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## **Dynamism and democracy: essays on the fiscal social contract in a globalised world**

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### **Citation**

Ganzen, B. N. van. (2025, March 6). *Dynamism and democracy: essays on the fiscal social contract in a globalised world*. Meijers-reeks.

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Dynamism and Democracy

Essays on the Fiscal Social Contract in a Globalised World



# Dynamism and Democracy

Essays on the Fiscal Social Contract  
in a Globalised World

PROEFSCHRIFT

ter verkrijging van  
de graad van doctor aan de Universiteit Leiden,  
op gezag van rector magnificus prof.dr.ir. H. Bijl,  
volgens besluit van het college voor promoties  
te verdedigen op donderdag 6 maart 2025  
klokke 14.30 uur

*door*

Bastiaan Niels van Ganzen

geboren te Amsterdam

in 1994

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Lay-out: AlphaZet prepress, Bodegraven  
Printwerk: Ipskamp Printing

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ISBN 978-94-6473-715-8

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## Acknowledgements

The role of fiscal policy in the relationship between the individual and the community has interested me since I began studying tax law. The impact of globalisation on that relationship has become an evergreen theme in tax scholarship, yet many aspects of it are still underexplored. Being able to contribute to the research on this important subject has been a unique honour and privilege. I am grateful to the Institute of Tax Law and Economics at Leiden University for giving me this opportunity.

I am particularly thankful to my supervisors, Koen Caminada and Henk Vording. Koen, thank you for your encouragement to stay focussed and to submit my manuscripts rather than striving for endless perfection, and for your unwavering availability and willingness to provide support, no matter the day or hour. You have not only helped me sharpen my analytical skills but also empowered me to believe in my abilities as a scholar. Henk, I deeply appreciate the incredible freedom you granted me during my PhD journey. I once read that saying this is a way to implicitly criticise one's supervisor, but here, it is genuine. Having near-absolute academic freedom to decide on research topics, write without strict deadlines, and determine the frequency of our meetings was invaluable to me. Those meetings have been absolutely eye-opening explorations of tax law that broadened my horizon towards what we might call fiscal sociology. The intellectual growth that I experienced as a result will benefit me throughout my career. I greatly enjoyed working together on chapters 2 and 5 of this dissertation.

The latter also applies to Dirk Broekhuijsen, co-author of chapter 5. Dirk, thank you for the numerous interesting and fun discussions, enriched by your ability to combine tax-technical knowledge with profound insights on international relations and philosophy, and by your great sense of humour and Dutch directness.

I would also like to thank my PhD committee members – Egbert Jongen, Laurens van Apeldoorn, Olaf van Vliet, Peter Essers and Yvette Lind – for dedicating their time to reviewing my manuscript and offering many insightful comments and suggestions that have been helpful in refining my work. Furthermore, a special thanks to Arjan Lejour, Hendrik Vrijburg, Lars van Doorn, Pierre Koning and Vincent Bakker for providing valuable feedback on empirical models and draft papers. I also gratefully acknowledge the feedback from participants at conferences where early versions of chapters were presented.

Writing this dissertation has been significantly facilitated by the inspiring and supportive academic environment provided by the Tax Law Department at Leiden University. Acknowledging that singling out certain individuals is inevitably unfair to others, I would like to stress that my thanks go



to all colleagues. Nevertheless, I would like to mention Jurian, with whom I have shared an office for five years, discussing so many topics ranging from the typology of taxes to the technicalities of carpentry, always in a relaxed and fun atmosphere and with plenty of puns. Thank you so much for sharpening my thinking, providing me with new perspectives on the world and making my PhD years even more enjoyable. I would also like to mention Allard, Elody, Laurens, Mohamed and Rens, with whom I enjoy teaching several courses – something that greatly enriches the academic profession. Koos and Jan, thank you for successively leading the Department during these years. Despite having strong doctrinal legal backgrounds, both of you have bravely broadened our horizon of tax scholarship by fostering multidisciplinary and empirical research. I believe that this has strengthened the scientific output of our Department and made it truly unique in the country. And thanks to both of you, our Department has always felt like home.

Although this part of my academic journey has been an overwhelmingly positive experience, my time as a PhD candidate was not without its challenges. It saddens me that my father will not witness my defence ceremony; I continue to miss him dearly. I am profoundly grateful for his support, patience and gentleness. My heartfelt thanks also go to those around me who have supported me during difficult times – they know who they are. Above all, I want to thank my mother. Her unconditional love, kindness, guidance, wisdom and selflessness have been the foundation of my life. This accomplishment is as much hers as it is mine.

Taxes constitute the foundation and the embodiment of the relationship between the individual and the community. Throughout the ages, taxes have functioned as a mechanism through which societies fund communal endeavours, shape relationships between citizens and express collective values. The ever-evolving nature of the relation between the individual and community, shaped by historical circumstances and social paradigms, renders taxation a context-dependent and dynamic phenomenon. One of the historically contingent aspects of taxation, though taken for granted since the twentieth century, is its link with democracy. The link between taxation and democracy is underpinned by the concept of the social contract, wherein citizens consent to taxation in exchange for the benefits and protection provided by the state. The social contract and hence, fiscal democracy, have traditionally been defined within national borders. Globalisation may therefore jeopardise the democratic basis of taxation. The tension between globalisation and national tax policy has been a key topic in tax policymaking and tax scholarship since the onset of globalisation in the late twentieth century. This thesis consists of four independently published chapters that, from three methodological perspectives, have aimed to fill specific gaps in different strands of literature on this topic.

Section 1.1 of this introduction sketches a brief history of modern taxation and demonstrates how the relationship between taxation and democracy in developed economies is embedded in social contract theory. Section 1.2 then explains how today's conceptions of the fiscal social contract are challenged by globalisation. Section 1.3 introduces the four substantive chapters of this thesis, their three methodological perspectives and their contributions to the existing literature.

## 1.1 THE FISCAL SOCIAL CONTRACT

In Western, post-classical history, we can only speak of taxation in the first place since the early modern era. What demarcates the early modern taxes from the levies of the medieval feudal systems is that they are collected by a public body and spent on a public purpose, rather than being based on

hierarchical personal relations.<sup>1</sup> The early modern era witnessed a gradual emergence of statehood as power centralised into independent political entities that were tied to a particular territory.<sup>2</sup> The evolution of political theory in early nation states has been shaped by contractarian thinkers, who refuted the doctrine of the divine right of kings and instead propounded the idea of a 'social contract' as a justification for state authority.

According to Thomas Hobbes, society initially comprises free and equal but self-interested individuals who have no capacity for self-government and who will live 'nasty, brutish and short' lives in a lawless state of nature. For the sake of their own safety, they sign a social contract in which they surrender their will to an absolute sovereign.<sup>3</sup> According to Hobbes, taxes are 'the wages due to them that hold the public sword to defend private men'; and they should be levied according to 'the benefit that every one receiveth thereby', namely 'the enjoyment of life, which is equally dear to poor and rich'.<sup>4</sup> This form of benefit taxation imposed by an absolute sovereign can hardly be called democratic, but the underlying contract signed 'voluntarily' by free and equal individuals was a radical innovation that has become the cornerstone of philosophy of taxation as well as modern political theory.<sup>5</sup> It laid the basis for the democratisation of taxation in the capitalist, parliamentary state that came to dominate most of Western Europe through the Age of Enlightenment. The social contract that underpins taxation in the parliamentary state is based on the thinking of John Locke and is centred on private property. Locke's imaginary state of nature looks less grim than Hobbes's because individuals in this world are not only equipped with natural rights but also with morals and reason.<sup>6</sup> According to Locke, reasonable individuals should agree that they are better off signing a social contract with a public body that pursues their common interests and pro-

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- 1 J Snape, 'The 'Sinews of the State': Historical Justifications for Taxes and Tax Law' in M Bhandari (ed), *Philosophical Foundations of Tax Law* (Oxford, Oxford University Press, 2017) 9-10. Or, as taught in Dutch tax law textbooks, levies are taxes when they are 'mandatory payments to the government, not to be considered as penalties, based on universally applicable legislation, which do not offset an individually identifiable government service': eg IJJ Burgers, HJ Bresser, W Grooten, FJPM Haas, MH Hogendoorn and RA Wolf, *Belastingrecht in Hoofddlijnen* (Deventer, Wolters Kluwer, 2019) 3.
  - 2 J Branch, *The Cartographic State: Maps, Territory, and the origins of Sovereignty* (Cambridge, Cambridge University Press, 2013). The Peace of Westphalia in 1648 should not primarily be seen as a confirmation of sovereignty, let alone as an endpoint of this process: A Osiander, 'Sovereignty, International Relations, and the Westphalian Myth' (2001) 55 *International Organization* 251.
  - 3 T Hobbes, *Leviathan* (first published 1651, Oxford, Clarendon Press, 1965) 132.
  - 4 Hobbes, *Leviathan* 266.
  - 5 The real innovation here was the contract, not moral equality of persons: K Hoekstra, 'Hobbesian Equality' in SA Lloyd (ed) *Hobbes Today. Insights for the 21st Century* (Cambridge, Cambridge University Press, 2012).
  - 6 J Locke, 'The Second Treatise: An Essay Concerning the True Original, extent, and End of Civil government' in I Shapiro (ed) *Two Treatises of Government and A Letter Concerning Toleration* (first published 1690, Binghamton NY, Vail-Ballou Press, 2003) 101-102.

fects their property.<sup>7</sup> However, they do not surrender their will, and the contract remains based on mutual consent: when the government violates the right to property, the governed have the right to withdraw.<sup>8</sup> Likewise, taxation should be based on the consent of taxpayers and can therefore only be justified in a democratic process.<sup>9</sup> In other words: the community ‘taxes itself’.<sup>10</sup>

While the constitutions of many nineteenth-century parliamentary states echoed this idea,<sup>11</sup> consent-based taxation largely remained an idea on paper, as voting rights were restricted to rich men while taxation sometimes heavily burdened the lower classes.<sup>12</sup> Only with the introduction of universal suffrage in the early twentieth century, taxation became fully legitimised by the democratic process while also effectuating the preferences of the demos.<sup>13</sup> These preferences included redressing the adverse social consequences of capitalism, which was increasingly seen as a construct that could be placed under political control rather than as a natural phenomenon. Instead of leaving the pre-tax income distribution intact, twentieth-century income taxation became based on a principle of equal sacrifice or ‘ability to pay’ that could be traced back to John Stuart Mill.<sup>14</sup> This principle not only served redistributive purposes, but it was also more feasible than benefit taxation due to increasing levels of government expenditures. However, it is inherently ambiguous and eventually evolved into a political slogan that justified taxation beyond equal sacrifices so as to realise any specific conception of distributive justice.<sup>15</sup> This evolution coincided with an implicit redefinition of property rights, based on the argument that the full right to one’s pre-tax income becomes meaningless when much

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7 Locke (n 6) 111; 141-142.

8 Locke (n 6) 163.

9 Ibid.

10 J Jaakkola, ‘A Democratic Dilemma of European Power to Tax: Reconstructing the Symbiosis Between Taxation and Democracy Beyond the State?’ (2019) 20 *German Law Journal* 660, 663. For a much more in-depth discussion of the Hobbesian and Lockean approaches to taxation, see W Schön, ‘Taxation and Democracy’ (2019) 72 *Tax Law Review* 235.

11 Schön (n 10).

12 S Steinmo, ‘The Evolution of Policy ideas: Tax Policy in the 20th Century’ (2003) 5 *British Journal of Politics and International Relations* 143.

13 This reciprocal relation between taxation and democracy is underlined by Jaakkola (n 10). It bears resemblance to Scharpf’s distinction between two components of democratic legitimacy, namely input legitimacy (governance ‘by the people’) and output legitimacy (the actual policy output, ‘for the people’): F Scharpf, *Governing in Europe: Effective and Democratic?* (Oxford, Oxford University Press, 1999).

