but merely exploit arbitrage opportunities offered by asymmetries in the interface between the various domestic tax systems and also between the latter and tax treaty rules.

Among taxpayers, those who have taken the advantage of such arbitrage opportunities the most are certainly the multinational enterprises (MNEs) - that is, those enterprises operating at a global-scale and through which the largest part of cross-border economic activities are carried out. Due to their structure, consisting of companies and branches stretching to many different countries, MNEs, indeed, are more easily able to

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[367] The most common hybrid mismatch arrangements are represented by the misuse of foreign tax credit and participation exemption regimes, the creation of deductions without corresponding income inclusions, or multiple deductions for one borrowing. OECD, ACTION PLAN ON BASE EROSION AND PROFIT SHIFTING, (Paris: OECD. 2013), 19-20, available at http://www.oecd.org/ctp/BEPSActionPlan.pdf (retrieved on January 2014).

[368] Indeed, MNEs have been able to shift significant parts of their income through fictitious transfers of intangibles for prices below their full value or the contractual allocations of risk to low-tax jurisdictions. OECD, ACTION PLAN ON BASE EROSION AND PROFIT SHIFTING, *supra*, 19-20.

[369] As highlighted by the OECD, "*another issue raising BEPS concerns is excessive deductible payments such as interest and other financial payments. The deductibility of interest expense can give rise to double non-taxation in both the inbound and outbound investment scenarios. From an inbound perspective, the concern regarding interest expense deduction is primarily with lending from a related entity that benefits from a low-tax regime, to create excessive interest deductions for the issuer without a corresponding interest income inclusion by the holder. The result is that the interest payments are deducted against the taxable profits of the operating companies while the interest income is taxed favorably or not at all at the level of the recipient, and sometimes the group as a whole may have little or no external debt. From an outbound perspective, a company may use debt to finance the production of exempt or deferred income, thereby claiming a current deduction for interest expense while deferring or exempting the related income*". OECD, ACTION PLAN ON BASE EROSION AND PROFIT SHIFTING, *supra*, 20.

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shift the location of profits and costs according to the most favorable tax conditions offered by various countries' tax systems.

It is difficult to estimate the size of the BEPS phenomenon illustrated above, but experts agree that BEPS will be at the core of the international tax debate in the next few years. As requested by the G20 finance ministers, the OECD first issued a report in which the main features of the BEPS phenomenon are illustrated,[370] and then released its *Action Plan on Base Erosion and Profit Shifting*,[371] in which it identified the pressure areas related to the BEPS issue and set the agenda for concrete development and implementation of coordinated solutions.

III.2.2 The Revitalization of Corporate Income Tax's Regulatory Function

However, what is most for important for purposes of this work is not the substantial analysis of the various MNEs' tax planning strategies giving rise to the BEPS issue or the potential solutions to BEPS as sought by the OECD and also by scholars. Our attention is rather focused on analyzing the underlying reasons justifying such increasing engagement of governments and international organization in dealing with the BEPS issue.

In its first OECD report on the topic, it is dramatically stated that "*what is at stake is the integrity of the corporate income tax*",[372] and therefore "*there is value and necessity in providing an internationally co-ordinated approach*".[373] But why the protection of the "integrity of the corporate income tax" is so critical for national governments to induce them to come together and engage in negotiations and discussions to achieve a new

[370] OECD, ADDRESSING BASE EROSION AND PROFIT SHIFTING, (OECD: Paris, 2013), available at http://www.oecd-ilibrary.org/taxation/addressing-base-erosion-and-profit-shifting_9789264192744-en (tretrieved on January 2014)
[371] OECD, ACTION PLAN ON BASE EROSION AND PROFIT SHIFTING, *supra*.
[372] OECD, ADDRESSING BASE EROSION AND PROFIT SHIFTING, *supra*, 8.
[373] OECD, ADDRESSING BASE EROSION AND PROFIT SHIFTING, *supra*, 9.

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dimension of coordinated international tax rules which certainly will imply concessions, compromises and constraints in terms of freedom to design investment-attracting tax policies?

In the official statements and reports of the OECD and the G20, as well as in most scholarly literature, it appears that the reason why the corporate income tax's integrity is worth being protected through internationally-coordinated measures against the BEPS strategies is the revenue loss arising from the latter.[374] Nevertheless, a deeper analysis shows that the revenue-loss argument officially advanced may not entirely justify such a deployment of resources.

As the OECD itself noted in its report, the revenue currently collected through the corporate income tax, on average, is around 10% of the total tax revenue.[375] This is certainly a substantial share of revenue but at the same time it gives an idea of the limited importance of revenue losses, in absolute and relative terms, arising from MNEs arbitraging behaviors in the BEPS category, which logically amounts to a very few percentage points. Therefore, engaging in the action plan proposed by the OECD in order to avoid a few percentage points of revenue losses which could be easily compensated through the increase of other existing direct or indirect taxes, would not be worthwhile, unless other intrinsic justifications support such new international commitment.

And, in fact, some authoritative academics correctly point out that regulatory reasons also lie at the foundation of the need to preserve the integrity of the corporate income tax. These scholars point out that the rise of MNEs as a result of globalization poses problems which are analogous to those created, between the nineteenth and the 20th century, by the rise of large corporations as a result of nation states' industrialization and which justified the introduction of the corporate income tax, as illustrated in Chapter 2.[376] In particular, it has been highlighted that MNEs today, like national large

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[374]OECD, ACTION PLAN ON BASE EROSION AND PROFIT SHIFTING, *supra*, 10.
[375] OECD, ADDRESSING BASE EROSION AND PROFIT SHIFTING, *supra*, 15.
[376] AVI-YONAH, R., *Corporations, Society, and the State: A Defense of the Corporate Tax*, 90(5) VA. L. REV. (2004): 1193-255, 1196 and 1244-45; *Three Goals of Taxation*, 60 Tax Law Review 1, (2006-2007), 18.

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corporations in the past, are able to accumulate enormous economic and financial wealth, and at the same time evade government controls and exercise a significant power and influence in national economies and politics.[377] Such situation, obviously, poses risks for the proper functioning of democracy and for equality, and therefore, it makes those regulatory goals which were historically at the basis of the adoption of the corporate income tax – the achievement of supervisory control over corporations and the avoidance of excessive concentration of power and wealth – still applicable.

Therefore, what emerges from the considerations above is that the internationally-coordinated effort for a joint response to the BEPS issue also serves the function of protecting the regulatory goals which are historically inherent to the genesis of the corporate income tax and which are still applicable today by the rise of MNEs. Under this perspective, such recent initiatives and the future internationally-coordinated actions which will be taken within the OECD framework, also fall within the category of the regulatory tax policy measures designed and undertaken at a supra-national or multi-national level and which, rather than representing a loss of national tax sovereignty, should be qualified as a coordinated exercise of the latter aimed at the maintenance and the protection of full national state sovereignty from issues whose nature is global. As highlighted by Professor Avi-Yonah, "*the rise of MNEs has significantly weakened the regulatory power of the state since MNEs by definition operate across jurisdictions and can set one jurisdiction off against another. Taxation is one vehicle of regulation and an area in which extraterritorial jurisdiction is well established in international law. Therefore, it offers a promising venue to regulate MNEs*".[378]

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[377] AVI-YONAH, R., *Corporations, Society, and the State: A Defense of the Corporate Tax*, *supra*, 1244-45; BLUMBERG, P., THE MULTINATIONAL CHALLENGE TO CORPORATION LAW (New York: Oxford University Press, 1993); VERNON, R., IN THE HURRICANE EYE: THE TROUBLED PROSPECTS OF MULTINATIONAL ENTERPRISES (Cambridge, MA: Harvard University Press, 1998).

[378] AVI-YONAH, R., *Corporations, Society, and the State: A Defense of the Corporate Tax*, *supra*, 1245.

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III.2.3 Conclusions

The analysis conducted in the sections above confirms that nation states are becoming increasingly aware that, in the current age of globalization characterized by a pervasive economic integration and interdependence, national tax sovereignty must be conceived "*as not exclusive but reciprocally conjunctive*".[379] This means that the preservation of national tax sovereignty, and in turn of complete state sovereignty necessarily implies the duty to establish and comply with global community tax policy standards. The global community tax policy standards, therefore, rather than constituting impairments to nation states' tax sovereignty, provide a necessary instrument to exercise tax sovereignty effectively. As highlighted by a tax scholar, in the current global environment "*non-compliance with community standards by some nations has been identified as the main contributor to a global environment of tax evasion and a critical erosion of every nation's ability to implement their sovereign right to tax*".[380]

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[379] CHRISTIANS, A., *Sovereignty, Taxation and Social Contract,* 18 MINN. J., INT'L L. (2009) 99, 108.
[380] CHRISTIANS, A., *supra*, 111-12.

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III.3 MAKING THE FINANCIAL SECTOR "BEHAVE": THE ROLE OF TAXATION

III.3.1 The Recent Financial Crisis and the Need for a Coordinated Response: A Tax Approach

The recent economic crisis - which hit the economies of most developed countries and provoked the enactment of significant government bailouts whose burdens have been borne indiscriminately by all taxpayers - was preceded by the financial turmoil which began in the United States migrated to many European countries later. Therefore, the crisis focused the attention of policy-makers and scholars on the systemic risks and negative externalities which can be generated, at an international level, by certain conduct adopted by operators of the most globalized economic sector, that is, indeed, the financial industry (together with the digital industry). In particular, one lesson from the crisis has been that the globalization of the financial markets gave rise to the current scenario in which each single national economy is entirely dependent on variables whose triggering factors and consequences cannot be confined and controlled within national borders. This, in turn, results in the impairment of the traditional capability of national government to unilaterally regulate and control their economy and the social consequences of the economic events, and, thus, weakens one of the three elements of state sovereignty, that is, the power to govern and ultimately to establish and maintain a given economic and social order within a specific territory (see Introduction).

Consequently, governments and international organizations of the countries hit by such phenomenon have increasingly focused on the study and the achievement of new and more efficient internationally coordinated responses and strategies aimed at preventing international financial turmoil from occurring again. On this path, efforts have been made not only for the issuance of new and more sophisticated international direct regulations and standards for the financial industry (for example, amendments to the

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Basel regulation), but also – and most importantly for the purposes of this work - for the design and the adoption of globally-coordinated regulatory tax policies. With specific regard to the latter, such initiatives have been initially pursued and designed within international forums and organizations like the G-20 Group and the International Monetary Fund (IMF) and resulted in official proposals subsequently discussed at the political level.

Although, as it will be illustrated, such first proposals have not met the consensus necessary to actually be adopted, they certainly contributed to credit regulatory tax measures as serious alternatives or complementary tools to correct, at an international level, certain behaviors adopted within the financial industry. The subsequent proposals advanced in both Europe and the United States for the enactment of regulatory financial taxes confirm this fact. The various models of regulatory financial tax policies discussed by policy-makers and scholars and the concrete proposals advanced by the IMF, the European Union Commission and United States' government will be analytically discussed in the following sections.

But, for the purposes of this work, the ultimate lesson which can be learned from the analysis of such proposals is that this new emphasis on the use of tax policy for international regulation of the financial sector confirms the pivotal role it can play for the purposes of maintaining and exercising national state sovereignty in its new globalized dimension.

III.3.2 The Financial Sector's Responsibility in the Creation of the Crisis and the International Tax Debate

The financial sector played a decisive role in the creation of the financial turmoil - and therefore in the subsequent economic crisis - based on the two following elements:

- The paramount role played by the financial institutions in creating the crisis; and
- The current under-taxation of financial institutions in comparison to other sectors.

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The first element – the attribution of the responsibility for the crisis to the financial sector - can be seen, in turn, as the undeniable result of the combination of three types of conducts generally adopted by the financial institutions:

- The engagement in excessively risky hazarding and short-term financial speculation;
- The financing of their activities with too little equity capital; and
- A structure of compensation awarded to their employees that provided incentives for excessive risk-taking.[381]

The second element - the under-taxation of financial institutions - is the consequence of well-known features of the tax systems of the countries in which the financial institutions carry on their business.[382] These include:

- The exemption of most financial services from the value added taxes;
- The deductibility of debt interest, as opposed to the cost of equity capital;
- The ability to deduct bad loan reserves;
- The ability to defer tax on interest earned abroad;
- The ability to acquire other banks and use their losses to offset future income.
- Loopholes in the anti-avoidance rules designed to mitigate the movement of financial institutions' income to jurisdictions characterized by a lower or non-existing taxation.

In light of these considerations, the G-20 leaders, at the end of the Pittsburgh Summit (2009), asked the International Monetary Fund (IMF) to prepare a report for their next meeting, on June 2010, "*with regard to the range of options countries have adopted or are considering as to how the financial sector could make a fair and substantial*

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[381] DEVEREUX, M., FUEST, C., MAFFINI, G., *Taxing Banks: A Briefing Note*, Centre for Business Taxation, Oxford University, April 20, 2010, 1. Available at http://www.sbs.ox.ac.uk/centres/tax/conferences/Pages/TaxingBanks.aspx (retrieved on March 2012).

[382] AVI-YONAH, R., *Taxation as Regulation: Carbon Tax, Health Care Tax, Bank Tax and Other Regulatory Taxes*, August 2010, PUBLIC LAW AND LEGAL THEORY WORKING PAPER SERIES, UNIVERSITY OF MICHIGAN LAW SCHOOL, 8. Available at: http://ssrn.com/abstract=1664045 (retrieved on January 2014).