14 M Pressman, ‘“The Ability to Pay” in Tax Law: Clarifying the Concept’s Egalitarian and Utilitarian Justifications and the Interactions Between the Two’ (2018) 21 *Legislation and Public Policy* 141; Steinmo (n 12).

15 See G den Hartogh, ‘The reality of ownership. Are there any principles of fiscal justice?’ (unpublished manuscript, University of Amsterdam, 2002). The manuscript can be accessed from the author’s personal web page: <https://govertdenhartogh.nl/downloads-3/>.

of our capacity to earn income is made possible by state institutions (e.g., education, infrastructure and the legal system as a whole).<sup>16</sup>

This refutation of the Lockean right to property<sup>17</sup> has neither been shared across the entire political spectrum nor been associated with expropriation,<sup>18</sup> but it does exemplify the consequentialist approach to taxation that is characteristic of today's mixed economies. Beyond simply raising revenues, taxation is nowadays seen as an instrument to achieve any income or wealth distribution deemed desirable by the electorate, and to pursue any other political goal, whether it be disincentivising excessive CEO pay or stimulating bicycle use.<sup>19</sup> The corresponding economic method of policy analysis aims to optimise taxes to best achieve certain objectives (e.g., minimising economic distortions and administrative costs) while taking into account certain constraints (e.g., a certain level of redistribution) – usually so as to maximise welfare. Although this welfare consequentialist approach does not prescribe certain objectives or constraints, its optimisation function implicitly prioritises the public interest over individual freedom and morality.<sup>20</sup> The dominance of consequentialist tax policy is framed by Snape as a shift from the Lockean social contract of the early parliamentary state towards a more Hobbesian contract, in which we have surrendered our will to a somewhat absolutist administrative state that pursues our interests as effectively as possible while giving less priority to taxpayer rights.<sup>21</sup>

Be that as it may, tax policy in modern, developed economies has become a central factor in our lives and a significant determinant of our

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16 Nowadays, that argument is best known from L Murphy and T Nagel, *The Myth of Ownership: Taxes and Justice* (Oxford, Oxford University Press, 2002). However, it was already made by mid-century tax scholars, eg HJ Hofstra, *Socialistische Belastingpolitiek* [Socialist Tax Politics] (Amsterdam, De Arbeiderspers, 1946).

17 Schön (n 10) 262-265.

18 As noted in chapter 3, 'whenever left-wing political forces questioned the very viability of capitalism during the post-war decades, they failed to win electoral support. Instead, the biggest successes of welfare state expansion were achieved by 'people's parties' that regarded the welfare state as a community project of which all co-nationals were members': see S Berman, *The Primacy of Politics: Social Democracy and the Making of Europe's Twentieth Century* (Cambridge, Cambridge University Press, 2006).

19 Regarding CEO pay, see T Piketty, *Capital in the Twenty-First Century* (Cambridge MA, The Belknap Press of Harvard University Press, 2014) 648. Regarding bicycle use: see Dutch House of Representatives 1997-1998, 25810 nr 2, 86-87.

20 The fact that the social planner may choose to pursue a low level of redistribution does not negate that aggregate welfare rather than personal freedom is the main goal. See also ER Morey, 'What are the ethics of welfare economics? And, are welfare economists utilitarians?' (2018) 65 *International Review of Economics* 201. Illustrative of consequentialist policy is the 304-page government memorandum referred to in n 19. Exploring options for the 2001 Dutch income tax reform, it mainly expresses the goal of securing stable revenue streams and contains only a handful mentions of a 'just tax burden distribution'. The latter goal remains entirely undefined and it is merely invoked as a means to increase political support: Dutch House of Representatives (n 19), as cited in Den Hartogh (n 15).

21 Snape (n 1) 28-32. Schön (n 10) already discerns a shift from a Lockean to a Hobbesian view in the nineteenth-century evolution of ideas on redistribution and progressive taxation: 262-265.

identities. The state explicitly influences our lives through redistributive and instrumental tax policies; but as stressed by Dagan, it also does so implicitly by deciding which elements of our identities determine our ability to pay – e.g., family size, marital status, work-related travel expenses, disabilities, children, healthcare need or informal caregiving.<sup>22</sup> Tax policies, therefore, affect our self-perceptions and have financial consequences that vary with our identities. That becomes evident, as de Cogan illustrates, for people with disabilities who need to work harder for an X amount of income than non-disabled people, when both are subject to an income tax that does not consider disability.<sup>23</sup> This observation is related to a strand of critical tax literature that questions the supposed neutrality of ability-to-pay taxation. By promoting certain identities, the argument goes, the state reinforces certain power structures in society. For example, certain beneficial tax policies may primarily accrue to privileged groups, depending on specific choices and identities correlated with those groups (e.g., if homeownership is correlated with ethnic background, so are mortgage interest deductions).<sup>24</sup> The Dutch childcare benefits scandal has recently illustrated that the consequences of bad tax or allowance policy may be distributed unequally among classes and backgrounds as well.<sup>25</sup>

In democratic states, it is debatable whether or not the latter observations should be regarded as examples of repressive taxation.<sup>26</sup> Either way, they illustrate the importance of sociological questions and the weighing of political values in tax policymaking.<sup>27</sup> These values boil down to our conceptions of the public interest, defined not only economically but also culturally, and to our understanding of equal respect and concern for individuals. The well-known debate on whether we should tax individual income or family income illustrates this point. One's position in that debate depends on one's political weighing of, inter alia, economic consequences (individual income taxation is related to higher labour market participation); sociological and cultural consequences (the rise of the two-earner family has social effects on parents and children); gender equality (family income taxation usually discourages women to perform paid work); and financial equality between one-earner families versus two-earner families with equal incomes.

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22 T Dagan, 'The Currency of Taxation' (2016) 84 *Fordham Law Review* 2537; 'The tragic choices of tax policy in a globalized economy' in Y Brauner and M Stewart (eds), *Tax, Law and Development* (Cheltenham, Edward Elgar Publishing, 2013).

23 D de Cogan, 'Public law and political values in tax law' in L Parada (ed) *A Research Agenda for Tax Law* (Cheltenham, Edward Elgar Publishing, 2022) 30.

24 See AC Infanti, 'Tax Equity' (2008) 55 *Buffalo Law Review* 1191.

25 See M Fenger and R Simonse, 'The implosion of the Dutch surveillance welfare state' (2023) 58 *Social Policy and Administration* 264.

26 At least, these policies are less intentional than the non-democratic, repressive taxes described in PHJ Essers (ed), *History and Taxation: The Dialectical Relationship between Taxation and the Political Balance of Power* (Amsterdam, IBFD, 2022).

27 See de Cogan (n 23).

Hence, the fact that today's tax policy brings not only the economy but also our notions of community and individual identity under political control still fits into the frame of fiscal democracy as a social contract. Whether this historically contingent contract should be viewed as Hobbesian (due to the allegedly technocratic and 'absolutist' nature of the state)<sup>28</sup> or Lockean (as the highly politicised nature of taxation should still allow for democratic deliberation, change and consent), its theoretical basis has remained unchanged since the Enlightenment: the promotion of the interests of morally equal individuals within a community.

## 1.2 THE FISCAL SOCIAL CONTRACT IN A GLOBALISING WORLD

Ever since the age of absolutism, this 'community' has been demarcated by geographical borders.<sup>29</sup> Resultingly, in the words of Schön, there has been 'congruence' between 'the persons who determine democratic inputs, the persons who bear the burden of taxation, and the persons who enjoy the benefit of public expenditure'.<sup>30</sup> The continuous increase in cross-border mobility of individuals, economic activities and paper profits since the last quarter of the twentieth century diminishes this congruence. As tax is one of the factors influencing the decision of individuals and businesses where to reside or conduct economic activities, national governments have the incentive to compete for foreign taxpayers through general tax cuts or targeted tax incentives.<sup>31</sup> The general consensus is that tax competition is a negative-sum game that might lead to tax revenue losses<sup>32</sup> and will result in lower levels of redistribution than states would have had in a closed-border situation.<sup>33</sup>

This is not just a threat to a Lockean social contract aimed at financing public goods, with the prior public good being the state itself.<sup>34</sup> It is also

28 See Snape (n 1). Note that this contract may nevertheless be called 'democratic' because in the modern version of the Hobbesian approach to taxation, the monarch as the absolute sovereign has been replaced by 'the people': Schön (n 10) 265.

29 However, the idea of a clear break in 1648 between geographically overlapping jurisdictions and territorial sovereignty is a myth: Osiander (n 2); Branch (n 2). What nowadays illustrates the remaining importance of geographical borders in the relation between taxation and democracy is the observation that the modern axiom 'no taxation without representation' often implies 'no representation without taxation'; see eg Y Lind, 'A Critical Analysis of How Formal and Informal Citizenships Influence Justice between Mobile Taxpayers' in D de Cogan and P Harris (eds), *Tax Justice and Tax Law* (Oxford, Hart Publishing, 2020); Essers (n 26).

30 Schön (n 10) 235.

31 P Genschel and P Schwarz, 'Tax competition: a literature review' (2011) 9 *Socio-Economic Review* 339.

32 eg T Plümper, V Troeger and H Winner, 'Why is There No Race to the Bottom in Capital Taxation?' (2009) 53 *International Studies Quarterly* 761.

33 KA Clausing, 'The Nature and Practice of Tax Competition' in T Rixen (ed) *Global Tax Governance: What Is Wrong with It and How to Fix It* (Colchester, ECPR Press, 2016).

34 P Dietsch and T Rixen, 'Tax Competition and Global Background Justice' (2014) 22 *Journal of Political Philosophy* 150, 152.



problematic in a liberal internationalist framework where states are seen as equal and independent, analogously to individuals.<sup>35</sup> The reason is that tax competition has the potential to gravely increase inequality between countries. First, large countries have more domestic revenues to lose relative to the potential gain of tax base inflows.<sup>36</sup> Second, poor countries depend to a larger extent on tax bases that are viable to competitive pressure, such as foreign direct investment.<sup>37</sup> Third, poor countries have less administrative resources to tackle the aggressive avoidance strategies of taxpayers who exploit mismatches between legal systems, tax treaties and transfer pricing rules.<sup>38</sup>

At the domestic level, tax competition threatens our twentieth-century, redistributive conception of the fiscal social contract by forcing countries to shift their tax burdens from mobile capital to immobile labour and consumption.<sup>39</sup> That potentially violates electoral preferences on taxation and redistribution. It also affects the democratic legitimisation of the social contract by giving mobile taxpayers two extra channels of influence in addition to the voting rights that are enjoyed by all. First, they can influence domestic policy by threatening to leave their jurisdictions;<sup>40</sup> and second, their preferences are catered to by foreign governments that aim to attract them. The option to leave one's jurisdiction does enhance one's Lockean right to withdraw from an unfair social contract.<sup>41</sup> However, this right is not equally enjoyed by all individuals, and these two extra channels of influence essentially triple the democratic representation of mobile taxpayers.<sup>42</sup> As taxpayers' mobility is often correlated with their wealth, income or profits, we partially return to the nineteenth-century conception of democracy that coupled representation with socioeconomic status.<sup>43</sup>

This point is related to the abovementioned connection between tax policy and identity. As stressed by Dagan, tax competition leads to an increased emphasis on taxpayers' mobility and use-value for the economy, rather than on their cultural identity as part of a national community.<sup>44</sup> Hence, taxpayers' personal characteristics are commodified in financial

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35 S Picciotto, *Regulating Global Corporate Capitalism* (Cambridge, Cambridge University Press, 2012) 28.

36 R Kanbur and M Keen, 'Jeux Sans Frontières: Tax Competition and Tax Coordination When Countries Differ in Size' (1993) 83 *American Economic Review* 877.

37 R de Mooij, T Matheson and R Schatan, 'International Corporate Tax Spillovers and Redistributive Policies in Developing Countries' in BJ Clements and others (eds), *Inequality and Fiscal Policy* (Washington DC, IMF, 2015).

38 Ibid.

39 eg Plümpert, Troeger and Winner (n 32).

40 Several real-life examples are provided by Schön (n 10) 295.

41 Dagan, 'The tragic choices' (n 22); Schön (n 10) 294-295, 297-298.

42 See J Jaakkola, 'Enhancing Political Representation Through the European Economic Constitution? Regressive Politics of Democratic Inclusion' (2019) 15 *European Constitutional Law Review* 194.

43 Ibid.

44 Dagan, 'The tragic choices' (n 22).



terms. It will be the subset of rich individuals and successful businesses that will be most sought-after, that will be able to find the best tax deals abroad, and that will disconnect from the national social contract. Dagan predicts a multiplying effect as communities become increasingly tenuous due to the erosion of a cultural sense of belongingness, a development that has indeed been observed in the literature on identity economics.<sup>45</sup> This erosion may be detrimental for redistributive tax policy because the demand for redistribution within national communities appears to depend on the sharing of identities based on place and culture rather than financial success.<sup>46</sup>

In sum, the justifications for and the functions of modern, developed tax systems are embedded in social contract theory that has its origins in Enlightenment philosophy. The fiscal social contract is aimed at promoting the public interest in a context of moral equality of persons. In modern times, democracy and redistribution have become its central elements. Economic globalisation and tax competition pose a threat to democracy, to redistribution, to moral equality of persons within and across nation states, and to the public interest as a whole.

This is not a new argument. For instance, in a wider context than tax policy, it has been formulated by Rodrik as a trilemma: we need to give up economic globalisation; or democracy; or national policymaking.<sup>47</sup> The observations above suggest that we are currently giving up fiscal democracy; but a normative attachment to a democratically inspired social contract implies that we should give up either of the other two. As argued by Dietsch and Rixen, the choice between globalisation and national policy autonomy is not dichotomous but allows for combinations of stricter capital controls in some areas and global governance in others.<sup>48</sup> It is also an essentially political choice, as both globalisation and the nation state are political constructs. As long as nation states remain the primary loci of democratic decision making, responses to globalisation in and outside tax law depend on what is arguably the key question in current political theory: how much normative weight should national communities assign to their insiders relative to outsiders?<sup>49</sup>

Answering that question with respect to fiscal policy requires a thorough understanding of national and international tax law, but it cannot be done through black-letter legal analysis alone. One reason is the centrality of political values in tax policy that has been illustrated above. Tax policy

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45 P Collier, 'Diverging identities: a model of class formation' (2020) 72 *Oxford Economic Papers* 567.

46 D Rueda, 'Food Comes First, Then Morals: Redistribution Preferences, Parochial Altruism, and Immigration in Western Europe' (2018) 80 *Journal of Politics* 225.

47 D Rodrik, *The Globalization Paradox: Democracy and the Future of the World Economy* (New York, W.W. Norton, 2011).

48 P Dietsch and T Rixen, 'Global Tax Governance: What It is and Why It Matters' in T Rixen (ed) *Global Tax Governance: What Is Wrong with It and How to Fix It* (Colchester, ECPR Press, 2016) 8.

49 P Dietsch, 'Rethinking sovereignty in international fiscal policy' (2011) 37 *Review of International Studies* 2107, 2115.

inevitably entails normative choices concerning the definition of the public interest; the economic and cultural aspects that are deemed relevant to that definition; our interpretation of moral equality of persons; and perhaps even our understanding of democracy. These normative choices largely fall outside the scope of doctrinal legal analysis, and that does not change in a globalised setting – any response to globalisation requires normative foundations.<sup>50</sup> In turn, these normative foundations require an understanding of the actual and desired contents of the fiscal social contract; the way in which national communities are affected economically and culturally by globalisation and tax competition; how national policymakers react; and what role global institutions play in reform processes.<sup>51</sup> That research agenda inevitably transcends the boundaries of academic disciplines.

### 1.3 STRUCTURE, RESEARCH QUESTIONS, METHODS AND CONTRIBUTIONS

This thesis makes a modest contribution to that project in four substantive chapters that are all related to the tension between globalisation and the fiscal social contract. These four chapters take three different perspectives and employ three different methodologies, namely: an exploration of the current nature of the fiscal social contract (chapter 2); empirical analyses of how globalisation affects tax systems (chapters 3 and 4); and a philosophical analysis of how countries should deal with the effects of their tax policies on other nations (chapter 5). As all chapters have been published separately and have made specific contributions to different strands of literature, together they will not cover all aspects of the relation between globalisation and the fiscal social contract. Their scope and depth were constrained by the respective word limits imposed by their publication venues. The citation styles used in these publications have been left intact rather than standardised in this thesis, in order to reflect the disciplinary conventions and methodological approaches of the respective chapters.<sup>52</sup> All chapters contain brief introductions and can be read independently.

Chapter 2 is a fiscal-historical and fiscal-sociological essay of an exploratory nature. It expands on the issues raised in this introduction and reflects on the current challenges to national tax systems through the lens of Joseph Schumpeter's essay *The Crisis of the Tax State*. Its echoes Schumpeter's

50 See generally P Hongler, *Justice in International Tax Law* (Amsterdam, IBFD, 2019).

51 See Dietsch and Rixen, 'Global Tax Governance' (n 48).

52 Chapters 1, 2, 5 and 6 use a footnote referencing system based on OSCOLA (Oxford University Standard for the Citation of Legal Authorities). The use of footnotes in these chapters allows for comprehensive referencing of legal sources and historical context without interrupting the flow of the main text. By contrast, the empirical chapters 3 and 4 adopt the APA (American Psychological Association) style of in-text referencing. In empirical disciplines where fewer and less extensive references are required, this system provides a relatively concise way to acknowledge sources, allowing for a smoother reading experience uninterrupted by footnotes. This is particularly helpful in discussions of data and statistical results, which already contain multiple references to figures and tables.

argument: taxation both shapes and reflects the course of economic and social history; the dynamic nature of societies renders taxation a contingent phenomenon; and the implication is that saving existing tax rules might not be the best way to deal with a changing social order.<sup>53</sup>

Then follow two chapters that empirically analyse the impact of tax competition on progressive income taxation and on the revenues of different taxes. Chapter 3 examines the determinants of statutory top personal income tax rate setting by governments in OECD countries using linear regression models.<sup>54</sup> Chapter 4 contains statistical analyses of the convergence and determinants of OECD countries' tax mixes.<sup>55</sup>

Chapter 5 takes a philosophical perspective. Its starting point is the central question in the extensive theoretical literature on national tax policy autonomy and tax justice: how should we deal with tax policy spill-overs on other nations? Chapter 5 makes a specific contribution by aiming to answer this question with respect to tax base distribution in bilateral treaties, through the lens of contract theory.<sup>56</sup>

Subsections 1.3.1 through 1.3.4 will introduce the research questions, methods and contributions to the existing literature of chapters 2 through 5. Chapter 6 will synthesise those findings and will provide some further reflections on multidisciplinary research in tax law.

### 1.3.1 Schumpeter's Crisis of the Tax State

Chapter 2 explores through a Schumpeterian lens the idea of taxes embodying the relationship between the individual and the community. It takes as a starting point Joseph Schumpeter's essay *The Crisis of the Tax State* (1918).<sup>57</sup>

The immediate concern of that essay is whether and how Austria, Schumpeter's home country, can overcome the enormous debt burden it faces in the aftermath of World War I. Schumpeter's answer to that question is: yes, it can; and among the various types of taxes examined, a one-off tax on capital would be the best way to raise extra revenues. But to make

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53 Chapter 2 has been published as a peer-reviewed book chapter: BN van Ganzen and H Vording, 'Schumpeter's Crisis of the Tax State, Globalisation and Redistribution' in D de Cogan, A Brassey and P Harris (eds), *Tax Law in Times of Crisis and Recovery* (Oxford, Hart Publishing, 2023).

54 Chapter 3 has been published as a peer-reviewed journal article: BN van Ganzen, 'Determinants of top personal income tax rates in 19 OECD countries, 1981–2018' (2023) 43 *Journal of Public Policy* 401.

55 Chapter 4 has been published as a peer-reviewed journal article: BN van Ganzen, 'Progressing regressively: conditional convergence and Europeanisation of tax mixes' (2025) 47 *Journal of European Integration* 1.

56 Chapter 5 has been accepted for publication as a peer-reviewed book chapter: BN van Ganzen, DM Broekhuijsen and H Vording, 'Contract theory as a guide to fairness in tax treaties' in IK Lindsay and B Mathew (eds) *Fairness in International Taxation* (Oxford, Hart Publishing, forthcoming).

57 Reprinted as JA Schumpeter, 'The Crisis of the Tax State' in R Swedberg (ed), *The Economics and Sociology of Capitalism* (Princeton, Princeton University Press, 1991).

that point, he undertakes a much broader analysis of what he calls the 'tax state', a state run by a government that is separate from, and financed through taxes on, the capitalist private sector. From today's viewpoint, that definition is not quite remarkable, but Schumpeter argues that this tax state is just one of the many ways to organise a society.<sup>58</sup> For instance, taxes defined as transfers from the private to the public sector did not exist in medieval feudal systems because collective needs were addressed through a system of personal relations. The tax state would also cease to exist in a socialist, planned economy because the concept of taxation requires a distinction between state and market. But as long as the tax state exists, its tax system will vary with the nation's entrepreneurial activity, its number of rentiers, the ratio of old wealth and growing wealth, its military expenses, the national debt burden, its bureaucratic capacity, the morality of its civil servants, the voluntary compliance of its taxpayers and much more.<sup>59</sup> Schumpeter's point is that the way we levy taxes reflects the structure of our social order, that is, the social ties within our community. This leads him to conclude that the tax state will have sufficient resilience to overcome macrolevel shocks, such as the debt crisis of 1918, as long as its underlying social ties remain intact. The real threat to its existence, instead, would be the demise of the social order it is based on.

The choice to use *The Crisis of the Tax State* as a starting point was influenced by the context of the COVID-19 crisis during the drafting of chapter 2. Without suggesting that the disruption caused by the COVID-19 pandemic has in any way been anywhere near the devastations of World War I, it is not difficult to draw some thematic parallels between the COVID crisis and the economic situation in 1918. One is the occurrence of a macrolevel shock that leads to an increased debt burden – at the time of writing chapter 2, at least. When the COVID lockdowns brought economic and social life to a standstill, many nations implemented extensive, debt-financed support measures for businesses and households. Given the resilience of most economies after the lockdown restrictions were lifted, worries in 2021 about the repayment of these debts have largely been overtaken by reality. A more accurate similarity is the focus on tax measures – by Schumpeter in his essay and by governments during the COVID crisis – as a remedy for acute economic problems. But the main focus of chapter 2 is Schumpeter's prediction that the tax state will have run its course once the social ties erode within the community it encompasses. How should we evaluate in that light the weakening connection of taxpayers with their national communities as a result of the physical and digital cross-border mobility of tax bases?

Chapter 2 therefore aims to answer the research question: *What lessons can be learned from Joseph Schumpeter's The Crisis of the Tax State regarding today's developed tax states and their underlying social order?*

To that end, chapter 2 first explores the main characteristics of

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58 See also de Cogan (n 23).

59 Schumpeter (n 57) 111.

Schumpeter's tax state. It is argued that the concept is inextricably linked to notions of dynamism and perpetual change: the social order of a community will continuously evolve, and so must the tax state. Then follows an examination of the relationship between crises and taxation through the modern era, intended as an extension of Schumpeter's primary object of study in his essay. A review of the historical literature on state building confirms Schumpeter's prediction by showing that macrolevel shocks did not pose a systemic threat to early modern and late modern tax states. To the contrary, especially wars but also financial crises tended to increase taxation and redistribution. These increases, however, were contingent on the social ties of the tax state in question. For instance, it was due to the development of a common or mass culture that tax rates and revenues rose to unprecedented levels during and after the two World Wars, fostered by a strong social cohesion within nation states. The post-war decades were arguably the heydays of both national identity and economic solidarity; and those social ties have considerably weakened since the onset of globalisation in the 1980s. The point is not that people or businesses avoid or evade the taxes they owe to their national communities – which also happened during the 1950s and 1960s – but that a subset of the population loses its connection to their national community in the first place.