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contribution toward paying for any burden associated with government interventions to repair the banking system."[383]

In April of 2010, this request was subsequently integrated by the G20 finance ministers and central banks governors when they called for the IMF to engage in "*further work on options to ensure domestic financial institutions bear the burden of any extraordinary government interventions where they occur, address their excessive risk-taking and help promote a level playing field, taking into consideration individual country's circumstances*".[384]

The IMF subsequently issued its report on June 2010. The IMF, after describing the various measures already adopted at the domestic level by various countries and indicating 'backward-looking' charges – such as one based on the balance sheet variables at the beginning of the crisis - as the least distortionary way to recover the fiscal cost of the bailouts for past, proposed the adoption of two globally-coordinated taxes on financial institutions aimed at preventing and addressing future financial failures.[385]

Despite these efforts, the Toronto Summit, which was held on June 26-27, 2010, clearly demonstrated the inability of the G20 leaders to reach an agreement on whether and how to create a globally-coordinated taxation of the financial sector. The main reasons for this failure had already been announced by the G20 ministers of finance and central bank governors after the preparatory meeting they had in Busan, South Korea, on June 5, 2010. At this meeting, the divide was clear: while Europeans and Americans – strongly affected by the financial crisis and by the burdens of the bailouts – pushed for the adoption of a globally-coordinated taxation, other countries - which had not been particularly affected by the crisis – were against the imposition of a new tax on their

[383] G20 Leaders', *Final Statement*, *A Framework for Strong, Sustainable, and Balanced Growth*, par. 16. The Pittsburgh Summit, September 24-25, 2009. Available at: http://www.cfr.org/world/g20-leaders-final-statement-pittsburgh-summit-framework-strong-sustainable-balanced-growth/p20299 (retrieved on July 2012).
[384] G20, *Communiqué, Meeting of Finance Ministers and Central Bank Governors*, Washington D.C., April 23, 2010. Available at: http://www.g20.utoronto.ca/ministerials.html#2010 (retrieved on July 2012).
[385] STAFF OF THE INTERNATIONAL MONETARY FUND, *A Fair and Substantial Contribution by the Financial Sector: Final Report for the G-20*, (Washington D.C.: IMF, June 2010). The IMF proposals will be discussed in 5.1.

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domestic banks, which had not benefitted from any government aid, and were rather in favor of the maintenance of the traditional regulatory measures.[386] These contrasting views were insurmountable and, at the end of the Toronto Summit, the G20 leaders "*recognized that there are a range of policy approaches to this end. Some countries are pursuing a financial levy. Other countries are pursuing different approaches*".[387] In addition, considerations of competitiveness between countries in attracting capitals and investments may also have played a decisive role in the failure to reach an agreement. Some countries may have been interested in becoming a 'financial tax haven' to attract financial institutions, at the expenses of other countries, relying on the belief that the latter, in the absence of an international agreement, would still implement a new domestic tax on the institutions established within their territories.[388] In the United States, indeed, the Obama Administration had already advanced, in January 2010, its unilateral proposal for the implementation of a national liability-based levy on large financial institutions.[389]

Since the Summit, the debate on the establishment and implementation of a new tax on the financial sector has evolved separately in both the European Union and the United States. In both places, the debate has currently been dominated by official government proposals on the table along with the comments and observations of academics, relevant organizations and lobbyists and has centered on the appropriateness

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[386] See "World finance ministers rule out global bank tax", France 24, June 5, 2010, available at http://www.france24.com/en/20100605-G20-bank-bailouts-public-debt-budget-tax-south-korea-summit. This situation is indirectly supported by the final joint statement of the Busan meeting, in which it is explained that the G20 ministers of finance and central bank governors agreed to develop common strategies "*taking into account individual country's circumstances and options*". See G20, Communiqué, Meeting of Finance Ministers and Central Bank Governors, Busan, Republic of Korea, June 5, 2010, p. 2. Available at http://www.g20.utoronto.ca/ministerials.html#2010 (retrieved on July 2012).

[387] G20, Toronto Summit Declaration, June 26-27, 2010, 5. Available at http://www.g20.utoronto.ca/2010/to-communique.html.

[388] This type of scenario already manifested in 1998, when the OECD failed to enforce its tax harmonization plan due to the unwillingness of certain jurisdictions to renounce the opportunity to attract investors from high-tax countries by offering them a lower level of taxation. See PAGE, R., *Foolish Revenge or Shrewd Regulation? Financial-Industry Tax Law Reforms Proposed in the Wake of the Financial Crisis*, 85 TULANE LAW REVIEW (2010) 191-214, 207.

[389] This proposal will be discussed in par. 3.7.2..

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of a tax on the financial sector as well as the goals, efficiency/efficacy, impact and administrative feasibility of such a tax

Before analyzing the EU and the US proposals, as well as the IMF proposals, the next sections will review the theoretical goals and standard models within the study of financial tax as it has been developed by scholars. Indeed, only a clear understanding of the theoretical consequences and functioning of the different types of financial taxes can allow for a reasoned evaluation of the pros and cons of the proposals formulated by governments and policy makers. Such an analysis will also help understand the reasons why different governments support different forms of financial taxes. Different types of taxes lead to different consequences and thus it is extremely important to verify that policy-makers adopt the appropriate tax that corresponds with the goal they are seeking. As highlighted by the EU Commission, the choice of one type of tax over the other "*is essentially a trade-off among the different objectives pursued*".[390]

III.3.3 Goals of a Financial Tax

The policy objectives of a new tax on the financial sector have been expressly discussed in public statements, legislative proposals and explanatory memoranda. As we will see, while there is consensus on certain broad objectives, there is considerable disagreement on others. This is mostly due, as it will be illustrated in III.3.5, to different approaches to the regulatory role of taxation and its relationship with traditional regulation. However, the various objectives of financial taxation as stated by its advocates can be reduced to three general goals.

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[390] EUROPEAN COMMISSION. 2011a. *Commission Staff Working Paper: Executive Summary of the Impact Assessment, accompanying the document, Proposal for a Council Directive on a common system of financial transaction tax and amending Directive 2008/7/EC*, 28 September, 6.

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III.3.3.1 Raising revenue

The first goal raised by proponents of the new tax on the financial sector is to raise additional revenue.[391] This revenue will be used to offset the cost of the past government bailouts and to reduce the high fiscal deficit of most OECD countries (which has increased as a result of bailouts as well as the recession that was caused by the financial crisis).

As illustrated in the Introduction, fairness concerns justify this goal. While the responsibility for the occurrence of the crisis is largely imputed to the financial sector's behavior, the revenue used to bailout the largest financial institutions - and those sectors of the so-called real economy that the financial crisis affected (consider, for example, the large funding provided by the US government to the American auto industry) - was collected through the taxes paid by all taxpayers, a general category which certainly cannot be blamed as responsible for the crisis. Additionally, the financial sector has exploited many tax privileges, including the exemption of most financial services from the value added tax in Europe, the deductibility of the payment of debt interest as opposed to the cost-of-equity, the ability to deduct bad loan reserves, to defer tax on interest earned abroad, to acquire other banks and use their losses to offset future income, to exploit loopholes in the anti-avoidance rules aiming to mitigate the movement of financial institutions' income to jurisdictions with lower or non-existing taxation.[392] Thus, the financial institutions are largely ripe for an increase in their tax liability.[393]

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[391] DEVEREUX, M., FUEST, C., MAFFINI, G., *Taxing Banks: A Briefing Note*, Centre for Business Taxation, Oxford University, April 20, 2010, 1. Available at http://www.sbs.ox.ac.uk/centres/tax/conferences/Pages/TaxingBanks.aspx (retrieved on March 2012); SHAVIRO, D., *The Financial Transaction Tax Versus (?) the Financial Activities Tax*, March 2012, LAW AND ECONOMICS RESEARCH SERIES, NEW YORK UNIVERSITY, 21-22.

[392] AVI-YONAH, R., *Taxation as Regulation: Carbon Tax, Health Care Tax, Bank Tax and Other Regulatory Taxes*, , PUBLIC LAW AND LEGAL THEORY WORKING PAPER SERIES, UNIVERSITY OF MICHIGAN LAW SCHOOL (August 2010). Available at: http://ssrn.com/abstract=1664045. SHAVIRO, D., *supra*, 27.

[393] This sentiment is well expressed by the words of President Obama, in announcing his Administration's proposal for a levy on financial institutions (discussed in 5.2.2). He emphasized his "*commitment is to recover every single dime the American people are owed*," and said his "*determination to achieve this goal is only heightened when I see reports of massive profits and obscene bonuses at the very firms who owe their continued existence to the American people*", see THE WHITE HOUSE, President Obama Proposes Financial Crisis Responsibility Fee to Recoup Every

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III.3.3.2 Discouraging excessive risk-taking

The second goal often discussed by many proponents of a new tax on the financial sector is discouraging and curtailing risk-taking behaviors.[394] As mentioned in the introduction, three types of conduct generally adopted by banks and other financial institutions have been blamed, with various degrees of intensity and with important distinctions, for triggering the financial and economic crisis and relate to risk-taking behavior:

- *Engaging in excessive, speculative and short-term financial trading* (mainly in the derivative markets) which is likely to destabilize the prices of the underlying assets and commodities, causing prices and risk levels to diverge from their fair value.[395]
- *Maintaining an excessively high debt-to-equity ratio* which increases the risk of bankruptcy and default. This risk increases because of the obligation to make regular payments to creditors and the inherent risk of default where there is only a relatively small amount of equity capital to fulfill such obligations.[396] Another issue, which is indirectly related and partially consequent to the excessively high leveraging of financial institution, is the *excessive size* of the institutions, which may amplify the so-called macro-prudential negative externalities generated by the

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Last Penny for American Taxpayers, available at: http://www.whitehouse.gov/the-press-office/president-obama-proposes-financial-crisis-responsibility-feerecoup-every-last-penn. .[393] Similarly, Columbia University Jeffrey Sachs, in manifesting his support for a financial transactions tax (whose features are discussed in 3.2), claimed that such a tax would properly burden a financial sector that was "*under-taxed*," "*out of control*," and was enjoying huge profits - even during the financial crisis - at the expense of the general public. "*Bankers* – he concluded - *are brazenly smirking as they pocket large amounts of our money*", see Larry Elliott, "Sachs calls for Robin Hood tax on 'smirking' Wall Street," guardian.co.uk, March 9, 2010, available at http://www.guardian.co.uk/business/2010/mar/09/jeffrey-sachs-robin-hood-tax.

[394] DEVEREUX, M., FUEST, C., MAFFINI, G., *supra*, 2. SHAVIRO, D., *supra*, 26.

[395] Although, as will be analyzed in 3.2.2, others make the argument that, in modern financial markets, high transaction volumes reflect the liquidity necessary for price discovery and, therefore facilitate the movements of asset prices towards their fundamental equilibrium. See SCHULMEISTER, S., *A General Financial Transaction Tax: A Short Cut of the Pros, the Cons and a Proposal*, WIFO WORKING PAPERS N. 3454, 4. available at attp://ssrn.com/abstract=17714336

[396] See PAGE, R., *supra*, 191-214, 208, according to which "There is a general consensus that high debt-to-equity ratio contributed to the Crisis". See also DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2011 REVENUE PROPOSAL 29-30 (2010), http://www.treas.gov/offices/taxpolicy/library/greenbk10.pdf

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financial sector.[397] In particular, policy-makers and academics often warn about the domino effect that the failure of one large institution can have on other institutions or clients. The presence of large financial institutions can indeed exponentially increase the risk of 'contagious' defaults arising from the natural interconnectedness of the financial institutions. In such cases, as explained by the IMF, "*so severe are the costs of their failure that financial markets will typically expect governments to support these institutions to avoid further consequences. This leads to (additional) moral hazard in the form of taking on more risks', and shifting risks and costs to the public sector*".[398]

- *Structuring compensation* for bank employees that incentivizes positive short-term performance by providing high bonuses connected to positive performance, in addition to base salary.[399] This incentive structure does not typically include high penalties for bad performances. The bonuses, then, strongly incentivize employees to make investments with a high-margin of profitability, which, at the same time, are extremely high risk. Moreover, as some research during and after the financial crisis has reflected, a large part of the profits for which the institutions paid performance-based bonuses to their employees were '*merely booking revenues*.'[400]

[397] STAFF OF THE INTERNATIONAL MONETARY FUND, *A Fair and Substantial Contribution by the Financial Sector*, *supra*, 48-49.
[398] Staff of the International Monetary Fund, *id.*, 49.
[399] Bonuses are usually provided in the form of stock options and other stock-based compensation. This is true because such compensation is traditionally subject to more favorable tax treatment compared to cash compensation. See ALWORTH, J. S., ARACHI, G., *Introduction*, in TAXATION AND THE FINANCIAL CRISIS, (ALWORTH, J. S., ARACHI, G. EDS.), (Oxford: Oxford University Press, 2012), 9.
[400] Ben Chu, *Bank Bonuses: No Rhyme, Reason or Justification,* The Independent*, Jan 25, 2011. http://blogs.independent.co.uk/2011/01/*25/bank-bonuses-no-rhyme-reason-or-justification/.

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III.3.3.3 Building an insurance fund available for future crisis management

The third goal often advanced by proponents of a new tax on financial institutions is to create an insurance-like system in the event of defaults or a new systemic crisis.[401] In particular, if designed and imposed in accordance with certain criteria, certain taxes, just like insurance premiums, would be susceptible to vary according to the probability and the size of default and would provide the necessary resources for creating a dedicated fund available to finance future crisis management without taking money from the general revenue.