The final section of chapter 2 aims to elucidate the meaning of these developments for the future of our tax state. One observation is that policy makers are still trying to save their twentieth-century tax rules – largely based on the income or profit made by a subject in a particular jurisdiction – from the twenty-first-century challenges of globalisation and digitalisation. This contrasts with the lasting heritage of Schumpeter's *Crisis of the Tax State*, which is much more dynamic and pragmatic: all taxes will and should reflect the specific economic and social conditions of a specific era, and hence, none are written in stone. A comparison is drawn to the introduction of income and profit taxes during the nineteenth century, which can be regarded as a response to technological and social changes that rendered the old taxes obsolete. Analogously, the main challenge today is to develop forms of taxation that address those who benefit from the new, globalised social order.

### 1.3.2 Determinants of top personal income tax rates

Chapter 2 will highlight how levels of taxation and redistribution have significantly risen over the course of the twentieth century across OECD countries, mainly as a response to wars and economic turmoil and always in a context of social cohesion and solidarity. Redistribution between richer and poorer members of the national community has since then remained a main goal of those countries' tax systems. One of the most effective redistributive instruments on the revenue side of the government budget is the

personal income tax.<sup>60</sup> A relatively good indicator of the tax's redistributive capacity is its top statutory rate, which is the central topic of chapter 3.

First and foremost, the top income tax rate determines the amount of tax revenue raised from high incomes, depending on the threshold at which the top bracket sets in. But it also affects the revenue-raising and redistributive capacities of medium-level tax brackets by setting their maximum rates. Furthermore, higher tax rates at the upper end of the income distribution may finance tax reliefs on lower levels of income, keeping revenues equal.<sup>61</sup> This may help unemployed individuals overcome the so-called 'poverty trap', a situation where they face disincentives to enter the labour market due to a loss of state benefits.<sup>62</sup> Relatedly, this may stimulate second earners in couples to enter the labour market and hence contributes to the labour force participation and economic empowerment of women.<sup>63</sup> It is more difficult to achieve these general and specific redistributive goals under a flat tax regime, which would require a costly tax-free sum that will accrue to all incomes.<sup>64</sup> Thus, the statutory top income tax rate affects redistribution throughout the entire tax rate schedule.

The top rate also has an important indirect redistributive function as highlighted by Piketty, Saez and Stantcheva: it raises the costs for employers of paying out excessive net wages and hence moderates pre-tax income inequality.<sup>65</sup> This effect is important in reducing both income and wealth inequality, given that a substantial share of wealth inequality may originate not from returns to capital or from bequests, but from top labour incomes.<sup>66</sup> Although redistributive policies can be implemented both on the revenue and spending sides of the government budget, the latter argument implies that solely assisting the poor through government expenditures is insufficient for a meaningful reduction in inequality: a progressive income tax is essential.

In this light, it is remarkable that top personal income tax rates have

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60 That is not to say that the income tax is the most important redistributive instrument in the entire government budget. Caminada and others find that income taxes contribute to approximately 25% of redistribution in a selection of 8 high-income countries; the remaining 75% takes place through social transfers: CLJ Caminada, KP Goudswaard, C Wang and J Wang, 'Has the redistributive effect of social transfers and taxes changed over time across countries?' (2019) 72 *International Social Security Review* 3.

61 Provided that the top rate does not exceed its revenue-maximising level through its effects on labour supply.

62 R de Mooij, *Reinventing the Dutch tax-benefit system: Exploring the frontier of the equity-efficiency trade-off* (2007) CPB Discussion Paper No 88.

63 See H Rosen, 'Is It Time to Abandon Joint Filing?' (1977) 30 *National Tax Journal* 423.

64 FT Zoutman, B Jacobs and ELW Jongen, *Optimal Redistributive Taxes and Redistributive Preferences in the Netherlands* (2013) <https://jacobs73.home.xs4all.nl/OTP.pdf>.

65 T Piketty, E Saez and S Stantcheva, 'Optimal Taxation of Top Labor Incomes: A Tale of Three Elasticities' (2014) 6 *American Economic Journal: Economic Policy* 230.

66 B Kaymak, D Leung and M Poschke, *Accounting for Wealth Concentration in the United States*, Working Paper No. 22-28 (Federal Reserve Bank of Cleveland, 2022). <https://doi.org/10.26509/frbc-wp-202228>



declined substantially in OECD countries over the last decades: their average has decreased from around 70% in the 1970s to 43% today.<sup>67</sup> Scholars have suggested various causes. One is the continuous decline in corporate income tax rates since the onset of globalisation in the 1980s. The corporate tax acts as a backstop of the personal income tax by disincentivising the avoidance of labour taxes through incorporation.<sup>68</sup> Hence, if governments are forced to cut their corporate tax rate under international competitive pressure,<sup>69</sup> they might want to reduce their top personal tax rate in order to preserve tax system integrity. This so-called ‘backstop hypothesis’ is far from new,<sup>70</sup> but it is important to test empirically. If corporate tax competition drags down top personal income tax rates, that has significant implications for national fiscal sovereignty. By undermining the main element of the redistributive tax system, it would reduce countries’ capacity to set redistributive policies according to the democratic preferences of their national communities – which is the core of the fiscal social contract outlined at the beginning of this introduction.<sup>71</sup>

But the political economy of the personal income tax consists of more than an interplay with the corporate income tax. It may also depend on domestic institutions and economic circumstances, such as the structure of the labour market, employment and economic growth.<sup>72</sup> Furthermore, labour taxation is highly politicised and strongly connected to arguments of fairness and economic efficiency.<sup>73</sup> Earlier research has shown that top rate reductions in many OECD countries have been part of a ‘neoliberal’ tax reform model with low rates and broadened bases, aimed at closing

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67 The estimate of 70% is based on own calculations using the earliest available data year in the data set used for the regression analyses in chapter 3 (namely, 1980, when the average top personal income tax rate following the definition outlined in chapter 3 was 68.21%, excluding Iceland, Türkiye and Switzerland due to missing data), combined with the statement by the OECD that ‘top tax rates were equal to or above 70% in half of the OECD countries in the mid-1970s’: OECD Directorate for Employment, Labour and Social Affairs, *FOCUS on Top Incomes and Taxation in OECD Countries: Was the crisis a game changer?* (2014). The 43% is the average of the values from the latest available data year (namely, 2022) in Table I.7 ‘Top statutory personal income tax rates’ in the OECD’s Data Explorer, which can be accessed via <https://data-explorer.oecd.org/>.

68 R Gordon and J MacKie-Mason, ‘The Importance of Income Shifting to the Design and Analysis of Tax Policy’ in M Feldstein, JR Hines Jr. and RG Hubbard (eds), *Taxing Multinational Corporations* (Chicago, University of Chicago Press 1995).

69 See Genschel and Schwarz (n 31).

70 See eg S Ganghof, *The politics of income taxation: A comparative analysis* (Colchester, ECPR Press, 2006).

71 T Dagan, ‘Re-imagining Tax Justice in a Globalised World’ in D de Cogan and P Harris (eds), *Tax Justice and Tax Law: Understanding Unfairness in Tax Systems* (Oxford, Hart Publishing, 2020); ‘The tragic choices’ (n 22) 67.

72 See generally A Kemmerling and Z Truchlewski, ‘The domestic determinants of tax mixes’ in L Hakelberg and L Seelkopf (eds), *Handbook on the Politics of Taxation* (Cheltenham, Edward Elgar, 2021).

73 See eg Ganghof (n 70).

loopholes and increasing economic efficiency.<sup>74</sup> Several countries enacted such tax reforms in the late 1980s and 1990s. Their reforms might either have been purely domestic political decisions, or emulations of the influential 1986 US tax reform which embodied the neoliberal worldview of the Reagan administration.<sup>75</sup> In either case, the reduction of top personal income tax rates could have been the result of governments being favourably disposed towards cutting taxes in general, rather than the result of tax competition depriving them of the leeway to set tax rates as they wished. The fact that OECD countries increased their top rates by around 5% on average in the aftermath of the 2008 financial crisis illustrates that at least some of this political leeway still exists.<sup>76</sup> A contributing factor to the recent top rate increases might have been the increasingly successful combat of illegal capital flight, which allowed governments to raise shareholder-level dividend taxes.<sup>77</sup> It is plausible that higher dividend taxation has alleviated the downward pressure on labour tax rates by restoring the balance between the respective tax burdens on labour and shareholder income.

Despite the political importance of the top income tax rate and the complexity of its political economy, little quantitative research has been conducted on the determinants of top rate setting. Many potential determinants, such as government ideology, political institutions and economic circumstances, have been tested only as determinants of average labour tax rates, labour/capital tax ratios or electoral preferences regarding redistribution.<sup>78</sup> Most studies that do focus on the top personal income tax rate do not include the corporate income tax rate as a control variable.<sup>79</sup> Studies that do include both rates generally find a strong correlation between them.<sup>80</sup> However, that correlation does not elucidate the underlying causal relationship. Their relation might be bidirectional or be influenced by a third factor – recall neoliberal politics. This blurs any evidence in favour of the

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74 See eg Steinmo (n 12).

75 In a context of corporate tax cuts, see D Swank, 'Taxing Choices: International Competition, Domestic Institutions and the Transformation of Corporate Tax Policy' (2016) 23 *Journal of European Public Policy* 571.

76 This hike was largely a response to fairness considerations among electorates: J Limberg, 'What's fair? Preferences for tax progressivity in the wake of the financial crisis' (2020) 40 *Journal of Public Policy* 171.

77 L Ahrens, F Bothner, L Hakelberg and T Rixen, 'New Room to Maneuver? National Tax Policy under Increasing Financial Transparency' (2020) *Socio-Economic Review*, <https://doi.org/10.1093/ser/mwaa007>

78 eg K Angelopoulos, G Economides and P Kammas, 'Does cabinet ideology matter for the structure of tax policies?' (2012) 28 *European Journal of Political Economy* 620; P Schwarz, 'Does capital mobility reduce the corporate-labor tax ratio?' (2007) 130 *Public Choice* 363. On electoral preferences, see generally S Berens and M Gelepithis, 'What do People Want? Explaining Voter Tax Preferences' in Hakelberg and Seelkopf (n 72).

79 eg J Limberg, '"Tax the rich"? The financial crisis, fiscal fairness, and progressive income taxation' (2019) 11 *European Political Science Review* 319.

80 eg J Slemrod, 'Are corporate tax rates, or countries, converging?' (2004) 88 *Journal of Public Economics* 1169.



‘backstop hypothesis’ according to which corporate tax competition spills over to personal tax rate setting.

The most convincing evidence in favour of that hypothesis follows from case studies by Ganghof of seven countries’ tax reforms between the 1980s and early 2000s.<sup>81</sup> Those case studies show that several personal income tax cuts were partially motivated by a wish to preserve the integrity of the tax system after corporate tax rates had fallen. A methodological pitfall of qualitative case studies, however, is the difficulty in discerning and quantifying the primary driving factors behind tax reforms, especially when government statements list multiple reasons for a reform’s implementation. For instance, a labour tax cut may be sold publicly under the slogan ‘making work pay’ while the government’s primary motive is restoring the balance between labour and capital tax burdens.<sup>82</sup>

A linear regression approach can complement the existing qualitative evidence by quantifying the effects of the various fiscal, political, institutional and economic factors that shape countries’ income tax policies. The availability of internationally comparable data that describe those factors for a large number of OECD countries between the 1980s and late 2010s makes it possible to substantially extend existing analyses in terms of countries and data years.