It is worth mentioning that providing an explicit insurance fund raises questions of *moral hazard*: the awareness of being insured may lead institutions to engage in riskier investments. On the other side, it has been pointed out that the significant bailouts recently provided by the governments contributed to the development of the idea, among institutions' managers, that they are implicitly insured. This would lead to an even worse type of moral hazard, because it would not be covered by a fund built in advance with money provided by the institutions themselves.[402]

III.3.4 Standard Models of Financial Taxation

Keeping in mind the three main goals pursued by the proponents of a new tax on financial institutions, we can now proceed to examine the basic models of such taxes as discussed by academics, experts and policy makers, which provide the basis for actual government proposals. Through this analysis, we can determine which of the types of taxes lead to which of the goals listed above and, therefore, which goals are supported by the proposals formulated by the IMF and submitted to the G-20 leaders and those currently debated in the US and in the EU.

[401] DEVEREUX, M., FUEST, C., MAFFINI, G., *supra*, 2.
[402] DEVEREUX, M., FUEST, C., MAFFINI, G., *supra*, 2.

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We can divide the various taxes on the financial sector that will be analyzed into three different macro-categories:

- Taxes on institutions;
- Taxes on transactions; and
- Taxes on bonuses.

III.3.4.1 Taxes on institutions

By 'taxes on institutions' we refer to those taxes which utilize balance sheets positions or the profits of the financial institutions as a basis for taxation.[403] Two types of financial taxes are included in this category:

- The excess profits tax; and
- The levy on liabilities or, alternatively, on risky assets.

III.3.4.1.1 The excess profits tax

The so-called excess profit tax is a special tax levied on profits above a standard level, commonly referred to as 'economic rent' or 'supernormal profit'.[404] Excess profits taxes are imposed in addition to any corporate income tax already in place and have historically been implemented during national emergencies like wars.[405]

[403] CORTEZ, B., VOGEL, T., *A Financial Transaction Tax for Europe*, 2011 EC TAX REVIEW 1, 16-29, 18.
[404] DEVEREUX, M., FUEST, C., MAFFINI, G., *supra*, 3. See also ALWORTH, J. S., ARACHI, G., *supra*, 15.
[405] The first implementation of an excess profits tax in the US was between 1917 and 1921 during the First World War. It was revived by federal legislation during World War II and during the Korean War. The tax was levied on the excess of a corporation's peacetime earnings at a rate set by the government.

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In particular, these taxes are implemented to increase revenue during periods of distress and to prevent corporations from unduly benefitting from atypical consumer purchasing or increased government spending during 'periods of distress'.

In certain delicate periods, policy-makers have also considered imposing an excess profit tax on specific private industries. For instance, during the 1980s the price of a barrel of crude oil went above a certain specified threshold due to the exercise of oligopolistic pricing power by the members of the Organization of Petroleum Exporting Countries, and gave rise to a sharp increase in domestic oil production income. The US legislator was convinced that oil producers were obtaining excess profits as a result of the situation and therefore enacted, for a period of time, an excess profit tax which is commonly referred to as 'windfall profits tax'.[406] In England, the government imposed an excess profit tax on banks in the 1981 Budget to counteract the sharp increase in interest rates caused by new monetary policies.

In light of the history of the excess profit tax, it is no surprise that academics and policy-makers have recently considered the adoption of an excess profits tax on financial institutions. Proponents of such a measure advocate only for an excess profit tax on the profits of financial institutions that are above the 'normal' rate of return for finance companies.[407] This 'normal' profit rate is defined by the interest due for debt finance and a notional return for equity finance.

Supporters of this tax tend to highlight two elements:

- Its *ability to generate a significant amount of revenue* (the proposed tax rates range between two and 5%); and
- Its *neutrality*, since it would be imposed on what companies aim to maximize (profits after allowing for a minimum return to the financial investors) and it

[406] *Crude Oil Windfall Profit Tax Act of 1980*, Pub. L. No. 96-223, 94 Stat. 229 et seq. (Apr. 2, 1980). DRAPKIN, D.B., VERLEGER, P. K. JR, *The Windfall Profit Tax: Origins, Development Implications*, (1981) 22 (4) BOSTON COLLEGE LAW REVIEW (1981), 631-704.
[407] DAVEREUX, M., *New bank taxes, New World Order?*, TAX ADVISER (2010), 12, 13.

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would have no effect on the institutions' behavior and therefore would not provoke any kind of market distortions.[408]

However, the selection of the criteria for the calculation of the notional rate of return of equity capital and the identification of a proper authority to make such a determination are critical.[409] It, indeed, raises issues similar to those associated with the transfer pricing policies, which involve finding the proper 'comparables', that is, financial institutions with identical or nearly identical features in terms of size, fees charged, and the type, amount and frequency of transactions. Such comparative research requires significant administrative effort and a high compliance burden, which may affect the administrative feasibility of the tax.

III.3.4.1.2 Levies on balance sheet positions

The second type of tax on institutions is represented by a levy characterized by a broad balance sheet base. The balance sheet base could be determined, alternatively, by the *risk-weighted assets* of the institution or by its *liabilities*. As the description of their features and functions will show in the two following paragraphs, the risky asset-based levy and the liability-based levy are two sides of the same coin. They are imposed on different bases - different elements within the balance sheet - but they are essentially aimed at reaching the same results: providing incentives to financial institutions to engage in less risky activities (i.e. the acquisition of too many high-risk assets and/or high leveraging) and to reduce their size and consequently their contribution to a future systemic crisis. Moreover, because of the intrinsic correlation between tax liability of the institutions and their contribution to systemic risk, the tax levy – based either on risky assets or liabilities – is the most suitable tax to function as an insurance policy, creating a

[408] DEVEREUX, M., FUEST, C., MAFFINI, G., *supra*, 3.
[409] CORTEZ, B., VOGEL, T., *supra*, 19.

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fund in case of future crisis.[410] Additionally, as the IMF suggests, maintaining a levy, even when the fund is built up, to feed general revenues would preserve its beneficial corrective impact on the behavior of financial institutions.[411]

- *Risky Asset-Based levy*

A risky-asset based levy is justified by the fact that one of the main reasons for the recent crisis was the engagement of banks and other financial institutions in high risk-taking investments. Therefore, a tax whose burden increases as the proportion of risky assets held by the institution increases will discourage high risk-taking policies. As suggested by the IMF, the levy should be imposed on level 2 and level 3 trading assets.[412] Adopting such a levy would also facilitate coordination on a global level and reduce the costs of compliance from cross-border institutions, as the definitions of level 2 and level 3 trading assets are defined internationally by the Basel capital requirements and the methodology for determining what constitutes a risk-weighted asset.

It has also been pointed out, however, that such a levy is susceptible to raise the risk of duplicating the effects of regulations also targeted at reducing the amount of risky assets held by financial institutions (e.g. Basel Committee capital requirement).[413]

In general, such a tax is potentially consistent with all three of the possible goals described above. Besides discouraging the acquisition of riskier forms of assets, as just mentioned, it would indeed also raise a significant amount of revenue and would be also consistent with the typical insurance mechanism – the higher the risk of default (commensurate with the amount of risky assets), the higher the insurance premium (in effect, the tax burden).[414]

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[410] STAFF OF THE INTERNATIONAL MONETARY FUND, *supra*, 15.
[411] STAFF OF THE INTERNATIONAL MONETARY FUND, *supra*, 15.
[412] STAFF OF THE INTERNATIONAL MONETARY FUND, *supra*, 17.
[413] STAFF OF THE INTERNATIONAL MONETARY FUND, *supra*, 17.
[414] DEVEREUX, M., FUEST, C., MAFFINI, G., *supra*, 4.

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- *Liability-Based levy*

The liability-based levy finds its roots, instead, in the attempt to provide incentives to reduce the financial institutions' excessive leverage. Highly leveraged financial institutions, as discussed in *III.3.3.2*, are generally regarded as one of the most significant threats to the stability of the financial sector.

Research suggests that the base of the tax should include uninsured liabilities and should exclude tier 1 capital and insured liabilities.[415] The exclusion of the tier 1 capital from the tax base is necessary in order not to discourage equity capital accumulation. Insured liabilities are excluded from the tax base in order to avoid a sort of double imposition where the institution is required to pay the levy in addition to the insurance premiums. Moreover, they represent stable sources of funding for the institutions, since they are covered by deposit insurance and are previously subject to assessment.[416] Finally, since insured liabilities are, by definition, supposed to be risk-free, taxing them would be contrary to the concept of making the institutions' tax liability proportionate to their contribution to systemic risk and potential cost of their default. [417] For the same reason, the IMF has asserted that "*the rate of the liability-based levy should be refined over time to reflect explicitly systemic risk*".[418]

It is worth mentioning that a levy with a narrower base has been also proposed. In particular, the base should include only short-term liabilities. Such a proposal is premised on the assumption that most of the problems at the root of the recent financial crisis arose from financial institutions' reliance on short-term uninsured funding. Therefore, its main goal is not to reduce the leverage in general, but rather to make banks and other institutions "internalize the negative systemic effects of fragile funding strategies".[419] It has been pointed out, nevertheless, that such a narrower base may increase the risk of

[415] STAFF OF THE INTERNATIONAL MONETARY FUND, *supra*, 17; PAGE R., *supra*.
[416] WHITE HOUSE, *Financial Crisis Responsibility Fee Fact Sheet*, available at *www.whitehouse.gov/.../financial_responsibility_fee_fact_sheet.pdf.*
[417] STAFF OF THE INTERNATIONAL MONETARY FUND, *supra*, 17.
[418] STAFF OF THE INTERNATIONAL MONETARY FUND, *id.*, 26.
[419] PEROTTI, E., SUAREZ, J., *Liquidity Risk Charges as a Macroprudential Tool*, 40 CEPR POLICY INSIGHT (2009), 3.

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arbitrage, evasion and, most important, may introduce distortionary effects in terms of economic efficiency resulting from investment decisions that change exclusively due to tax reasons.[420]

III.3.4.2 Taxing financial transactions

III.3.4.2.1 Definition and history

As the name suggests, a tax on financial transactions – generally referred to as the financial transactions tax or simply 'FTT' – is not a levy on financial institutions per se; it is, instead, a charge on specific transactions, which are previously designated as taxable by the legislator. More precisely, a tax on financial transactions is a tax which "*is intended to apply to purchases and sales of financial instruments as well as other types of financial transactions that may not technically constitute a purchase or sale (e.g., various types of derivatives) but have a similar effect. As such, a tax on financial transactions can be levied on one, a few, or a broad range of instruments – including stocks, fixed income securities, derivatives, and foreign exchange*".[421]

The first, authoritative, proponent of the implementation of a financial transaction tax was the economist John Maynard Keynes. Keynes claimed that short-term speculation over enterprises by means of financial instruments trading, like speculation carried out in Wall Street during the 1930s, could affect the price of the underlying assets and push them away from their fundamental equilibrium values, with negative impacts on the real economy and employment. In order to deal with this phenomenon, Keynes proposed "*the introduction of a substantial government transfer tax on all transactions (which) might provoke the most serviceable reform available, with a view of mitigating the*

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[420] See STAFF OF THE INTERNATIONAL MONETARY FUND, *supra*, 17.
[421] BRONDOLO, J. D., *Taxing Financial Transaction: An Assessment of Administrative Feasibility*, (IMF Working Paper, Washington D.C.: 2011), 3.

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predominance of speculation over enterprises".[422] According to this proposal, the tax should have been imposed on transactions in the stock market (not every financial transaction in every market).[423]

More than forty years later, the idea of a financial transaction tax was revived by James Tobin after the break-down of the Bretton Woods system for stabilizing currencies in the early 1970s. In that context, Tobin advanced the proposal for a global uniform tax at a very low rate on all currency exchanges. According to Tobin, this tax would have been particularly effective at deterring "*short-term financial round-trip excursions into another currency*" and therefore reducing currency market volatility.[424] Such a global uniform tax was never implemented, but since then the introduction of a financial transaction tax has become a heavily debated and researched issue. Some countries have even enacted their own transaction taxes, although all of them were limited to the domestic transactions and not coordinated in any way.[425]

Beginning in the 1980s, the liberalization of financial markets and financial innovations, in particular derivatives instruments, provoked a boom in trading activity (that is, 'liquidity') characterized by the predominance of short-term speculation which, in turn, gave rise to wide fluctuations of asset prices (that is, 'volatility') not just in the short-run but also in the medium and long run. Nevertheless, economic policies of the various countries have not tried to mitigate these price swings. In fact, many transaction taxes that had been enacted during the previous years were repealed.[426] This mainly was due to the fact that said liberalization and globalization of markets inevitably made it

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[422] KEYNES, J. M., THE GENERAL THEORY OF EMPLOYMENT, INTEREST AND MONEY, (London: MacMillan, 1936), 160.
[423] *Id.*
[424] TOBIN, J., *Proposal for International Monetary Reform*, 4 EASTERN ECONOMIC JOURNAL (1978), 153-59, 155.
[425] SCHULMEISTER, S., SCHRATZENSTALLER, M., PICEK, O., *A General Financial Transaction Tax. Motives, Revenues, Feasibility and Effects*, OSTERREICHISCHES INSTITUT FUR WIRTSCHAFTSFORSDCHUNg, March 2008. Available at: http:ssrn.com/abstract=1714395, 4.
[426] In particular, financial transaction taxes were eliminated in the United States (turnover tax on federal level, 1966), Spain (1988), the Netherlands (transfer tax 1990, capital duty 2006), Germany (security tax, 1965), Sweden (transfer tax 1991), Denmark (capital duty 1993, transfer tax 1999), Japan (1999), Austria (securities tax 1995, stock exchange turnover tax 2000), Italy (capital duty 2000), Ireland (2005), Belgium (2006). See SCHULMEISTER, S., SCHRATZENSTALLER, M., PICEK, O., *supra*., 4.

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much easier to relocate transactions among different markets. Thus, competition between markets intensified and led to the elimination of most barriers to trading activities, including financial transaction taxes, in order to attract investments.[427]

A renewed interest by policy-makers in the debate over the financial transaction tax was spurred by the last crisis (2008-2010) and the European Commission has officially proposed the adoption of a tax which would apply to all transactions in which a European-based institution is involved. The proposal is currently being discussed at the highest political levels in Europe and will be analyzed in III.3.7.1.

III.3.4.2.2 Goals

As explained above, the main goal of the implementation of a financial transaction tax is to *reduce market volatility* and stabilize assets' price. The current proposals for a financial transaction tax are indeed premised on the assumption that modern financial markets – more or less like the 1930s markets Keynes referred to in his original proposal - are characterized by an excessive trading activity (i.e. liquidity) due to the high volume of short-term speculation, which gives rise to "long swings in asset prices and, hence, persistent deviation from their fundamental equilibrium" (i.e. long-term volatility).[428] The financial transactions tax would reduce the short-term liquidity by imposing an additional transaction cost on each trade – it would impact the short-term liquidity rather than the medium and long-term liquidity because the more frequently transactions occur, the higher the cumulated effect of an FTT; this would, in turn, reduce the volatility of both the short and long-term asset prices and positively affects the overall macroeconomic performance. [429]

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[427] SCHULMEISTER, S., SCHRATZENSTALLER, M., PICEK, O., *supra*, 4.
[428] SCHULMEISTER, S., *A General Financial Transaction Tax: a Short Cut of the Pros, the Cons and a Proposal*, 3. Available at: http://ssrn.com/abstract=1714336
[429] SCHULMEISTER, S., SCHRATZENSTALLER, M., PICEK, O., *supra*.

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If characterized by a wide scope, a financial transaction tax, even if levied at a very low rate (as its proponents suggest – see the following paragraph), may raise a significant amount of *revenue*.[430] Nevertheless, the availability of such revenue may be subject to a substantial degree of instability and uncertainty due to the risk of 'substitution' and 'relocation', as described in *III.3.4.2.4*.

Finally, even though the revenue raised by a financial transactions tax could, theoretically, be used to create an *insurance fund*, the features of such a tax make it a less stable means for the creation of an insurance-like system. Indeed, since it is imposed on the transactions rather than on the institutions, its burden is not suitable to clearly reflect the contribution of the single institutions to the systemic risk (in terms of risk-taking, leverage and size).

III.3.4.2.3 Criticisms

It is, however, highly debated whether such a tax would in fact reduce volatility. Some scholars, indeed, argue that there is empirical evidence that suggests that such a tax has little effect on volatility.[431] Proponents of the financial transaction tax reply that, on the contrary, it has already proved to be effective, if properly designed, and cite the UK experience as an example of successful implementation of the FTT (the UK experience will be described, in comparison with the unsuccessful Swedish experience, in III.3.7.1.1).[432]

But the principal criticism often brought by opponents of such a tax is that reducing short-term volatility is not, by itself, a good aim. According to this view, rather

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[430] ALWORTH, J. S., ARACHI, G., *supra*, 20.

[431] As highlighted by ALWORTH & ARACHI, *supra*, 20: "*the various empirical studies fail to detect a strong relationship between an increase in transaction costs (via either taxes or other means) and the functioning of markets. Most studies find that trade volume is reduced, but the effects on volatility and prices are less clear, even though results based on panel data and estimation approaches that better identify transaction cost effects seem to find unexpectedly a positive relationship between transaction costs and volatility*". See also DEVEREUX, M., FUEST, C., MAFFINI, G., *supra*, 5.

[432] SCHULMEISTER, S., SCHRATZENSTALLER, M., PICEK, O., *supra*.

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than acting as a destabilizing market force, high trading volumes in modern financial markets are crucial for the price discovery and for driving asset prices toward their fundamental equilibrium. In addition, it is claimed that much of short-term trading is related to hedging and, therefore, risk management.[433] More moderate opponents to the adoption of a financial transaction tax admit that even though it "*may reduce activity by 'noise traders' who trade on spurious information such as past price movements and are thought to destabilize markets [….] it may also suppress activity by informed traders and arbitrageurs, whose trading tends to push prices towards their fundamental values*".[434] Unfortunately, "*absent the ability to thus discriminate {between good and bad trading}, it is hard to be sure whether the tax has a greater discouraging effect on the "good" trading or the "bad*".[435]

Proponents of the financial transaction tax emphasize, instead, that "*there is a remarkable discrepancy between the levels of financial transactions and the levels of the 'underlying' transactions in the 'real world'* [which] *suggests that financial markets are currently characterized by excessive liquidity and by excessive long-run volatility of prices*".[436] In particular, they point out that "*the volume of financial transactions in the global economy is 73.5 times higher than nominal world GDP".*[437] This being so, it is not conceivable that this spectacular rise in trading is caused by hedging or genuine price discovery.

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[433] SCHULMEISTER, S., *A General Financial Transaction Tax*, *supra*, 4.
[434] MATHESON, T., *Taxing Financial Transactions: Issues and Evidence*, IMF WORKING PAPER No. 11/54 (Washington D.C.: International Monetary Fund, 2011).
[435] SHAVIRO, D., *The Financial Transaction Tax Versus (?) the Financial Activities Tax*, LAW AND ECONOMICS RESEARCH SERIES, NEW YORK UNIVERSITY, (2012), 26.
[436] See SCHULMEISTER, S., SCHRATZENSTALLER, M., *supra*, 43-44.
[437] See SCHULMEISTER, S., *supra*, 5.

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III.3.4.2.4 Scope, rate, and potential distortionary effects: risks of 'substitution', 'relocation' and capital cost increases

Defining the scope and the rate at which to apply a financial transactions tax in a way that it reduces the ('bad') volatility but at the same time does not discourage the 'good' trading activity is an extremely complicated and sophisticated task.[438]

In regard to the *scope*, such a tax can apply to transactions of all kinds or only to certain specific transactions (e.g. only to transactions involving shares, corporate bonds, derivatives, or currencies). Most academics suggest the broadest possible scope, since - as we will see also in the discussion of the financial transactions tax proposed by the European Commission - a financial transaction tax involves a significant *risk of 'substitution'*.[439] A tax that is imposed only on specific markets may indeed create distortionary effects, since it may induce a shift of investments from one type of instruments to another solely for tax reasons, and therefore produce economically inefficient outcomes. If, for example, assets which are not subject to the transaction tax are characterized by the same level of profitability as the transactions subject to the tax, investors and institutions are likely to switch their investment to the former if the net cost of switching is lower than the tax imposed on the latter, especially in light of the fact that "*all types of financial instruments [] are often close substitutes for each other*".[440]

A financial transaction tax also involves a significant risk of avoidance by means of *'relocation'* of the transactions or institutions to other jurisdictions where a similar tax is not imposed. For this reason, policy-makers should constantly monitor the efficacy of the tax and ensure that its *rate* is adjusted so that it does not have unintended distortionary effects. This issue will be further described more in detail in *III.3.7.1.1* with specific regard to the territorial scope of the tax.

[438] As clearly summarized by Alworth & Arachi, "*tax design is crucial both for the effect of the tax on the functioning of the market and for revenues*". ALWORTH, J. S., ARACHI, G., *supra*, 15. See also MATHESON, T., *supra.*
[439] SCHULMEISTER, S., SCHRATZENSTALLER, M., *supra*.
[440] EUROPEAN COMMISSION, *Proposal for a Council Directive on a common system of financial transaction tax and amending Directive 2008/7/EC*., Brussels Sept. 28, 2011, 6.

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There is an additional reason for keeping the tax rate low. Namely, that a financial transaction tax may provoke an *increase in the cost of capital*. This is due to the fact that, since a company's cost of capital is determined by the minimum rate of return demanded by investors, the imposition of an additional transaction cost arising from the transaction tax could be accompanied by demand from investors for a higher minimum rate of return on their investment. For companies, this would increase their cost of capital, which would have detrimental effect on the real economy and on economic growth.[441]

III.3.4.3 Taxes on bonuses

As previously discussed, the structure of compensation of most financial institutions before the crisis strongly incentivized employees to engage in excessively high-risk investments and activities. Therefore, during the crisis the idea of imposing a high-rate tax on those individuals who gained an enormous amount of money in the form of bonuses for making decisions which largely contributed to the creation of the financial crisis was strongly supported by public opinion.

Temporary taxes on bonuses were introduced in the UK and in France. Specifically, the UK "Bank Payroll Tax", which took effect on December 9, 2009 and expired on April 5, 2010, was imposed on all bonuses payment exceeding 25,000 pound sterling at a 50% rate. The French bonus tax was also levied at 50% rate. It had a similar threshold and was levied upon bonuses paid during the 2009 accounting year.[442]

These taxes were designed as *retrospective* and *temporary* because they were considered penalties for the past behaviors of bank employees. However, it seems that such a *penalty-like goal* was not reached. There is, in fact, evidence, that these taxes were

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[441] See CORTEZ, B., VOGEL, T., *supra*, 21, where it is also explained that "*the increase {in the cost of capital} could be mitigated by the reduced volume of government bonds due to the tax revenue generated by the FTT, which, in turn, would increase the demand for non-government securities*".

[442] STAFF OF THE INTERNATIONAL MONETARY FUND, *supra*, 8.

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actually remitted by the employers via a grossing-up of pre-tax compensation;[443] as a consequence, the cost of the taxes was borne by the financial institutions' shareholders rather than the employees who received the bonuses.[444] It has been pointed out that the motivation for this tax shifting may have originated in the 'mobility' of skilled labor - that is, shareholders accepted to bear the burden of the tax in order to prevent top managers from moving to other companies with headquarters located in countries where such a tax was not adopted. The decision to pay the tax out of the institutions' profits was also influenced by the shareholders' awareness of the temporary nature of the tax.

Such tax shifting raises two main questions. First, there are indirect consequences of such a tax on bank capitalization. The fact that financial institutions are induced – at least in the short-term - to pay the tax on employees' bonuses out of their profits (via a grossing-up of the managers' compensation) may make it more difficult to comply with the regulatory capital requirements. The second issue is whether the *penalty-like goal* pursued through a tax on bonuses may be more efficiently reached by means of a direct tax on banks' profits, like an excess profits tax.[445]

If, instead, a tax on bonuses is expected to recur, it is simply an "*invitation to avoidance, given the difficulty of ascertaining and monitoring what part of compensation is in fact a "bonus"*".[446]

In light of these considerations, and of the fact that the revenue raised is not significant in macroeconomic terms,[447] the idea of the implementation of this type of tax has been substantially abandoned by both scholars and legislators.

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[443] ALWORTH, J. S., ARACHI, G., *Introduction*, in TAXATION AND THE FINANCIAL CRISIS, ALWORTH & ARACHI edts, (Oxford University Press: UK, 2012), 13-14.
[444] SHACKELFORD, D.A., SHAVIRO, D., SLEMROD, J., *Taxation and the Financial Sector*, NEW YORK UNIVERSITY SCHOOL OF LAW: PUBLIC LAW & LEGAL THEORY RESEARCH PAPER SERIES, WORKING PAPER N. 10-30, 18.
[445] ALWORTH, J. S., ARACHI, G., *supra*, 14.
[446] SHACKELFORD, D.A., SHAVIRO, D., SLEMROD, J., *supra*.
[447] As it has been pointed out, "*if the bonus tax has the objective to raise revenue from bank employees in leading positions, a levy on all types of remuneration (including the fixed wages) beyond a certain wage level would seem more appropriate in the financial sector*". DEVEREUX, M., FUEST, C., MAFFINI, G., *supra*, 5.

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III.3.5 Taxation as a Regulatory Tool and Its Relationship With Traditional Regulation

From the description of the four models of taxes on the financial sector, it emerges that three of them – the levies on risky-assets or liabilities, the financial transactions tax and the tax on bonuses – are principally aimed at changing specific behaviors rather than raising revenues. Indeed, as it has been explained, the levies on assets and liabilities respectively encourage institutions not to engage in excessively risky investments and not to rely on an excessively high leverage; the financial transactions tax aims principally at reducing short-term speculative trading; the taxes on bonuses are directed at limiting the incentives for institutions' employees to engage in excessively high-risk investments.

The excess profits tax, instead, is not targeted at changing any particular behavior as affirmed by its advocates and results clear from the circumstance that it is levied upon what companies maximize. The only declared goal of the excess profits taxes, as claimed by its proponents, is collecting additional revenue from financial institutions.[448] In other words, instead of aiming to change the behaviors of financial institutions, the excess profits tax would simply capture their profits that are considered to exceed a normal rate of return and then redistribute that revenue in the form of government spending.

These two different orientations clearly reflect the two opposite approaches to the 'regulatory role' of taxation on the financial sector in the current debate.

III.3.5.1 "Tax neutrality" approach

According to one approach, in accordance to the "tax neutrality" theory (see *Introduction*), regulation of behaviors in the financial market should be exercised exclusively left to direct regulation and government subsides. No regulatory role should

[448] DEVEREUX, M., FUEST, C., MAFFINI, G., *supra*, 3; DAVEREUX, M., *New bank taxes, supra*, 13.

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be left to taxation. The main reasons for this position are those already described in the Introduction in regard to the tax neutrality theory.