The central research question in chapter 3 is therefore: *What are the political economic determinants of OECD countries’ top statutory personal income tax rate setting?*

Two subsequent questions are:

- *To what extent should corporate tax competition be identified as the cause of the declined top personal income tax rates of OECD countries?*
- *Insofar low corporate tax rates exert downward pressure on personal income tax rates, can governments mitigate that pressure through shareholder taxation?*

To answer these questions, chapter 3 studies tax reforms between 1981 and 2018 by 226 cabinets in 19 OECD countries using linear regression models. The models use cabinet periodisation rather than standard country-year data. This is a relatively novel approach that should conform better to the political reality of fiscal policy, because a government normally drafts one tax plan instead of evaluating the tax system each year.<sup>83</sup>

### 1.3.3 Convergence of tax mixes

Whereas the top statutory personal income tax rate, studied in chapter 3, is a politically salient element of the tax system and a clear signal of redis-

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81 Ganghof (n 70).

82 As highlighted in chapter 3, the 2018 income tax cuts in the Netherlands exemplify this unclarity.

83 C Schmitt, ‘Panel Data Analysis and Partisan Variables: How Periodization Does Influence Partisan Effects’ (2016) 23 *Journal of European Public Policy* 1442; Ahrens and others (n 77). Country-year models will be estimated as a robustness check.

tributive policy, chapter 4 focusses on a less visible but nevertheless relevant component of the tax state: the aggregate composition of government revenues, or tax mix.

The tax mix is an important object of study firstly because it affects the tax system's redistributive capacity – though in a less direct way than tax rates.<sup>84</sup> Taxes that fall on capital, such as property taxes, normally have more redistributive capacity than taxes on labour, because people whose income largely originates from capital are usually wealthier than labour income earners. Incidentally, whereas the corporation tax should fall on capital, it may be redistributive in name only, insofar corporations shift their tax burden to workers and consumers by adjusting wages and product prices. Among the taxes that instead fall mainly on labour, especially the personal income tax has substantial redistributive power, for the reasons outlined in the introduction to chapter 3. Social security contributions have less redistributive capacity because their tax base generally consists of a capped amount of labour income. Consumption taxes are considered to be regressive because poorer individuals usually spend a larger share of their income on consumption than richer individuals.<sup>85</sup> But the tax mix does not only affect a country's income and wealth redistribution; it also influences labour market performance and aggregate economic output. For instance, social security contributions have been linked to lower employment levels,<sup>86</sup> and corporate taxes are generally considered worse for economic growth than consumption taxes.<sup>87</sup> These effects render the composition of the tax mix a relevant object of study in two different strands of literature that chapter 4 will speak to.

First, tax mix composition is an important but overlooked factor in the literature on European economic and welfare state convergence. An explicit goal of the European Union is that domestic welfare states develop and become more homogeneous across Member States as the Union economically integrates.<sup>88</sup> A large body of literature has studied this convergence process, but has mainly looked at various government expenditures, such as benefit systems.<sup>89</sup> Despite the importance of the tax mix for a country's

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84 Kemmerling and Truchlewski (n 72).

85 N Warren, *A Review of Studies on the Distributional Impact of Consumption Taxes in OECD Countries* (2008) OECD Social, Employment and Migration Working Papers No. 64.

86 A Kemmerling, 'Tax mixes, welfare states and employment: tracking diverging vulnerabilities' (2005) 12 *Journal of European Public Policy* 1; FW Scharpf 'The viability of advanced welfare states in the international economy: vulnerabilities and options' (2000) 7 *Journal of European Public Policy* 190.

87 O Akgun, B Cournède and JM Fournier, *The effects of the tax mix on inequality and growth*, OECD Economics Department Working Papers No. 1447 (Paris, OECD Publishing, 2017).

88 eg, article 3 of the Treaty on European Union stipulates that the Union must aim towards social progress, and article 151 of the Treaty on the Functioning of the European Union mentions that 'the functioning of the internal market (...) will favour the harmonisation of social systems'.

89 eg CLJ Caminada, K Goudswaard and OP van Vliet, 'Patterns of Welfare State Indicators in the EU: Is there Convergence?' (2010) 48 *Journal of Common Market Studies* 529.

economy and welfare state, only a limited number of studies have analysed convergence on the revenue side of the government budget.<sup>90</sup> Most of the existing studies only focus on Western Europe in the late twentieth century, while currently one third of all Member States are Central and Eastern European (CEE) countries. Moreover, most studies measure unconditional convergence across their entire sample of countries. That measure is inconsistent when sub-sets of the sample actually converge into dispersed 'clubs' as a result of specific political or economic conditions.<sup>91</sup> The existing evidence on the political economy of tax systems suggests that several convergence clubs are plausible. For instance, countries that experience more competitive pressure on their tax systems may gradually form a distinct group with less income taxes and more consumption taxes than other countries.<sup>92</sup> Countries with high levels of government expenditures may also have distinct tax mixes because the economic efficiency costs of high income taxes might require them to rely on social premiums and/or indirect taxes.<sup>93</sup> EU countries should have more homogeneous tax systems because of the EU's harmonisation efforts;<sup>94</sup> whereas the CEE Member States might converge into a specific direction because of their distinct political economies.<sup>95</sup>

Second, the abovementioned determinants of tax mixes are relevant objects of study in a broader literature on the political economy of taxation that relates to the issues raised in the first part of this introduction. Earlier studies have identified a wide range of domestic determinants, including partisan and interest group politics, and electoral and labour market institutions.<sup>96</sup> These domestic determinants may co-exist beside international policy diffusion through tax competition or European harmonisation. A central question in the twenty-first-century literature on the political economy of taxation concerns the relative influence of these factors. In other words: are domestic governments still able to shape tax policy according to democratic preferences under increasing globalisation and Europeanisation?

Chapter 4 aims to answer the following research question: *What are the determinants of tax mix composition in OECD countries?*

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90 See eg A Kemmerling, 'Does Europeanization lead to policy convergence? The role of the Single Market in shaping national tax policies' (2010) 17 *Journal of European Public Policy* 1057; F Delgado and M Presno, 'Tax evolution in the EU: A convergence club approach' (2017) 64 *Panoeconomicus* 623.

91 T Plümpner and CJ Schneider, 'The analysis of policy convergence, or: How to chase a black cat in a dark room' (2009) 16 *Journal of European Public Policy* 990.

92 S Loretz, 'Corporate taxation in the OECD in a wider context' (2008) 24 *Oxford Review of Economic Policy* 639.

93 S Ganghof, 'Tax mixes and the size of the welfare state: causal mechanisms and policy implications' (2006) 16 *Journal of European Social Policy* 360.

94 Kemmerling (n 90).

95 H Appel and MA Orenstein, 'Why did Neoliberalism Triumph and Endure in the Post-Communist World?' (2016) 48 *Comparative Politics* 313.

96 Kemmerling and Truchlewski (n 72).

Two subsequent questions are:

- *Do the tax mixes of OECD countries converge?*
- *If the tax mixes of OECD countries converge, which factors shape the direction of convergence?*

The focus of chapter 4 lies on four categories of taxes: personal income taxes, corporate income taxes, social security contributions and general consumption taxes.<sup>97</sup> Their relative shares in total tax revenues are studied as dependent variables in error correction models. Because these models regress the change in a dependent variable on its lagged level, they are able to detect so-called  $\beta$ -convergence: a negative  $\beta$ -coefficient would indicate that low levels have higher growth rates and high levels have lower growth rates, which implies that values are moving towards each other. Control variables and interaction terms are included to estimate the determinants of both tax mix composition and the convergence process. Data are available for 30 OECD countries, 23 of which are EU member states, including 8 CEE countries. Tax mixes in the entire panel are studied between 1996 and 2019, and an additional analysis excluding the CEE countries runs from 1980 to 2019.

### 1.3.4 International tax fairness in a bilateral setting

As will be argued in chapter 2, the main challenge to the twenty-first-century tax state is our globalising and digitalising world where taxpayers are losing their connection to national communities. For a subset of mobile taxpayers, taxation has either become a mere payment for the public services enjoyed in a country of choice rather than a collective tool to finance societal objectives;<sup>98</sup> or a cost to be minimised altogether through aggressive tax planning strategies. Countries, in turn, use tax policy to compete for the economic activities or paper profits of those mobile taxpayers.<sup>99</sup> Whereas tax competition will not be found in chapter 4 to be a major determinant of the revenues of different taxes, chapter 3 will clearly underline its negative effects on tax rates. The decline in top personal income tax rates of OECD countries is caused by tax competition, not by domestic preferences. The result is that one nation's competitive tax policy may deprive policymakers in other jurisdictions of a pivotal instrument of redistribution between their constituents, hence undermining fiscal social contracts abroad. The general consensus among governments and scholars is that these spill-over effects can be so harmful to the entire purpose of national tax policy that uncondi-

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97 I follow the categorisation of tax revenues used by the OECD. The categories of property taxes and specific consumption taxes are excluded. The political economies of the taxes in those categories are too diverse to capture in one model, and those taxes are not studied individually because of their unimportance in the tax mix.

98 Dagan, 'Re-imagining Tax Justice' (n 71).

99 Genschel and Schwarz (n 31).

tional tax sovereignty is a thing of the past.<sup>100</sup> Hence, countries are required to somehow consider the impact of their tax policies on the interests of other nations and their citizens. The resulting question is what normative weight one should give to insiders of the national community relative to outsiders. As highlighted earlier in this introduction, this is one of the most important current questions in political theory.<sup>101</sup> The aim of chapter 5 is to contribute to the extensive philosophical literature that grapples with this question.

Many studies in that literature have focussed on countries' sovereignty over unilateral tax policy. For instance, Dietsch argues that we should move from a Westphalian principle of non-intervention towards a concept of 'sovereignty as responsibility', which entails the obligation to cooperate in tax matters so as to limit harmful tax competition and protect the effectiveness of domestic tax systems.<sup>102</sup> In an attempt to codify which unilateral policies should be allowed or disallowed, Dietsch and Rixen propose a 'Fiscal Policy Constraint'.<sup>103</sup> This principle proscribes fiscal policies which are implemented solely with a strategic purpose, that is, to attract tax base from abroad, insofar these policies negatively affect the aggregate fiscal autonomy of nations. Their aim is to protect countries' autonomy to implement non-strategic policies according to national democratic preferences, even if those policies happen to be competitive and incidentally attract foreign tax base. Risse and Meyer go further and argue that the relevant criterion to test the acceptability of national tax policies should be the protection of 'global justice'.<sup>104</sup> Such an approach is less accommodative to national autonomy because it requires countries to pursue a single conception of justice that cannot vary across jurisdictions.<sup>105</sup>

This small selection of the many existing papers on fair unilateral tax policy already highlights a major difference in normative premises that can render two approaches conceptually incommensurable – in this case, a deontological attachment to national autonomy versus a consequentialist pursuit of global justice. This dichotomy is reminiscent of the classic division between pure statist approaches to international tax justice (which only require nation states to care for their own citizens) versus cosmopolitan

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100 For instance, Christians observes (ahead of the BEPS project) that the OECD's work on international taxation 'evidences an emergent vision of sovereignty that entails positive obligations or duties of nations in exercising the power to tax (...) under an implied social contract': A Christians, 'Sovereignty, Taxation and Social Contract' (2009) 18 *Minn J Int'l L* 99.

101 Dietsch (n 49) 2115.

102 Dietsch (n 49).

103 Dietsch and Rixen (n 34).

104 M Risse and M Meyer, 'Tax Competition and Global Interdependence' (2019) 27 *Journal of Political Philosophy* 480.

105 See P Dietsch and T Rixen, 'Debate: In Defence of Fiscal Autonomy: A Reply to Risse and Meyer' (2019) 27 *The Journal of Political Philosophy* 499.

approaches (which require equal moral concern for all individuals worldwide) – although both dichotomies do not necessarily coincide.<sup>106</sup>

Whereas most theories of international tax justice take a normative stance on the fairness of unilateral tax policy, the perspectives of those studies and the tensions between them – especially those outlined above – are equally relevant in discussions on fair tax base distribution in bilateral tax treaties. Arguably, bilateral treaties are even more important a factor in international tax justice than unilateral policies, because they constitute the cornerstone of current international tax law. Most taxpayers who conduct cross-border economic activities are subject to a treaty that divides taxing rights between the state where they reside and the state where their economic activities take place. This division may have significant redistributive consequences among the two treaty partners, especially because taxpayers who make outward investments usually reside in high-income countries, whereas low-income countries often rely on investment inflows. Tax treaties may also have external effects on third nations by stimulating investments in the two treaty partners at the expense of the rest of the world – quite similarly to the external effects of unilateral tax cuts. Furthermore, their specific divisions of taxing rights and their reductions in withholding tax rates on dividend, interest and royalty payments may contribute to tax planning opportunities. These effects, in turn, may have redistributive consequences that are especially negative for low-income countries. Tax revenues on foreign direct investments are relatively important in low-income countries' tax mixes; and those countries usually have less administrative capacity than high-income nations to tackle tax avoidance strategies.<sup>107</sup>

Several authors approach the issue of fair tax base distribution in bilateral treaties from a relatively cosmopolitan viewpoint by serving a goal of global justice or redistribution. One radical proposal is to abolish the system of bilateral treaties altogether and switch toward a global formulary apportionment of tax bases that grants low-income countries enough taxing rights. In a world where bilateral treaties do exist, Musgrave and Musgrave propose that the amount of taxing rights granted to the source country should increase with the differential between the two treaty partners' levels of economic development.<sup>108</sup> In a similar vein, Infanti proposes to make tax

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106 For one thing, Dietsch and Rixen assert that their attachment to national tax policy autonomy, while being relatively statist, should be palatable for cosmopolitans as well. They argue that nation states outperform a hypothetical world government in determining and effectuating local perceptions of what 'justice' entails. If that is true, national tax policy autonomy is the better way to achieve the cosmopolitan ideal of justice for all individuals worldwide, provided that strategic and harmful policies are filtered out: Dietsch and Rixen (n 34) 172-175. See also Dietsch and Rixen (n 105).

107 de Mooij, Matheson and Schatan (n 37).

108 RA Musgrave and PB Musgrave, 'Inter-nation Equity' in RM Bird and JG Head (eds), *Modern Fiscal Issues: Essays in Honor of Carl S. Shoup* (Toronto, University of Toronto Press, 1972) 63.



treaties instruments of development aid.<sup>109</sup> Both formulary apportionment and the use of tax treaties as instruments of development aid constrain countries' autonomy to conclude tax treaties as they see fit; and both require worldwide efforts based on strong cosmopolitan premises that wealthy nations might be reluctant to accept.

Benshalom tries to avoid pure cosmopolitanism by arguing that the duty to include redistributive considerations in tax treaties is partial and relational, rather than impartial and global.<sup>110</sup> His starting point is freedom of contract: countries should be allowed to conclude trade agreements and tax treaties as they wish. Benshalom challenges the standard intuition in our liberal societies that both the fairness of contracts and distributive justice within the community as a whole should be guided solely by impartial rules that apply equally for all individuals. Normally, the division of mutual benefits that arise from private contracts is not required to vary with the relative wealth of both contracting parties. Clear differences between parties in vulnerability or negotiating power are instead assumed to be mitigated through impartial contract law. Income redistribution within the community as a whole is relegated to the tax-and-transfer system. By contrast, Benshalom draws upon our 'moral intuition' that individuals have relational duties that increase with the amount of cooperation, reciprocity and commonalities between them. He argues that these duties are independent from, and not second-best to impartial rules, not in the least because the legal system often fails to sufficiently reduce vulnerabilities. In the realm of international tax law, therefore, high-income countries should help low-income countries by giving up taxing rights, but this duty depends on the intensity of the two treaty partners' economic ties. Besides this duty, countries are free to design tax treaties as they see fit.

Whereas the main problem with cosmopolitan approaches to fair tax base distribution is their impracticability due to their utopian natures, a key challenge to Benshalom's approach is the question why considerations of justice should not apply to all countries alike. In particular, consider a poor and isolated country in need of capital. This country might sign any unfavourable tax treaty to attract investments, but it cannot invoke Benshalom's fairness considerations due to the weakness of its trade connections. Both the cosmopolitan approach and the relational duties approach, moreover, fail to provide an adequate response to tax treaties' external effects on third countries. Those may occur under any particular division of taxing rights between the two treaty partners. The approaches may also be unpracticable in a world with tax planning opportunities.

In sum, the debate on fair tax base distribution in bilateral tax treaties remains open-ended. In its contribution to this debate, chapter 5 will

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109 A Infanti, 'Internation Equity and Human Development' in Y Brauner and M Stewart (eds), *Tax, Law and Development* (Cheltenham, Edward Elgar Publishing, 2013) 209.

110 I Benshalom, 'The New Poor at our Gates: Global Justice Implications for International Trade and Tax Law' (2010) 85 *New York University Law Review* 1.

implicitly subscribe to the position that we should take countries' tax policy autonomy as given. The reason is pragmatic as well as normative. We happen to live in a world where the power to tax is mainly in the hands of nation states; and there are good reasons for that: nation states are more democratic and more sensitive to local perceptions of 'justice' than a world government.<sup>111</sup> Moreover, constraining the range of treaty conditions so as to protect countries' tax policy autonomy is an endeavour with a narrower scope than setting up a global system of formulary apportionment. Hence, the goal of chapter 5 is to find an impartial (rather than partial) framework for fair tax base distribution among bilateral treaty partners, which defines the positive 'sovereign duties' of nations attached to their legitimate exercise of national tax policy autonomy.<sup>112</sup> This definition should ideally include a standard to judge the acceptability of tax treaties' external effects on third nations. The latter goal is similar to the aim of Dietsch and Rixen's Fiscal Policy Constraint, but then applied in a bilateral setting – without suggesting that Dietsch and Rixen themselves are in favour of such an application.<sup>113</sup>

In theories of international tax justice, the concepts of 'tax sovereignty' or 'national tax policy autonomy' are often explicitly or implicitly viewed as analogues of individual freedom as defined in liberal political theory.<sup>114</sup> In determining the 'sovereign duties' of national governments to uphold other countries' tax policy autonomy, the implicit idea is that 'one's freedom ends where another's begins'. The closest analogue in a bilateral situation is contract theory, which provides the philosophical framework for the norms that govern the relation of two autonomous parties who enter into an agreement.<sup>115</sup> Contract theory has been examined in extensive and intersecting strands of literature from philosophical, and law and economics perspectives. Much of this analysis centres on so-called contracting problems, one of those being the issue of external effects on third parties, which is a central problem in international tax law.

Chapter 5 therefore aims to answer the question: *How can contract theory provide guidance in discussions of fair tax base distribution in bilateral tax treaties?*

Chapter 5 will first address and categorise the main issues of unfairness in bilateral tax treaties. It will argue that these boil down to three contract-

111 P Dietsch and T Rixen (n 34), 172–175.

112 See Christians (n 100).

113 Rather, they 'endorse unitary taxation with formulary apportionment': Dietsch and Rixen (n 34) 152.

114 eg P Dietsch, 'The State and Tax Competition: A Normative Perspective' in M O'Neill and S Orr (eds), *Taxation: Philosophical Perspectives* (Oxford, OUP, 2018), 214–15; I Benshalom (n 110), though his concept of relational duties between states primarily serves as a solution to the collective action problems that constituents face in fulfilling their relational duties vis-à-vis trade partners abroad. See also Picciotto (n 35) 28.

115 The aim is not to draw an analogy between the law of contracts and international tax law, as they are incomparable in many respects: Y Brauner, 'The True Nature of Tax Treaties' (2020) 74 *Bulletin for International Taxation* 28; A Rasulov, 'Theorizing Treaties: The Consequences of the Contractual Analogy' in CJ Tams, A Tzanakopoulos and A Zimmermann (eds), *Research Handbook on the Law of Treaties* (Cheltenham, Edward Elgar, 2014).



ing problems: externalities, that is, effects on third parties who are not involved in the treaty itself; coercion, defined as the absence of voluntary consent as a result of constrained choices; and information asymmetry, whereby inadequate information about the contents and consequences of the treaty leads to the absence of informed consent. These respective problems are then analysed using insights from literature on both tax justice and contract theory.

As mentioned, chapter 5's focus on bilateral tax treaties rather than unilateral tax policy complements the existing philosophical literature on the normative weight that should be given to insiders versus outsiders of national communities in tax matters. But whereas international tax law is indeed largely built on bilateral tax treaties, it is nowadays also increasingly shaped by multinational tax legislation, including the OECD Action Plans intended to reduce Base Erosion and Profit Shifting (BEPS) and the Pillar 2 directive aimed at establishing a global minimum corporate tax rate. Recent discussions regarding fairness in international taxation have centred on the democratic legitimization of the decision-making processes behind such multinational initiatives.<sup>116</sup> A key critique is that these initiatives are largely shaped by the OECD and G20 and fail to take into account the interests of low-income countries.<sup>117</sup> Arguably, the problems that arise for those countries are quite similar to those analysed in chapter 5 in the context of bilateral tax treaties. In particular, there are similarities with the contracting problem of 'coercion', defined as the absence of voluntary consent as a result of constrained choices.<sup>118</sup> However, these parallels do not imply that contract theory is the best tool to analyse those problems, given that multinational tax law making involves broader decision-making frameworks than the situation where two countries enter into a bilateral agreement. Furthermore, the issue of fair tax base distribution between source countries and resident countries in bilateral treaties remains relevant as long as those treaties exist, even in the presence of multinational tax law. Thus, including a detailed critique of multinational tax law and its democratic legitimacy falls outside the scope of chapter 5.

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116 eg P Essers, Klaus Vogel Lecture 2013, 'International Tax Justice between Machiavelli and Habermas' (2014) 68 *Bulletin for International Taxation* 54; S Hemels, 'Tax Autonomy from a Member State Perspective: Are We Faced with a Democratic Deficit?' in R Luja (ed), *National (Tax) Autonomy and the European Union: Revival or Demise?* (Amsterdam, IBFD, forthcoming).

117 See eg Y Brauner, 'Serenity now! The (not so) inclusive framework and the multilateral instrument' (2022) 25 *Florida Tax Review* 489.

118 For instance, Oei finds 'evidence suggesting that coercion-based pathways were important in the proliferation of BEPS Inclusive Framework membership': S Oei, 'World Tax Policy in the World Tax Polity? An Event History Analysis of OECD/G20 BEPS Inclusive Framework Membership' (2022) 47 *Yale Journal of International Law* 199.

## ABSTRACT

The Austrian economist Joseph Schumpeter regarded taxation as central to state-building. According to him, the 'tax state' both reshapes and reflects the social structure and spirit of a community. He argued that macrolevel shocks do not threaten this tax state, as long as its social order remains intact. Only when the order breaks down, so will the tax state. Indeed, historical evidence shows that wars and economic downturns often caused tax states to expand rather than collapse. The same will probably happen during today's financial and geopolitical turmoil. Much more threatening to modern tax states, however, is the weakening of social ties between taxpayers and their communities in our globalising world. In line with Schumpeter's notions of dynamism and societal change, we argue that the solution to this new 'Crisis of the Tax State' lies not in saving twentieth-century income tax arrangements from twenty-first-century challenges, but in adapting our tax systems to the new social order.