However, the use of taxation to achieve regulatory aims has been opposed by some scholars and policy-makers also on other grounds. First, practical considerations have been pointed out, which can be reduced to the argument that while traditional regulation expressly sets forth what conduct it aims to regulate, discourage or incentivize and its message is clear to both the recipients of the regulation and the authorities in charge for its implementation or monitoring, a tax would need to be designed and set at a level intended to indirectly induce the targeted actors to act in the desired way.[449] Therefore using taxation as a regulatory tool may require legislators and regulators to make multiple adjustments to rate or bases, in order to finally obtain the desired change in behavior.

In addition, it has been argued that while taxation is generally based on relatively 'hard' information and is non-discriminatory by nature, direct regulation is often more detailed and permits regulators to use 'soft' information to consider individual circumstances: therefore, regulation seems to allow a margin of discretion which may be useful in dealing with emergency situations like the financial crisis or defaults of large institutions. Also, "*addressing systemic risk through regulatory means would simplify international coordination by relying on existing institutional arrangements (e.g., the Basel Committee for Banking Supervision)*."[450]

III.3.5.2 "Taxation as regulation" approach

According to the other approach, the use of taxation as a tool aimed at regulating certain fields and activities by changing, modifying or encouraging certain behaviors is theoretically acceptable and, in certain circumstances, may be considered better than

[449] DEVEREUX, M., FUEST, C., MAFFINI, G., *supra*, 3
[450] STAFF OF THE INTERNATIONAL MONETARY FUND, *supra*, 53.

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traditional regulation. To use the words of University of Michigan Law School Professor Reuven Avi-Yonah, "*in some instances taxation is the most effective way to achieve a specific regulatory goal*".[451] Advocates of such an approach refer, first of all, to the famous studies of the English economist Arthur Cecil Pigou, who was the first to claim that the standard public finance model (and therefore the tax neutrality approach) was affected by the failure to account for the various negative externalities generated by certain economic actors and sectors.[452] According to the Pigouvian approach, in certain circumstances taxes may constitute efficient market-based instruments to induce industries to internalize the negative externalities generated by their behaviors.[453] Precisely, such types of taxes, which are now generally referred to as "Pigouvian taxes" – in honor of the theorist -, are designed to impose a burden equal to the cost of the negative externality generated by the targeted behavior. Because of this, the affected economic actors will be induced to take into account the entire economic cost of their activities and as a consequence will likely change their behavior and/or will try to refine their production techniques in a way that substantially reduce the negative externalities. The adoption of Pigouvian taxes has been long studied and discussed by academics with regard to the issue of environmental pollutions, in light of the large consensus on the insufficiency of command and control regulation.[454] In various countries, so-called 'carbon taxes' have been adopted. Unfortunately, the failure to achieve a binding international agreement on the implementation of an internationally-coordinated

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[451] AVI-YONAH, R., *Taxation as Regulation: Carbon Tax, Health Care Tax, Bank Tax and Other Regulatory Taxes*, August 2010, PUBLIC LAW AND LEGAL THEORY WORKING PAPER SERIES, UNIVERSITY OF MICHIGAN LAW SCHOOL. Available at: http://ssrn.com/abstract=1664045. It seems that such a position has been recently endorsed also by the U.S. Supreme Court in its decision on the constitutionality of the Patient Protection and Affordable Health Care Act (the so-called "Obamacare"). In his controlling opinion, indeed, Chief Justice Roberts affirmed that "*taxes that seek to influence conduct are nothing new*" and that "*every tax is in some measure regulatory. To some extent it interposes an economic impediment to the activity taxed as compared with others not taxed*". *Virginia v. Sebelius*, Civil Action No. 3:10CV188-HEH, mem. op. at 29 and 37, (E.D. Va. Aug. 2, 2010).

[452] PIGOU, A.C., THE ECONOMICS OF WELFARE, 4th Ed. (London, UK: Macmillan & Co., 1932), 172-78.

[453] PIGOU, A.C., *supra*.

[454] Basically due to the recognition of the fact that governments will never be able to collect all the information necessary to grant an efficient distribution of the emissions' reductions among the various actors. See AVI-YONAH, R., *supra*, 3; AVI YONAH, R., UHLMANN, D., *Combating Global Climate Change: Why a Carbon Tax is a Better Response to Global Warming than Cap and Trade*, (2009) 28 STAN. ENVIR. L. J. 3.

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environmental policy, heavily affected the efficacy of these various local measures, due to the carbon leakage opportunities such a situation gives rise to.[455] An example of the successful use of taxation for regulatory purposes can be found, instead, in the taxes which were levied on items like alcohol and tobacco, whose consumption implies costs on the entire society that neither the sellers nor the consumers account for through their selling and purchasing activities. There is empirical evidence that taxation more successfully reduced the consumption of alcohol and cigarettes than prohibition of such behaviors.[456]

With specific regard to the financial sector, it has been pointed out that taxes "can be more directly geared toward certain activities" and have a smoother and more continuous impact on bank finances than higher capital requirements.[457] Indeed, while the latter may impose significant costs if conditions make it difficult to raise new capital, the former do not involve high up-front costs. Usually, such taxes only entail relatively modest yearly payments and above all are not likely to amplify the negative effects of a crisis by requiring the institutions to satisfy prohibitively expensive surcharges.[458] Furthermore, it has been highlighted that the experience shows that "*taxation as regulation makes sense when (1) it is applied to small numbers of taxpayers, (2) the taxpayers are sophisticated and able to deal with complex tax incentives, (3) the regulatory goal is clear and related to the level of the tax*".[459] All of these criteria are met by those financial taxes which are designed to play regulate behaviors. Finally, taxes create fiscal space that, as already illustrated, can be viewed "*as a form of government-facilitated co-insurance of financial institutions against idiosyncratic risks, and as a payment for fiscal support that may become necessary during a systemic crisis*".[460]

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[455] METCALF, G., WEISBACH, D., *The Design of a Carbon Tax*, 33 (2) HARVARD ENVIRONMENTAL LAW REVIEW, (2009) 499.
[456] AVI-YONAH, R., *supra*, 5.
[457] STAFF OF THE INTERNATIONAL MONETARY FUND, *supra*, 51
[458] STAFF OF THE INTERNATIONAL MONETARY FUND, *supra*.
[459] AVI-YONAH, R., *supra*, 8.
[460] STAFF OF THE INTERNATIONAL MONETARY FUND, *supra*, 51.

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III.3.5.3 The peculiarity of the financial sector and the arguments for a 'compromise solution'

In most cases, advocates of taxation as a regulatory tool in the financial sector, however, do not call for a complete replacement of traditional regulation with sectorial tax measures. Rather, they pragmatically look at taxation and regulation as two complementary tools for controlling behaviors. Indeed, unlike other fields where regulatory taxation has historically been adopted or proposed – i.e. environmental pollution or the alcohol or tobacco markets - the situation with respect to the financial sector is much more complex and seems to leave little room for a mutually exclusive solution.

The failure of traditional regulation in preventing the last crisis clearly shows that such a tool must be properly amended and reformed at both a national and international level. In addition, most of the deep analyses of the financial system after the crisis induced many scholars and policy-makers to believe that the traditional regulation, alone, will always be insufficient. This is particularly true in dealing with macro-prudential externalities related to systemic risk like excessive leverage or excessive market volatility.[461] These considerations apparently further the arguments for the introduction of a regulatory tax, given also the fact that at a first glance most of the conditions for the its introduction seem to be met – in particular, the relatively small number of actors involved and their unquestionable level of sophistication in dealing with the complexity of the tax system.[462]

Nevertheless, it has been correctly pointed out that for two distinct reasons, regulatory taxes will not be suitable to entirely replace traditional regulation. First, there is no single activity of financial institutions whose aggregate sum equals the expected harm. Indeed, as the description above of the goals and four standard models of new tax partially showed, unlike the markets or sectors where Pigouvian taxes have been

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[461] STAFF OF THE INTERNATIONAL MONETARY FUND, *id*, 47-50, KEEN, M., *supra*, 6.
[462] STAFF OF THE INTERNATIONAL MONETARY FUND, *id*, 51.

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historically enacted or proposed, the financial sector's negative externalities arise not simply from one single activity but from many distinct aspects of the various institutions' activities – including liquidity, volatility, leverage, size or market share, interconnectedness.[463] Second, as the recent crisis demonstrated, the nature and power of the financial sector within the economy makes the consequences and the harms arising from its collapse suitable to affect any aspect of organized society – not just other economic sectors.[464] Therefore, as summarized by authoritative scholars, the "*expected social harm, other than the purely pecuniary to the government as insurer, is multi-dimensional and difficult to measure*" and "*even that pecuniary harm cannot be measured entirely accurately through a risk-adjusted fee. Thus, the classic tax-or-regulation debate is surely beyond the point with respect to financial institutions, because regulation of the financial sector both is not going away, and should not*". [465]

On the contrary, "*given the multi-dimensional character of systemic risk", both "multiple tax and/or regulatory instruments are likely to be needed*".[466] This seems to be the most realistic and effective response to the call for a reform of the financial sector. Within this multi-dimensional response to a multi-dimensional issue, a regulatory tax, even if imperfect, clearly can play a positive role in coordination with the reform and the improvement of the traditional regulation, in particular capital adequacy regulation. Therefore, rather than using regulatory tax in the attempt to address all the potential sources of systemic risk, policy-makers and legislators should use a regulatory tax to address one of the central externalities (for example, volatility through financial transaction tax or excessive leverage through a liabilities-based levy) and address the other externalities by improving traditional regulation and making it harder to avoid. This

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[463] SHACKELFORD, D.A., SHAVIRO, D., SLEMROD, J., *Taxation and the Financial Sector*, NEW YORK UNIVERSITY SCHOOL OF LAW: PUBLIC LAW & LEGAL THEORY RESEARCH PAPER SERIES, WORKING PAPER N. 10-30, 15.

[464] First of all, due to the size of some institutions and to their interconnectedness, the default of one institution is suitable to 'infect' other firms and provoke their collapse as well, thus giving rise to a systemic crisis of the entire sector. This, in turn, is likely to generate a lack of liquidity which will provoke a crisis in all other economic sectors and will lead to a shortage of resources necessary to carry out most human activities.

[465] SHACKELFORD, D.A., SHAVIRO, D., SLEMROD, J., *supra*, 15.

[466] SHACKELFORD, D.A., SHAVIRO, D., SLEMROD, J., *supra*, 15.

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'compromising' position is well expressed by the IMF, which, in the Report prepared for the G-20 Toronto Summit, concludes its analysis of the relationship between taxation and regulation stating that "*overall, the discussion suggests that taxes may be a useful complement to regulation in addressing macro-prudential concerns*".[467] [468]

III.3.6 The IMF proposals

As illustrated at the beginning, the G-20 leaders, at the end of the Pittsburgh Summit (2009), requested the International Monetary Fund (IMF) to prepare a report for their next meeting, on June 2010, "*with regard to the range of options ... as to how the financial sector could make a fair and substantial contribution toward paying for any burden associated with government interventions to repair the banking system*".[469] In April of 2010, this request was subsequently integrated by the G20 finance ministers and central banks governors when they called for the IMF to engage in "*further work on options to ensure domestic financial institutions bear the burden of any extraordinary government interventions where they occur, address their excessive risk taking and help*

[467] STAFF OF THE INTERNATIONAL MONETARY FUND, *supra*, 53.

[468] Nevertheless, a complementary tax policy does not come about spontaneously, but is always the result of difficult and complex coordination and compromising activity by policy makers. The treatment of debt interest in both Europe and the US is the clearest example of a lack of coordination between tax policy and regulation. While the regulation system aims to mitigate the use of debt finance, the corporation tax system favors debt finance over equity finance by granting a passive debt interest deduction but not allowing for a cost-of-equity deduction. See PAGE, R., *supra*, 195-196, and DAVEREUX, M., *New bank taxes*, *supra*, 13. There have been various proposals and attempts to eliminate this disparity of tax treatment between debt capital and equity capital, above all in the US, by entirely repealing the deductibility of debt interest but none of them have succeeded due to questions of political practicability (basically, the resistance of the financial lobbies to eliminating such a privilege). See AVI-YONAH, R., INTERNATIONAL TAX AS INTERNATIONAL LAW, (Cambridge: Cambridge University Press, 2007), 97.

[469] G20 Leaders, *A Framework for Strong, Sustainable, and Balanced Growth*, par. 16. The Pittsburgh Summit, September 24-25, 2009. Available at: http://www.cfr.org/world/g20-leaders-final-statement-pittsburgh-summit-framework-strong-sustainable-balanced-growth/p20299 (retrieved on July 2012).

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promote a level playing field, taking into consideration individual country's circumstances".[470]

The report, issued on June 2010, after describing the various measures already adopted at the domestic level by various countries and indicating 'backward-looking' charges – such as one based on the balance sheet variables at the at the beginning of the crisis - as the least distortionary way to recover the fiscal cost of the past bailouts, further proposed the simultaneous adoption of two new taxes on banks and other financial institutions aimed at addressing future financial failures, reducing the systemic risk inherent in the financial sector and raising a significant amount of revenue.[471] As illustrated in the Introduction, the G-20 leaders did not reach an agreement on the adoption of the IMF proposal, whose main features are nevertheless still worth describing. Indeed, the two new financial taxes proposed by the IMF - the 'Financial Activities Tax' and the 'Financial Stability Contribution' – combine principles of tax neutrality and regulatory taxation.