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- This chapter has been published in D de Cogan, A Brassey and P Harris (eds), *Tax Law in Times of Crisis and Recovery* (Oxford, Hart Publishing, 2023): <https://www.bloomsbury.com/ca/tax-law-in-times-of-crisis-and-recovery-9781509958078/>. It was co-authored with Henk Vording. To comply with the PhD regulations outlined by the Doctorate Board of the Faculty of Law at Leiden University, which require me to provide an overview of contributions to co-authored chapters, I declare the following. The idea to use Schumpeter's essay *The Crisis of the Tax State* as a starting point for an analysis of today's tax states was Henk Vording's. The design of this study was a common effort with equal input of both authors. Attributable to Henk Vording are: the first three sentences of section 2.1 ('Using the words (...) depends on taxation.');
- the first three sentences of the second paragraph of section 2.1 ('Schumpeter's essay is (...) of tax bases.');
- the third paragraph of section 2.1 ('We first discuss (...) connection to it.');
- and the first three paragraphs of section 2.2 ('The text of (...) ages of feudalism').
- Common efforts were: the fourth paragraph of section 2.1 ('We conclude with (...) find additional ones.');
- the fifth paragraph of section 2.2 ('the tax state (...) with bureaucratic decision-making.');
- the first two paragraphs of section 2.5 ('It has been (...) action (size/redistribution).');
- nine paragraphs in the middle of section 2.5 ('The finalisation of (...) market state tax.');
- and section 2.6. All other parts were written by Bastiaan van Ganzen. Editing was done by Bastiaan van Ganzen. Bastiaan van Ganzen claims >70% authorship.

## 2.1 INTRODUCTION

Using the words ‘crisis’ and ‘tax’ in one sentence brings us inevitably to Joseph Schumpeter’s essay *The Crisis of the Tax State* (1918). In that essay, Schumpeter analysed taxation as the corollary of the modern state based on market economy and political representation. What underlies his analysis is a Weberian typology of social organisation: the medieval feudal state was based on personal ties and hence, did not need taxation; the modern state relies on bureaucratic formalisation of ties and fully depends on taxation. As long as those ties between members of communities remain intact, Schumpeter suggested, tax states will have sufficient resilience to overcome large macrolevel shocks, including the debt burden crises that several countries faced in the aftermath of World War I. However, he predicted that a successful tax state could eventually crumble under the weight of increasing demands for redistribution. To him, the tax state is a body that reflects and reshapes the social order of a free market society, and hence requires a distinction between state and market. Once the ties between members of a community are fully socialised and pricing is replaced by planning, this distinction disappears and so does the tax state.

Schumpeter’s essay is now over a century old. It is outdated in important respects, for example in its emphasis on socialism as the viable alternative to free market democracy. Furthermore, Schumpeter’s world simply did not know many of today’s tax challenges: how to tax digital services, how to deal with conflicting national interests concerning cross-border mobility of tax bases. Yet, his work is of continuing relevance. Like his contemporary Austrian economists, Schumpeter was driven by a desire to understand the extensive social, cultural and political changes of his time, in particular the demise of the Austro-Hungarian empire.<sup>1</sup> ‘Understand’ here means ‘Verstehen’ in a Weberian sense, being interpretative rather than quantitative and transcending the boundaries of economics, law, history, sociology and political science. Applying this qualitative method to the area of taxation, which he regarded as the central aspect of the modern state, Schumpeter pioneered the academic discipline of fiscal sociology.<sup>2</sup> Central

1 E Dekker, ‘Left luggage: finding the relevant context of Austrian Economics’ (2016) 29 *Review of Austrian Economics* 103.

2 This field has recently made a comeback with a new wave of multidisciplinary research on taxation: IW Martin, AK Mehrotra and M Prasad, ‘The Thunder of History: The Origins and Development of the New Fiscal Sociology’ in IW Martin, AK Mehrotra and M Prasad (eds), *The New Fiscal Sociology: Taxation in Comparative and Historical Perspective* (Cambridge, Cambridge University Press, 2009). For an application of the fiscal sociological method to current issues, such as gender equality and global taxation of capital, and for an extensive review of Schumpeter’s ideas on taxation, see A Mumford, *Fiscal Sociology at the Centenary: UK Perspectives on Budgeting, Taxation and Austerity* (Cham, Palgrave Macmillan, 2019). Mumford’s starting point is Schumpeter’s list of central questions of fiscal sociology: ‘What does “failure of the tax state” mean? What is the nature of the tax state? How did it come about? Must it now disappear and why? What are the social processes which are behind the superficial facts of the budget figures?’. Her primary focus is the fifth question in a UK context, and she does not propose answers to the first and the fourth questions, which, by contrast, are our main objects of study.

to his work is a notion of dynamism and perpetual change, encapsulated in the well-known phrase 'creative destruction'. This notion relates not only to entrepreneurial innovation as the primary driver of economic progress, but also to the inevitability of change in the entire social order of a community.<sup>3</sup> His definition of a 'crisis of the tax state' is strongly connected to this idea of social change. Therefore, his concept of the tax state is a useful tool for analysing the viability of present tax arrangements both in the light of sudden crises – the debt burden crisis caused by COVID-19 and the recent geopolitical turmoil – and in relation to changes in social ties caused by globalisation.

We first discuss Schumpeter's concept of the tax state in some more detail (section 2.2). Then we turn to Schumpeter's immediate concern: the role of crises in the development of the tax state (section 2.3). We suggest that crises have on balance increased the weight of the tax state, both in terms of tax burden and of redistributive effort, rather than diminishing it. It seems that an increasingly unstable geopolitical environment and the financial aftermath of the pandemic crisis will just repeat that story. We then turn to economic globalisation as a challenge to the tax state, and one that Schumpeter did not foresee (section 2.4). Here, the 'fiscal sociology' of social ties illuminates how the tax state may run into trouble as taxpayers lose their connection to it.

We conclude with discussing alternative ways to 'protect' the tax state (section 2.5) along two vectors. One denotes the degree of effectiveness of the tax state: its grip on the tax bases that it wants to address. The other is its economic impact: overall tax burden and redistributive effort. We track the historical path of developed tax states through this vector space and conclude that it was strongly shaped by both the occurrence of crises and the choice of tax instruments. We argue that Schumpeter's world was one in which states felt free to develop sophisticated tax rules of the income/profits tax type and did not have to bother seriously about effectiveness of their taxes; while currently, concerns over cross-border avoidance have grown considerably and we still try to run those sophisticated tax rules. We use Schumpeter's analysis to raise the question how long-run changes in the social fabric may affect the viability of existing taxes – and perhaps give reason to find additional ones.

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3 Schumpeter used the phrase 'creative destruction' only in the context of entrepreneurial innovation and not in the context of societal change, but arguably, he regarded both types of progress as two sides of the same coin, not in the least because economic development changes social life. See E Dekker, 'Schumpeter: Theorist of the avant-garde: The embrace of the new in Schumpeter's original theory of economic development' (2018) 31 *Review of Austrian Economics* 177, who shows that an avant-gardist embrace of 'the new' in general, relating to both economic and social change, particularly pervades JA Schumpeter, *Theorie der wirtschaftlichen Entwicklung* (Berlin, Duncker & Humblot, 1919).

## 2.2 SCHUMPETER'S TAX STATE<sup>4</sup>

The text of Schumpeter's essay is derived from a lecture that he gave to the Wiener Soziologische Gesellschaft and was originally published in 1918 as *Die Krise des Steuerstaates*.<sup>5</sup> The political context of the time was the imminent collapse of the Austro-Hungarian empire. It had ignited World War I only to become trivial to its outcome – the defeat of Germany at the western front, and the communist seizure of power in Russia. Indeed, quite a number of long-established states were on the verge of disappearance. In his essay, however, Schumpeter flatly denies that there exists a 'crisis of the tax state'.<sup>6</sup>

The immediate concern of his lecture was to respond to Rudolf Goldscheid's *Staatssozialismus oder Staatskapitalismus* (1917), a plea for strong state involvement in market processes. Schumpeter's argument is basically that there is no urgent reason for any move to socialism; acute financial concerns may be solved by a temporary tax on capital. But to undershore that argument, he undertakes a much broader analysis of the 'Tax State'.<sup>7</sup> To some extent, it foreshadows his *Capitalism, Socialism and Democracy* (1942),<sup>8</sup> especially in its analysis of the state, run by a government based on political contest and competition, as the organisation that matches free-market capitalism. That state is the Tax State, as taxation is the link between state and market. When a society relies on planning instead of the market to confront demand for and supply of goods and services, the concept of state becomes useless. That is what happens under socialism – which, for Schumpeter, consistent with his economic interpretation of politics, is not primarily a political doctrine but a non-market mode of organising the economy.

To be sure, the tax system is much more than just the financial flow from market to state. 'The spirit of a people, its cultural level, its social structure, the deeds its policy may prepare – all this and more is written in its fiscal history, stripped of all phrases. He who knows how to listen to its message here discerns the thunder of world history more clearly than anywhere else'.<sup>9</sup> Schumpeter makes no attempt to apply this promising starting point

4 See generally: KH Schmidt, 'Schumpeter and the Crisis of the Tax State' in J Backhaus (ed), *Joseph Alois Schumpeter: Entrepreneurship, Style and Vision* (Dordrecht, Kluwer, 2003).

5 Reprinted as JA Schumpeter, 'The Crisis of the Tax State' in R Swedberg (ed), *The Economics and Sociology of Capitalism* (Princeton, Princeton University Press, 1991). Swedberg offers an overview of Schumpeter's life and work in his introduction. Richard Musgrave, once Schumpeter's student, who translated *Die Krise* in English, summarises and discusses the text in RA Musgrave, 'Schumpeter's crisis of the tax state: An essay in fiscal sociology' (1992) 2 *Journal of Evolutionary Economics* 89.

6 Schumpeter (n 5) 130.

7 It has been noted that his analysis was firmly rooted in the German Historische Schule: S Huhnholz, 'Was soll das heißen: Steuerstaat?' (2017) 29 *Ökonomie und Gesellschaft* 15.

8 JA Schumpeter, *Capitalism, Socialism and Democracy*, 5th edn (London, George Allen & Unwin, 1976).

9 Schumpeter (n 5) 101.

to actual tax policy choices. But he does discuss how the tax state emerged from the dark ages of feudalism.

In the medieval feudal societies of Germany and Austria, he explains, taxes did not exist: peasant-serfs paid dues and vassals made gifts to their prince, but the revenues were not spent in a 'public' sphere by a sovereign state. The prince, the estates and the lesser lords shared power over the same territory, and they used it for their own benefits; their expenses were private affairs. Political power rested on personal ties; we recognise what Max Weber had dubbed *Traditionale Herrschaft* (traditional rule). This system of feudal relations was not too stable by itself, as it had to rely on the intensity of the vassal relationship. But it finally crumbled down under the growing pressure of military expenses in the fifteenth and sixteenth centuries. The prince was unable to finance mercenary armies from his private means and had to rely on the estates for subsidies. In turn, the estates had to raise a revenue stream and spend it in a public sphere, and so the tax state was born. Here we see both a systemic crisis (the loosening ties of the vassal relationship) that induces the demise of an economic system, and a macrolevel shock (war) that leads to an increase in government revenues.

The tax state that, in a gradual historical process, replaced the feudal society, does no longer address collective needs through personal relations; the state assumes that role. But still, there is the idea of 'common purposes', to be served by and through the state.<sup>10</sup> Quite comparable to, for instance, John Rawls's Social Contract, the implication seems to be that the spatial limits of the state coincide with the presence of a sense of cohesion by its inhabitants.<sup>11</sup> Schumpeter denied that the debt crisis left by World War I would necessitate a major overhaul of the pre-war economic order, as he saw no change in the basics of the tax state. If the tax state were indeed to fail, this would be the result of a more structural, societal crisis: 'If the will of the people demands higher and higher public expenditures, if more and more means are used for purposes for which private individuals have not produced them ... and if finally all parts of the people are gripped by entirely new ideas about private property and the forms of life – then the tax state will have run its course...'.<sup>12</sup> In line with the notion of inevitable change that pervades his work, Schumpeter regarded this transition to socialism as unavoidable. As he explains twenty-four years later in his *Capitalism, Socialism and Democracy*, it is an inherent result of the internal dynamics of capitalism: innovative entrepreneurship increases people's standards of living and opportunities for leisure, which in turn fosters a

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10 Musgrave (n 5) 92.