III.3.6.1 The Financial Activities Tax

The Financial Activities Tax (also referred to as 'FTA'), in its basic version, is levied on the sum of profits and remuneration of financial institutions and could raise a significant amount of revenue. However, the IMF pointed out that alternative definitions of profits and remuneration can be adopted for inclusion in the base of the FAT. Depending on which definition is adopted, the FAT can serve a range of objectives. In particular, three alternative forms of FAT – FAT1, FAT2 and FAT3 – are discussed in the IMF Report. FAT 1 is characterized by a base which includes all wages and profits, FAT

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[470] G20, *Communiqué*, Meeting of Finance Ministers and Central Bank Governors, Washington D.C., April 23, 2010. Available at: http://www.g20.utoronto.ca/ministerials.html#2010 (retrieve from July 2012).

[471] BRONDOLO, J. D., *supra*, 4.

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2 is a tax on supernormal wages and profits; and FAT 3's base includes only 'very high' wages and profits.

It is important to highlight here that, while FAT 2 and FAT 3 are a combination of an excess profits tax and a tax on remuneration,[472] FAT 1 is designed in such a way that it would substantially function as a value added tax (VAT). The standard consumption-type VAT is, indeed, a tax on sales of real goods and services less purchases of non-labor inputs, that is, implicitly a tax on the sum of wages and 'profits'.[473] This is an interesting point to consider, since various parties have claimed that the exemption of most financial services from the value added taxes is one of the factors which, together with the other tax privileges already mentioned in III.3.2, permitted the financial institutions to become unduly large, distorting competition in several ways.[474] As affirmed by the IMF itself, thus, the implementation of a FAT could "*partially offset the risk of the financial sector becoming unduly large because of its favorable treatment under existing VAT*".[475] There would be, however, the risk that, as with a normal value added tax, the burden of the tax falls on customers and also increases the cost of employment. This view is shared also at

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[472] DEVEREUX, M., FUEST, C., MAFFINI, G., *Taxing Banks: The IMF Proposals. A Briefing Note*, April 21, 2010, Centre for Business Taxation, Oxford University. 1, available at: http://www.sbs.ox.ac.uk/centres/tax/conferences/Pages/TaxingBanks.aspx (retrieved on March 2012). It is worth mentioning that the IMF considers FAT 3 to be aimed at changing institutions' behaviors. This opinion is not shared by the authors of this paper and other authoritative scholars, according to whom the excess profits taxes are not suitable to change behaviors, since they are imposed on what companies aim to maximize (profits after allowing for a minimum return to the financial investors). See par. 3.2.1, DEVEREUX M., FUEST C., MAFFINI G., *id.*. 3. See also CONWAY, E., *IMF targets banks with 'excess profits tax'*, The Telegraph, April 5 2010, available at http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/7557409/IMF-targets-banks-with-excess-profits-tax.html (retrieved on March 2012).

[473] STAFF OF THE INTERNATIONAL MONETARY FUND, A FAIR AND SUBSTANTIAL CONTRIBUTION BY THE FINANCIAL SECTOR: FINAL REPORT FOR THE G-20, (Washington D.C.: IMF, June 2010), 66.

[474 474] The main reason for the exemption from the VAT of most financial services is due to practical considerations. Indeed, calculating the value added by a financial institution to a financial product is extremely complicated due to the fact that in most cases the charges for financial services are not explicitly stated as fees or commissions but are simply implicitly included in interest rate spreads and other margins. See AUERBACH, A., GORDON, R., *Taxation of Financial Services Under a VAT*, (2002) 92 AMERICAN ECONOMIC REVIEW 2, 411-416. However, as explained by Vella et al., "*the overall effect of the VAT exemption, however, is ambiguous. The exemption reduces the tax burden on services to consumers but it also increases the tax burden on transactions with businesses. Some studies do suggest under-taxation, however they are not without difficulty and so uncertainty does remain around this issue*". VELLA, J., FUEST, C., SCHMIDT-EISENLOHR, T., *The EU Commission's Proposal for a Financial Transaction Tax*, BRITISH TAX REVIEW (2001) 6, 6. See also MERRILL, P., *VAT Treatment of the Financial Sector*, TAX ANALYST (2011), 163-185, 167-168.

[475] STAFF OF THE INTERNATIONAL MONETARY FUND, *supra*, 22.

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the academic level, where it has been affirmed that "*the remuneration component will create an additional tax wedge on employment costs*" and "*may be passed on in higher prices to consumers*".[476]

As mentioned above, the FAT is suitable to generate a large amount of revenue. The IMF, however, specifies that the amount of this revenue may largely "*differ across countries depending on the relative size, profitability and wage structures of their financial sectors, and may be constrained by the need to apply low rates where the impact on competitiveness or the risk of avoidance are of concern*".[477]

III.3.6.2 The Financial Stability Contribution

According to the IMF, the FAT is considered complementary to the Financial Stability Contribution ('FSC'). The FSC is a liability-based levy whose main goal is "*to pay for the fiscal cost of any future government support to the financial sector*".[478] In addition, and consistent with the liability-based levy standard model discussed in *III.3.4.1.2*, other goals pursued through the FSC would be to prevent banks from highly leveraging and from becoming too large.

According to the IMF Report, the proceeds of the FSC could either be paid to the general revenue or accumulate in a specific fund.[479] If the second option is chosen, the FSC would provide the financial sector with an insurance-like system, with the premium (the tax) paid being proportional to the size and the level of risk of the companies[480] and

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[476] DEVEREUX, M., FUEST, C., MAFFINI, G., *supra*, 1. See also SHAVIRO, D., *The Financial Transaction Tax Versus (?) the Financial Activities Tax*, , LAW AND ECONOMICS RESEARCH SERIES, NEW YORK UNIVERSITY, March 2012.
[477] STAFF OF THE INTERNATIONAL MONETARY FUND, *supra*, 68.
[478] STAFF OF THE INTERNATIONAL MONETARY FUND, *supra*, 5.
[479] Staff of the International Monetary Fund, *supra*., 5
[480] In particular, the IMF suggests that the rate, which initially may be kept flat for practical reasons, be progressively "*refined to reflect individual institutions' riskiness and contributions to systemic risk—such as those related to size, interconnectedness and substitutability—and variations in overall risk over time*". STAFF OF THE INTERNATIONAL MONETARY FUND, *supra*, 5.

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available to governments to establish a resolution fund for a future crisis.[481]

III.3.7 The Current Proposals in the EU and US

As previously mentioned, both the European Commission and the United States government formulated a proposal for a financial tax to be implemented within their jurisdictions. These two proposals are currently the object of heated debate within both the academic and political sphere. Several experts oppose such proposals and a number of political obstacles created by financial institutions' lobbyists have prevented their enactment. Issues of competition between countries and the lack of determination of government actors have also played a role. As we will see, both proposals are based on one of the four basic models of financial tax described above. Therefore, in many cases we will refer to the discussion of these models.

III.3.7.1 EU Commission's proposal for a financial transaction tax

On September 28, 2011 the European Commission released a proposal for a European financial transaction tax.[482] Due to the veto posed by some countries led by the United Kingdom,[483] the proposal, in a slightly updated version,[484] is currently the subject

[481] STAFF OF THE INTERNATIONAL MONETARY FUND, *supra*, 22.
[482] EUROPEAN COMMISSION. *2011c.* PROPOSAL FOR A COUNCIL DIRECTIVE ON A COMMON SYSTEM OF FINANCIAL TRANSACTION TAX AND AMENDING DIRECTIVE 2008/7/EC, (Brussels: September 28, 2011), available at http://ec.europa.eu/taxation_customs/resources/documents/taxation/com_2013_71_en.pdf
[483] See the official Ecofin press release of June 22, 2012, at http://www.consilium.europa.eu/press/press-releases/latestpress- releases/newsroomloadbook?target=2012 &infotarget =&max= 30&bid=93&lang=en.
[484] EUROPEAN COMMISSION, PROPOSAL FOR A COUNCIL DIRECTIVE IMPLEMENTING ENHANCED COOPERATION IN THE AREA OF FINANCIAL TRANSACTION TAX, February 14, 2013, COM(2013) 71 final, available at http://ec.europa.eu/taxation_customs/resources/documents/taxation/com_2013_71_en.pdf,

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of "enhanced cooperation" procedure promoted by ten Member States.[485] By settling on this form of taxation, the European Union has demonstrated, contrary to its previous position,[486] that it will not use the taxation tool to reduce high leveraging, to reduce the holding of excessively high-risk assets by financial institutions, or to limit their size. The European Union now appears to believe that traditional regulatory tools, like capital requirements or the definition of risk-weighted assets, can still deal effectively with such issues.[487] Instead, in its official proposal, the EU Commission identified short-term speculative trading and the consequent high volatility of the markets as the main targets of its harmonized tax tool. This is consistent with what was explained above, in paragraph *III.3.4.2.*2, regarding the primary objective of a financial transactions tax: by imposing an additional transaction cost (the amount of the tax) to the trading activity, the tax is aimed to reduce the liquidity of the market and, as a consequence, decrease market volatility.

Other objectives of the proposed European financial transactions tax, as expressly stated in the proposal, are:

- Raising revenue and adequate contribution from the financial sector to the public finances; and

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[485] Austria, Belgium, France, Estonia, Germany, Italy, Ireland, Portugal, Slovenia, Spain. The Council authorized the requesting Member States to engage in the enhanced cooperation procedure on December 12, 2012. See Council of the European Union, Press Release, Dec.12, 2012, available at http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/134949.pdf. the UK has challenged the legality of the decision of 22 January 2013 of the Council to authorize enhanced cooperation on a common framework of FTT and the scope and objectives of the initial commission proposal (see Case C-209/13 UK v Council). This legal challenge has, however, no suspending effect.

[486] The European Commission was indeed initially in favor of the implementation of a liability-based levy rather than a financial transaction tax. See EUROPEAN COMMISSION, *Innovative financing at the global level*, (Brussels: April 2010.).

[487] EUROPEAN COMMISSION, EXECUTIVE SUMMARY OF THE IMPACT ASSESSMENT, *(Brussels* EU: Commission Staff Working Paper, Sept. 28, 2011), 6. In assessment of the potential impact of a harmonized European financial transaction tax, which accompanied the proposal for the directive, the European Commission clearly stated that "*regulatory measures are more appropriate*" for the purpose of "*addressing the distortions of financing decisions and the incentives to excessive leverage created by the different treatment of debt and equity under the current corporate tax system*".

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- Ensuring the functioning of the European Internal Market.

Many scholars and other important actors have opposed the EU proposal, or the general idea of the implementation of a financial transaction tax. These critical players include both private actors - like business and financial organizations - and public actors – in particular the UK government and the IMF. The reasons behind the various criticisms tend to be similar and, in particular, five issues are often raised:

- The lack of evidence that a financial transaction tax is actually an efficient tool for the purposes of reducing market volatility;
- The detrimental effect that the tax may have on the financial sector and on the European real economy in terms of increase in the cost of capital and competitive disadvantage;
- Disagreement over the revenue potential and its allocation among Member States;
- The risks of substitution and relocation;
- The administrative feasibility;
- The inconsistency with the explicit goal of harmonizing the European internal market.

Some of these issues can be substantially traced back to the potential distortionary effects of the standard model of financial transaction tax already addressed in par. *III.3.4.2.4.* Therefore, in order to avoid repetition, the following paragraphs will only address these issues with specific reference to the design of the proposed EU financial transactions tax.

III.3.7.1.1 Design of the proposed tax and related issues

As mentioned above, lowering market volatility, raising revenue through a more substantial contribution from the financial sector to public finances, and harmonizing the European Internal Market are the three express goals of the European Commission's proposal. However, as described in *III.3.4.2.4*, reaching these goals through a financial transaction tax may be difficult due to the risk of 'substitution' and 'relocation'. It is thus

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extremely important to determine how the EU's proposed financial transaction tax is designed and deals with these issues.

- *Scope and Substitution Risk*

As explained in paragraph *III.3.4.2.4*, the scope of the financial transaction tax plays a decisive role in mitigating the substitution risks, that is, the risk of inducing investors to shift their investments from certain transactions to other tax-exempted transactions only for tax reasons and not for economic reasons.

The scope of the tax proposed by the European Commission covers a broad range of financial transactions. In particular, the scope of the tax would include financial transactions involving the following instruments:

- financial instruments which are negotiable on the capital market (transferable securities;
- money market instruments (except the instruments of payment);
- units or shares in collective investment undertakings; and
- derivative agreements.[488]

Moreover, the tax would also cover transactions outside the organized markets, including over-the-counter transactions.[489]

There are, however, some transactions to which the tax will not apply. These exemptions were motivated by public interests concerns. Transactions with the European Central Bank or national central banks of EU Member States would not be subject to the tax, so as not to affect monetary policies or refinancing opportunities for financial institutions. Transactions with international organizations would also be excluded from the scope of the tax; such choice was taken in consideration of the sovereign debt

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[488] EUROPEAN COMMISSION, PROPOSAL FOR A COUNCIL DIRECTIVE IMPLEMENTING ENHANCED COOPERATION IN THE AREA OF FINANCIAL TRANSACTION TAX, February 14, 2013, *supra*, Art. 3(2)(a) and (b). Actually, for the meaning of "financial instruments", the Commission's proposal refers to the MiFID Directive, which, in turn, provides an enumeration of instruments which qualify the transactions as "financial transactions". See EUROPEAN COUNCIL, DIRECTIVE 2004/39/EC.

[489] *Id*.

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crisis.[490] Transactions connected with business activities or carried out by investors in their capacity as citizens would be excluded as well. Examples of these transactions are insurance contracts, mortgage lending, consumer credit and payment services. Currency transactions on spot markets are also exempted.[491] In addition, the proposal sets forth an exception for primary market transactions and for transactions arising from restricting operations.[492]

By implementing the tax with such a wide scope and few exemptions justified by overwhelming public policy reasons, it seems that the risk of substitution of taxed instruments with tax-free instruments would be significantly mitigated.

- *Tax Rate and Relocation Risk*

In addition to the scope, the revenue potential of any tax depends primarily on its rate. With regard to the financial transaction tax, in *III.3.4.2.4*. this work already explained how the setting of an appropriate tax rate is also influenced by the high level of mobility of financial transactions, meaning that there is a significant risk of avoidance through relocation of the transactions to other jurisdictions where a similar tax is imposed at lower tax rates or is not imposed at all. For this reason, policy-makers should constantly monitor the efficacy of the tax and ensure that its rate is adjusted so that it does not have unintended distortionary effects.

According to the proposal, the tax would be levied at the rate of 0.1% on transactions involving shares of stock and bonds, and 0.01% on all transactions involving derivatives transactions and, in the Commission's forecast, the it is expected to raise 30-

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[490] DE LA METTRIE, L., SONGNABA, P., MURRE, D., *The European Financial Transaction Tax: The New Reality*, 15 (3) DERIVATIVES & FINANCIAL INSTRUMENTS (2013) 71-79, 73.

[491] EUROPEAN COMMISSION, PROPOSAL FOR A COUNCIL DIRECTIVE IMPLEMENTING ENHANCED COOPERATION IN THE AREA OF FINANCIAL TRANSACTION TAX, February 14, 2013, *supra*, Art. 3(4)(f) However, if these instruments and services are securitized and traded as structured products, these transactions are within the scope of the tax. See also DE LA METTRIE, L., SONGNABA, P., MURRE, D., *The European Financial Transaction Tax: The New Reality*, *supra*, 72.

[492] EUROPEAN COMMISSION, PROPOSAL FOR A COUNCIL DIRECTIVE IMPLEMENTING ENHANCED COOPERATION IN THE AREA OF FINANCIAL TRANSACTION TAX, February 14, 2013, *supra*, Art. 3(4)(f).

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35 billion euros per year.[493] The establishment of low flat rates is consistent with what the great majority of experts suggest. Setting low and flat tax rates is crucial to avoid severe distortions of the market in terms of relocation risk and increase in the cost of capital (see *III.3.4.2.4*).[494]

As for the allocation of the revenue arising from the proposed tax, according to the proposal it will mostly be divided among the various countries, depending "*on the place of establishment of the financial institution involved in the transaction and not on the place of trade*".[495] It has been pointed out that this solution, while satisfying Member States like France or Germany, which are the headquarters of large financial institutions - is not likely to satisfy the UK, which hosts, through the City of London, a disproportionate (with respect to the amount of institutions headquartered within its jurisdiction) share of transactions.[496]

Under the proposal, an unspecified portion of the revenue could be used for the EU budget, therefore reducing the required contribution of Member States.[497] This is a meritorious idea, but raises serious questions in terms of feasibility. In particular, the already mentioned uncertainty regarding the amount of revenue makes such a type of tax an unstable source of funding upon which a budget can rely.[498]

EUROPEAN COMMISSION, PROPOSAL FOR A COUNCIL DIRECTIVE IMPLEMENTING ENHANCED COOPERATION IN THE AREA OF FINANCIAL TRANSACTION TAX, February 14, 2013, *supra*, Art. 9. The rates are the same ones indicated in the original proposal, but in its new proposal the Commission lowered the expected revenue per year, which originally was 57 million euros.

[494] SCHULMEISTER, S., SCHRATZENSTALLER, M., PICEK, O., *supra*. COMMISSION STAFF WORKING PAPER, Executive Summary of the Impact Assessment. 9.

[495] EUROPEAN COMMISSION, *supra.* Art. 10(3).

[496] According to the City of London officials, indeed, up to 80% of income raised by the tax could arise from transactions based in London. See NOKED, N., *EU Proposed Financial Transaction Tax – Fortune or Folly?*, THE HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION (2011), 3, available at: http://blogs.law.harvard.edu/corpgov/2011/11/17/eu-proposed/financial-transaction-tax-—-fortune-or-folly/.

[497] EUROPEAN COMMISSION, *supra,* 11 (fn 3).

[498] VELLA J., FUEST C., SCHMIDT-EISENLOHR T., *The EU Commission's Proposal for a Financial Transaction Tax*, BRITISH TAX REVIEW (2001) 6.

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- *The Territorial Scope. Two Case Studies: Sweden and the UK*

Due to the high mobility of financial transactions, the territorial scope of the financial transaction tax represents an additional decisive factor to be taken into consideration for the purposes of discouraging avoidance by means of relocation.

In particular, a *world-wide* application of the tax is the most efficient way to deal with the risk of tax avoidance by means of relocation. Take, as examples, the contrasting outcomes of Sweden's implementation of the financial transaction tax between 1984 and 1991, and the UK's implementation of the financial transaction, which has been in place for over 25 years.

The Swedish tax, characterized by rates ranging between 0.5% and 2%, adopted a *residence* approach by taxing all transactions of securities registered in Sweden and in which a Swedish brokerage was involved.[499] Therefore, the parties of a transaction of shares of Swedish companies were not subject to tax if the transaction was not carried out through a Swedish dealer. As a result, a large part of shares trading of Swedish companies moved abroad while the tax was levied (mainly to the London market, which was in the same time zone) with detrimental effects not just in terms of revenue collected but also in terms macroeconomic performance.[500] Thus, the Swedish experience constituted a tax policy failure and an economic disaster. The Swedish financial transaction tax was finally repealed in 1991.

The British Stamp Duty Reserve Tax, which is levied upon all transaction involving UK shares (resembling the EU Commission's proposal but covering a much narrower range of transactions), was enacted in 1964 and, although it has been largely modified over the years, is still valid law.[501] It is a 0.5% tax on the registration of ownership of the shares, consisting in a stamp (now an electronic stamp) that is a

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[499] CAMPBELL, J.Y., FROOT, K.A., *International Experiences with Securities Transaction Taxes*, in THE INTERNATIONALIZATION OF EQUITY MARKETS, (J. Frankel ed.) (Chicago: University of Chicago Press, 1994): 280.
[500] SCHULMEISTER, S., SCHRATZENSTALLER, M., PICEK, O., *id.*, 20-24.
[501] CANNON, P., TOLLEY'S STAMP DUTIES AND STAMP RESERVE TAX 2001-02, 9th Ed. (London: Tolley Publishing, 2001), 61.7.

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necessary requirement to make the purchases legally effective. Unlike the Swedish FTT, the British tax is a worldwide tax on ownership transfer of shares of companies established in the UK, regardless of the location of the transaction and the establishment of the trader.[502] In addition, a special "exit charge" of 1.5% is applied when shares are transferred to clearance services or converted into financial products that are excluded from the scope of the tax. Avoiding the Stamp Duty Tax is therefore much more difficult than avoiding the Swedish tax. This insight is confirmed by the data regarding the revenue collected, which shows that "*stamp duty yields are a function of share prices, share quantity and turnover and thus reflect the development of the stock market*".[503]

These two examples suggest that if the financial transaction tax is not dependent on the location of the trade and the institution and is supported by proper anti-avoidance mechanisms (like the 'exit tax'), as with the UK tax, large relocation or substitution effects are unlikely.

The European Commission proposal, even in its updated version from February 2013, adopts a residence principle. Under this approach, a transaction is subject to taxation as long as at least one of the parties is a financial institution established in a Member State.[504] Therefore, only financial transactions of which one of the parties is a financial institution established in a participating Member State are subject to the common tax. It must be highlighted that "establishment" for the purpose of the financial transaction tax is not the place of incorporation, but is the so-called "deemed establishment", that is, the place of establishment is identified by applying several criteria set forth by the Commission's proposal.[505]

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[502] This means that shares of foreign companies issued or listed on the London Stock Exchange are not subject to the tax.
[503] SCHULMEISTER S., SCHRATZENSTALLER M., PICEK O., *supra*, 25.
[504] According to Art. 3 of the proposal, a financial institution is considered 'established' in the European Union when it is authorized, has its registered seat, its permanent address, its usual residence or a branch in one of the Member States.
[505] Such criteria are, in particular, i) the authorization of the financial institution by the regulator of a participating Member State; ii) the authorization provided by a participating Member State different from that where the transaction takes place; iii) the holding of a registered seat in a participating Member State; iv) the holding of a

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After the issuance of the original proposal, it was highlighted that such design deals very effectively with the risks of relocation within the EU but leaves the tax still vulnerable to avoidance by financial institutions through relocation to non-EU markets.[506] Recognizing the correctness of this critique, and also in light of the fact that the tax would now be adopted only by a limited number of Member States, the European Commission added to the updated version of its Proposal the so-called "issuance principle". According to this principle, financial instruments issued in the participating Member States will be taxed when traded, even if those trading them are not established within the FTT-zone.[507] Furthermore, explicit anti-abuse provisions are now included.

III.3.7.1.2 Main criticisms from within Europe

As anticipated above, the European Commission's proposal has been opposed by many academics, financial and business organizations and few Member States. Besides the traditional 'substitution' and 'relocation' risks described in the previous paragraphs, critics are mainly focused on the detrimental effect that the proposed tax would have on the financial sector and on the overall GDP growth, on its administrative feasibility, on

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permanent address in a participating Member State; v) the disposal of a branch within a participating Member State; vi) a residual criterion according to which if a financial institution takes part in a transaction with another financial institution, or even with a non-financial institution, established in a participating Member State according to one of the previous five criteria, such financial institution is deemed to be established in that Member State as well. EUROPEAN COMMISSION, PROPOSAL FOR A COUNCIL DIRECTIVE IMPLEMENTING ENHANCED COOPERATION IN THE AREA OF FINANCIAL TRANSACTION TAX, February 14, 2013, *supra*, Art. 4(1). See also DE LA METTRIE, L., SONGNABA, P., MURRE, D., *The European Financial Transaction Tax: The New Reality*, *supra*, 75.

[506] It was noted that If the parties of the transaction are both established in territories of countries which are not members of the EU, the transaction is not subject to the common tax. This type of avoidance is quite easy to pursue by larger institutions, which can carry out transactions through their subsidiaries incorporated and established in non-EU jurisdictions. See VELLA, J., FUEST, C., SCHMIDT-EISENLOHR, T., *supra*; GARBARINO, C., ALLEVATO, G., *Financial Transaction Tax europea: obiettivi dichiarati e potenziali effetti distorsivi*, 12 FISCALITÀ E COMMERCIO INTERNAZIONALE (2012) 14, 17-19.

[507] EUROPEAN COMMISSION, PROPOSAL FOR A COUNCIL DIRECTIVE IMPLEMENTING ENHANCED COOPERATION IN THE AREA OF FINANCIAL TRANSACTION TAX, February 14, 2013, *supra*, 18.

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the potential competitive disadvantage for European financial centers and on the inconsistency with the explicit goal of harmonizing the European internal market.[508]

It has been claimed, in first instance, that "*a financial transaction tax of the type proposed by the Commission is likely to result in a significant decrease in the volume of trades, particularly in the high frequency trading markets, as the additional cost of each transaction makes it less profitable to perform*".[509] This, rather than stabilize the asset prices, would end up depriving the financial sector of the liquidity necessary for price discovery. Such observation reflects one of the traditional critics against the standard model of financial transaction tax, as seen in *III.3.4.2.*3. In response, proponents of the tax have pointed out that there is evidence that financial markets are now characterized by excessive liquidity, whose determinants and exponential rise over the last two decades do not leave room for justifications in terms of hedging or genuine price discovery activity.[510] Therefore, the implementation of a financial transaction tax suitable to reduce this trading activity, mainly short-term activity, should be more than welcome.

In addition, the ISDA, the global organization promoting swap and derivative markets, claimed that the proposed tax "*would make it more expensive for financial institutions to engage in hedging and risk-management transactions, both of which were essential for the long-term economic growth and should be encouraged by the financial regulators*."[511] Supporters of the proposed tax have replied that it is not conceivable that the spectacular rise of trading, in particular derivatives trading, is caused by hedging.

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[508] The European Commission itself originally estimated the impact of the financial transaction tax, in terms of GDP losses, between 0.5 and 1.76%. [508] EUROPEAN COMMISSION, EXECUTIVE SUMMARY OF THE IMPACT ASSESSMENT, *(Brussels* EU: Commission Staff Working Paper, Sept. 28, 2011), 6.

[509] NOKED, N., *supra*, 2.

[510] It is pointed out that "*the volume of financial transactions is the global economy is 73.5 times higher than the world GDP. In 1990 this ratio amounted to 'only' 15.3.*", SCHULMEISTER, S., *A General Financial Transaction Tax: A Short Cut of the Pros, the Cons and a Proposal*, *supra*, 5. And "*the volume of foreign exchange transactions is almost 70 times higher than world trade of goods and services. In Germany, the UK and the US the volume of stock trading is almost 100 times bigger than business investment, and the trading volume of interest rate securities is even several 100 times greater than overall investment*". SCHULMEISTER, S, SCHRATZENSTALLER, M., PICEK, O., *A General Financial Transaction Tax. Motives, Revenues, Feasibility and Effects*, *supra*, 43-44.

[511] NOKED, N., *supra*, 2. See ISDA, *Comments on EC's Proposal for a Financial Transaction Ta*x, September 29, 2011, available at: http://www2.isda.org/news/isda-comments-onecs-proposal-for-a-financial-transaction-tax (retrieved on April 2012).

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Moreover, hedging, as well as 'real world transactions', would hardly be affected by a tax of 0.1% or 0.001%.[512] The same source affirmed that "*the estimates assume that trading volume would decline by roughly 65% if a FTT of 0.05% is implemented. Even then, however, transaction volume in advanced economies would still be 35 times higher than GDP. This should be sufficient to enable an efficient price discovery process and provide enough liquidity for hedging purposes*".[513]

Another reason for concern has been that a financial transaction tax applied to such a large range of transactions, including transactions outside the organized markets, would be considerably more difficult to administer than the balance sheet approach, "*with a taxation viewpoint having to be taken in respect of each transaction rather than a singular view at the end of the financial year*".[514] Nevertheless, these administrative problems have been largely mitigated by several factors, including clearinghouses taking a more prominent role in settling financial transactions, the growth of automated trading platforms, the movement from paper securities to electronic book entries, and the recent progression toward more stringent regulation of over-the-counter derivatives in a number of countries.[515] On this point, the Commission's Proposal appears quite vague, since it only states that the tax should be paid at the moment of the electronic transactions - or within three working days from the conclusion of the transaction for all the other transactions – and that the burden of the collection of the tax will fall upon the participating Member States on the basis of internal regulations to be enacted and potential delegated acts that the Commission itself may adopt in the future.[516]

It has been also argued that the adoption of a financial transaction tax in Europe, without similar provisions in the other main financial centers around the world, would

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[512] SCHULMEISTER, S., *Bank levy versus transactions tax: A critical analysis of the IMF and EC reports on financial sector taxation*, AUSTRIAN INSTITUTE OF ECONOMIC RESEARCH, 5, available at *stephan.schulmeister.wifo.ac.at/index.php?id=7*
[513] SCHULMEISTER, S., *supra*, 5.
[514] NOKED, N., *supra*, 2.
[515] BRONDOLO, J. D., *supra*, 5.
[516] EUROPEAN COMMISSION, PROPOSAL FOR A COUNCIL DIRECTIVE IMPLEMENTING ENHANCED COOPERATION IN THE AREA OF FINANCIAL TRANSACTION TAX, February 14, 2013, *supra*, Art. 10(1) and (2).

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represent a significant competitive disadvantage for the European centers. The lack of a global implementation of a financial transaction tax may drastically increase the risk of relocation of the transactions to other financial centers where such a tax is not implemented, as pointed out by the City of London officials.[517] This concern has been amplified by the chief executive of ICAP, one of the world's largest inter-dealer brokerage institutions, who stated that in case of implementation of the tax they would move their main operations away from Europe.[518] Due to this concern, the UK Treasury stated that it would oppose the adoption of the proposed tax if not implemented within a globally-coordinated framework.[519] And, indeed, the United Kingdom was one of the countries which vetoed the adoption of the Proposal on June 2012. As a result of the decision by only eleven Member States to engage in enhanced cooperation procedure, the relocation risk has been augmented. Due to the absence, at the moment, of an established common administrative control mechanism, it is questionable that the "issuance principle" contained in the new Proposal (see *III.3.7.1.1*) can effectively prevent avoidance by relocation. Such a risk, in a comparative perspective, is less likely to occur in case of implementation of excess profits taxes and levies on balance sheet positions. Given the fact that the latter are, by definition, taxes on the institutions and not on the transactions, they could be avoided only by means of relocation of the institutions to other jurisdictions. But financial institutions, in particular banks, are extremely tied to the financial centers in which they have been located for many years. The human capital and the advanced legal structures available in these locations represent, in fact, highly precious advantages. Financial institutions are, therefore, extremely unlikely to give up such supportive infrastructure simply for the purpose of avoiding the payment of a minimal levy.[520]

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[517] NOKED, N., *supra*, 3.
[518] I*d.*
[519] HOUSE OF LORDS, EUROPEAN UNION COMMITTEE, *Call for evidence: towards a Financial Transaction Tax*, available at http://www.parliament.uk/documents/lords-committees/eu-sub-com-a/FinancialTransactionTax/CfEFTT.pdf. (retrieved on July 2012).
[520] PAGE, R., *supra*, 207.

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Finally, some criticisms are related to the level of consistency of the proposal with the disclosed goal of ensuring harmonized functioning of the European Internal Market. In the proposal, the European Commission clearly stated that by enacting the proposed tax it seeks "*to avoid fragmentation in the internal market for financial services, bearing in mind the increasing number of uncoordinated national tax measures being put in place*" during the crisis. Indeed, "*several EU Member States have already taken divergent action in the area of financial sector taxation. The purpose of this proposal is to provide a common European approach to this issue that is consistent with the internal market*".[521] Nevertheless, it has been observed that when the proposal was originally formulated, no Member State had introduced a financial transaction tax in the last years (which had instead been gradually repealed starting from the 1990s as seen in III.3.4.2.1). On the contrary, during the crisis some Member States had introduced other types of bank levies. Therefore, to effectively avoid fragmentation, the Commission should have rather tried to coordinate the various national bank levies.[522]

Only after the issuance of the Commission's proposal, a few Member States enacted domestic financial transaction taxes.[523] These measures were strongly criticized as well. The critiques focused on the potential counter-productive effects of unilateral enforcement and on the fact that such taxes differ from each other and even from the EU Commission's proposal.[524]

[521] EUROPEAN COMMISSION, *id.*, 4.
[522] VELLA, J., FUEST, C., SCHMIDT-EISENLOHR T., *supra.* DAVEREUX, M., *New bank taxes, New World Order?*, *supra*, 12-13, 13.
[523] Specifically, domestic financial transaction taxes have been enacted by Italy, France and Hungary.
[524] GARBARINO, C., ALLEVATO, G., *Financial Transaction Tax europea: obiettivi dichiarati e potenziali effetti distorsivi*, *supra*.

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III.3.7.2 The U.S. proposal for a levy on uninsured liability: the Financial Crisis Responsibility Fee

On January 2010, President Obama proposed, as part of the 2011 fiscal budget, the implementation of a 0.15% levy on the largest financial institutions' uninsured liabilities. According to the Treasury's original estimations, such a levy was supposed to raise about 117 billion dollars over 12 years which would have been used to "*pay back taxpayers for the extraordinary assistance provided so that the TARP [Troubled Asset Relief Program] does not add to the deficit…*".[525]

Since then, the proposal has never been enacted. It has been, instead, presented again in the 2012, 2013 and 2014 fiscal budgets. The current design (as of the last fiscal budget) of the proposed tax did not vary substantially from the original proposal included in the 2011 budget, except for the estimation of the revenue which it is supposed to raise over the first 12 years of implementation: in the 2012 budget the estimation was cut to 30 billion dollars, and in the last 2013 budget it has been recalibrated to 60 billion dollars.

An interesting amendment to the original proposal, which was included in the last fiscal budget, was a statement that part of the tax revenue would be used to pay for President Obama's mortgage refinancing program.

According to the proposals formulated in the 2011, 2012 and 2013 fiscal budgets, the levy would cover only those institutions which were recipients and/or indirect beneficiaries of financial aid programs established by the government for the purposes of limiting the impact of the financial crisis,[526] and would be applied to the financial institutions with more than 50 billion dollars in consolidated assets. Therefore, it would cover only the largest firms.

[525] THE WHITE HOUSE, FINANCIAL CRISIS RESPONSIBILITY FEE, 2010, available at: http://www.whitehouse.gov/sites/default/files/financial_responsability_fee_fact_sheet.pdf. See also PAGE R., *supra*.
[526] These institutions include "*firms that were insured depository institutions, bank holding companies, thrift holding companies, insurance or other companies that owned insured depository institutions, or securities broker dealers as of January 14, 2010, or that become one of these types of firms after January 2010*". THE WHITE HOUSE, *supra*.

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As mentioned above, the fee would be levied upon the institutions' uninsured liabilities. We already discussed, in *III.3.4.1.2*, the reasons for excluding equity capital and insured liabilities from the base of a liability-based levy.

III.3.7.2.1 Consistency and differences with respect to the standard-model of Liability-Based levy

With respect to the standard model of liability-based levy described in *III.3.4.1.2*, the Obama proposal shares the regulatory approach, represented by the explicitly manifested goal of "*discouraging excessive risk-taking.*" By levying the tax on the uninsured liabilities, it certainly provides the institutions with incentives to reduce their debt-to-equity ratio.

Moreover, by imposing the tax burden exclusively to those institutions with more than 50 billion dollars in consolidated assets, the proposed levy would deter financial firms from increasing or maintaining their size in excess of levels that may threaten the stability of the financial system.

One negative side effect of the 50 billion dollar threshold may be represented by the fact that it does not provide the smaller institutions with incentives to lower their debt-to-equity ratio, which in most cases is probably as high as the larger firms.

Notably, the liability-based levy proposed in the US lacks any provision for the creation of an insurance/resolution fund. This may represent a missed opportunity to provide the system in advance with the necessary resources for a bailout in case of a future crisis. On the other hand, the lack of an insurance fund could turn out to be a positive element of the proposal because it does not increase moral hazard among the firms, as discussed in III.3.3.3.

In addition, according to the Obama proposal, the Responsibility Fee, unlike the European FTT and consistently with the US tax system, would be characterized by a world wide territorial application that would make it really difficult to avoid the

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imposition of the tax. Indeed, for institutions headquartered in the US, the levy would be levied upon all uninsured liabilities globally. The levy would also cover the uninsured liabilities of the US subsidiaries of foreign firms. Besides this, it is worth remembering that, as already pointed out in *III.3.7.1.2*, the risk of relocation of financial institutions for the purposes of avoiding a liability-based levy is, in general, very low. In absence of a globally-coordinated tax policy, as the current scenario seems to suggest, this may constitute an important comparative advantage of the US proposal over the EU proposal.

III.3.7.2.2 Criticism by financial organizations

The Obama proposal has been the subject of multiple criticisms. In particular, it has been depicted as an arbitrary tax by some financial organizations.[527] This accusation is based on the fact that, according to the Obama proposal, the revenue collected from the levy will payback the taxpayers for the costs of the bailout. However, the TARP is apparently paying for itself -- the large firms which benefited from the TARP are returning their financing. [528]

These claims have been further fueled by the circumstance that, as mentioned above, the Obama Administration significantly cut (from 117 billion dollars to 30 billion dollars.) the revenue expected to arise from the implementation of the fee just one year

[527] See J. Linn Yankg, Z. G. A. Goldfarb, *Obama Budget Would Double Bank Tax Size*, http://www.washingtonpost.com/blogs/ezra-klein/post/obama-budget-would-double-bank-tax-size/2012/02/13/gIQA0bnJBR_blog.html "*The banking industry strongly opposes the $61 billion bank tax included in President Obama's budget proposal*," American Bankers Association CEO Frank Keating declared. "*Despite claims to the contrary, the facts on TARP are very clear,"* he said. *"Taxpayers have profited $13 billion from their investments in banks through the program and Treasury predicts they will see a lifetime positive return of more than $20 billion" without the proposed tax. "Given that non-bank programs are responsible for all of TARP's losses, this would simply be an arbitrary tax with no regard to where losses actually occurred.*"

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after the formulation of the original proposal and increased it again (from 30 to 61 billion dollars) in the 2013 fiscal budget -- the last budget before the re-election campaign.

Finally, opponents of the levy look at the fact that, as specified in the last budget, part of the revenue of the levy would be used for the Obama's mortgage refinancing program as additional proof that the proposal is focused on garnering support from the public in an election year.[529]

III.3.8 Conclusions

The paragraphs above have illustrated how nation states, scholars and international organizations and institutions like the IMF and the European Union have discussed and made significant steps towards the use of taxation as a sound and innovative regulatory tool for governments to make the financial institutions and other operators acting within the financial market internalize the negative externalities of their excessive risk-taking behaviors, including the costs imposed on society in case of default and the contribution to systemic risk.

This moves are, first of all, an additional and important demonstration of the fact that nation states are becoming aware of the fact that the regulatory function of their tax sovereignty can be effectively exercised to deal with issues whose effects are spread at a global level only if such exercise of sovereignty is internationally-coordinated. In turn, the debate, the studies and the issuance of actual proposals for the adoption of an internationally-coordinated regulatory financial tax confirm that the use of the taxing power for regulatory purposes can still play a pivotal role in the maintenance of national state sovereignty. Indeed, the inability to regulate activities which produce negative

[529] SHESHUNOFF, *Obama Renew Bank Tax Proposal*, Feb. 17, 2012, http://www.sheshunoff.com/news/52/Obama-Renews-Bank-Tax-Proposal.html (retrieved on April 2012)

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externalities within their jurisdiction would represent a substantial impairment of the power to govern, that is, the core of state sovereignty (see *Introduction*).

Of course, designing and implementing an internationally-coordinated financial tax is an extremely complicated task, since, as we have seen, every type of financial tax corresponds to a particular goal and entails different costs and advantages. Also, without the involvement of all the jurisdictions belonging to a macro-financial region, any financial tax incurs the risk of being easily avoided by means of relocation techniques and therefore being ineffective and reducing the competitiveness of the locality in attracting investments.

The failure of the G-20 leaders to reach an agreement on the implementation of a global financial tax represents a significant missed opportunity for the development of a globally-coordinated regulatory tax policy. It is therefore unsurprising that both the European Commission and the US government are incurring serious difficulties in turning their proposals into law. However, the proposals currently on the table, above all the European proposal, certainly constitute important opportunities for the continuation and the development of the debate concerning the use and the role of taxation to regulate the financial sector and therefore preserve national state sovereignty from the negative externalities of financial markets' globalization.

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