11 In his *Law of Peoples*, Rawls denied the viability of a worldwide Social Contract of the type he had proposed in his *Theory of Justice*: J Rawls, *The Law of Peoples* (Cambridge MA, Harvard University Press, 1999). The underlying idea that states are the political organisations of people who share a sense of 'belonging' inspires the 'statist' (as opposed to 'cosmopolitan') view of international relations.

12 Schumpeter (n 5) 116.

class of intellectuals who criticise capitalism because they do not understand its function. Gradually, redistribution will increase to excessive levels and capitalism will destroy itself by replacing entrepreneurialism with bureaucratic decision-making.<sup>13</sup>

Summing up, Schumpeter's tax state is a contingent and context-dependent phenomenon,<sup>14</sup> connected to a free market that accommodates entrepreneurship and to representative government based on the historical notion of no taxation without representation. Its foundation is a desire of a coherent group of people to cooperate. As a social institution, the tax state is stable enough to endure temporary crises. Those should be distinguished from the inevitable structural crisis in which the capitalist and entrepreneurial social order will erode, culminating in a socialist system that is incompatible with the concept of the tax state.

### 2.3 CRISES AND THE TAX STATE

Although the latter prediction is outdated, there may be much truth in Schumpeter's distinction between short-term macrolevel shocks and structural (social) crises. But whereas he formulates the effect of short-term crises negatively, namely, as not posing a systemic threat, evidence shows that they did shape the evolution of today's developed tax states. In particular, they tended to increase taxation and redistribution.

Many of those crises were wars. In fact, warfare was the main driving factor behind the development of European tax systems during the early modern era.<sup>15</sup> The lion's share of government budgets was devoted to the military and much of the remainder consisted of interest payments on war debts.<sup>16</sup> War fostered the growth of the tax state through prolonged 'ratchet effects', as increased wartime tax levels were retained in peacetime and became the 'new normal'.<sup>17</sup> It also incentivised governments to invest in legal and fiscal capacity, which, in turn, positively affected future fiscal innovations in both peacetime and wartime.<sup>18</sup>

Admittedly, bellicist theories are insufficient to explain the growth of

13 Schumpeter (n 8) chs XII–XIII.

14 As de Cogan puts it: 'a modern tax system is not the only way of funding a political community': D de Cogan, 'Public Law and Political Values in Tax Law' in L Parada (ed), *A Research Agenda for Tax Law* (Cheltenham, Edward Elgar, 2022).

15 C Tilly, *Coercion, Capital, and European States, AD 990–1990* (Cambridge MA, Basil Blackwell, 1990).

16 PT Hoffman, 'What Do States Do? Politics and Economic History' (2015) 75 *Journal of Economic History* 303.

17 E Ames and RT Rapp, 'The Birth and Death of Taxes: A Hypothesis' (1977) 37 *Journal of Economic History* 161; E Kiser and A Linton, 'Determinants of the Growth of the State: War and Taxation in Early Modern France and England' (2001) 80 *Social Forces* 411.

18 Kiser and Linton (n 17); T Besley and T Persson, 'The Origins of State Capacity: Property Rights, Taxation, and Politics' (2009) 99 *American Economic Review* 1218; M Dinicecco and M Prado, 'Warfare, fiscal capacity, and performance' (2012) 17 *Journal of Economic Growth* 171.



the tax state in the nineteenth and early twentieth centuries.<sup>19</sup> Consistent with Schumpeter's view of taxation as the central element of the capitalist state, much of that growth can be attributed to the economic development initiated by the industrial revolution, which increased taxable surpluses and stimulated the demand for growth-enhancing public goods.<sup>20</sup> The emergence of a cash and exchange economy fostered the transition from taxes on 'observable facts' to accountants' taxes, which were easier to administer and collect.<sup>21</sup> New transportation and communication technologies enhanced monitoring capacity and facilitated the centralisation and bureaucratisation of tax administrations. Centralised systems largely replaced the patrimonial tax administrations of landed elites, which had been weakened or swept away in democratic revolutions.<sup>22</sup> Relatedly, democratisation paved the way for higher revenues by improving the legitimacy of the state, increasing the credibility of the executive's commitments and fostering 'quasi-voluntary compliance' of taxpayers.<sup>23</sup> Suffrage was slowly extended and political demand for higher taxation and redistribution grew.<sup>24</sup> Even before universal suffrage was adopted, evolving elite views on tax policy-making induced many governments to implement or increase income and profit taxes for equity and efficiency reasons.<sup>25</sup>

But these nineteenth-century developments appear to have amplified rather than negated the effects of warfare, or crises in general, on the size of the twentieth-century tax state.<sup>26</sup> The extreme costs of World War I forced

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- 19 See Martin, Mehrotra and Prasad (n 2); PF Andersson, 'Political institutions and taxation, 1800–1945' in L Hakelberg and L Seelkopf (eds), *Handbook on the Politics of Taxation* (Cheltenham, Edward Elgar, 2021).
  - 20 HH Hinrichs, *A General Theory of Tax Structure Change during Economic Development* (Cambridge MA, Law School of Harvard University, 1966); P Beramendi, M Dincecco and M Rogers, 'Intra-Elite Competition and Long-Run Fiscal Development' (2018) 81 *Journal of Politics* 49.
  - 21 TS Aidt and PS Jensen, 'The taxman tools up: An event history study of the introduction of the personal income tax' (2009) 93 *Journal of Public Economics* 160. See also Martin, Mehrotra and Prasad (n 2) for alternative accounts of this development.
  - 22 E Kiser and SM Karceski, 'Political Economy of Taxation' (2017) 20 *Annual Review of Political Science* 75.
  - 23 M Levi, *Of Rule and Revenue* (Berkeley, University of California Press, 1988); M Dincecco, 'Fiscal Centralization, Limited Government, and Public Revenues in Europe, 1650–1913' (2009) 69 *Journal of Economic History* 48; D North and BR Weingast, 'Constitutions and Commitment: The Evolution of Institutions Governing Public Choice in Seventeenth-Century England' (1989) 49 *Journal of Economic History* 803.
  - 24 The underlying causal relation is debated: see L Seelkopf and others, 'The rise of modern taxation: A new comprehensive dataset of tax introductions worldwide' (2019) 16 *Review of International Organizations* 239.
  - 25 Regarding equity, those taxes better reflected people's 'ability to pay' than the existing motley collection of regressive taxes on goods and services: S Steinmo, 'The evolution of policy ideas: tax policy in the 20th century' (2003) 5 *British Journal of Politics and International Relations* 206. As to efficiency, it is plausible that emerging industrial elites realised that income tax revenues could be directed towards public goods that benefitted their industries: Beramendi, Dincecco and Rogers (n 20).
  - 26 This interaction partly explains why the war–taxation relationship is weaker in modern low-income countries: P Emmenegger and A Walter, 'War and taxation: the father of all things or rather an obsession?' in Hakelberg and Seelkopf (n 19).



governments to exploit the revenue-raising potential of the new income and profit taxes.<sup>27</sup> These taxes not only turned into major components of governments' revenue mixes, they also proved useful tools to capture excess profits that individuals and corporations made as a result of the war.<sup>28</sup> As in the pre-modern era, the war had a significant ratchet effect: while top rates were reduced after 1918, they did not return to pre-war levels.<sup>29</sup> The story was repeated during World War II. Besides increasing top rates, governments substantially lowered income tax thresholds. They converted a 'class tax' that had affected only a small number of wealthy taxpayers into to a 'mass tax' that was levied on nearly every income.<sup>30</sup> Average government size increased to an unprecedented level.<sup>31</sup> In many countries, high top rates were sustained well into the following decades.<sup>32</sup>

While financial necessity and institution-building explain much of the early modern relation between war and taxes, the underlying dynamics in the modern tax state are more complex. Political participation in the pre-modern and early modern eras was limited to the upper classes, and medieval princes and peasants would not even have comprehended the idea that they both belonged to the same society.<sup>33</sup> The modern nation state, however, is defined in terms of 'the people', who govern themselves democratically, speak the same language and are exposed to a common culture.<sup>34</sup>

In this context, it is not surprising that severe crises forge a strong national identity. A 'we're in this together' mentality during wartime is likely to increase people's willingness to comply voluntarily with tax obligations, hence allowing the government to set high rates at a relatively low social cost.<sup>35</sup> The political consensus about high tax and redistribution

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27 Steinmo (n 25).

28 Steinmo (n 25); Emmenegger and Walter (n 26); S Tandon, 'Taxes During Wars and Crisis' in D de Cogan, A Brassey and P Harris (eds), *Tax Law in Times of Crisis and Recovery* (Oxford, Hart Publishing, 2023).

29 K Scheve and D Stasavage, *Taxing the Rich: A History of Fiscal Fairness in the United States and Europe* (Princeton, Princeton University Press 2016) 56.

30 Steinmo (n 25); R Walters, 'Lessons Of Three World Wars' in de Cogan, Brassey and Harris (n 28).

31 Scheve and Stasavage (n 29) 91.

32 ibid 56.

33 W Kymlicka, *Contemporary Political Philosophy: An Introduction*, 2nd edn (Oxford, Oxford University Press, 2002) 262.

34 W Kymlicka, 'Solidarity in diverse societies: beyond neoliberal multiculturalism and welfare chauvinism' (2015) 3 *Comparative Migration Studies* 1.

35 N Feldman and J Slemrod, 'War and Taxation: When Does Patriotism Overcome the Free-Rider Impulse?' in Martin, Mehrotra and Prasad (n 2) *The New Fiscal Sociology*. Or, as noted by Schumpeter: 'In times of patriotic fervour, tax payments are consistent with extreme productive adaptation of strength which normally would make production cease altogether': Schumpeter (n 5) 112. Such a mentality may also reduce tolerance of tax avoidance: see Walters (n 30).

levels in the mid-twentieth century has indeed been attributed to a sense of social cohesion that, plausibly, resulted from World War II.<sup>36</sup>

Relatedly, the democratic idea of treating citizens as equal members of a national community strengthens the role of reciprocity and desert in modern tax policy making. Demand for high and progressive taxation appears to be positively related to citizens' perception that political and economic circumstances leading to a certain income or wealth distribution are undeserved. This applies particularly in times of mass warfare, because wealthier citizens are more likely to escape conscription or to make business profits out of the hostilities.<sup>37</sup> It has been shown that the twentieth-century increases in both income tax progressivity and inheritance tax rates were indeed related to mass mobilisation for the two World Wars, more than to the extension of suffrage or the emergence of left-wing parties.<sup>38</sup>

Similar fairness arguments shape the relation between non-war crises and taxation. Banking crises have been important driving factors of income tax introductions since the nineteenth century.<sup>39</sup> For instance, the introduction of the US income tax in the 1890s was a direct result of public aversion against rising inequality after the 1893 financial crisis.<sup>40</sup> Economic hardship increases the demand for tax progressivity as well. The tax policy of Roosevelt's New Deal was a clear example; it was largely based on fairness considerations in response to the inequities caused by the Great Depression.<sup>41</sup> According to Schumpeter in his *Lowell Lectures* (1941), the tax increases in the 1930s reflected a 'moral disapproval of high incomes, of capitalist profit making'.<sup>42</sup> The underlying mechanisms of tax increases during financial crises seem to resemble the arguments for taxing the rich in wartime: people will demand compensatory taxation when they believe that the rich caused

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36 eg AT Peacock and J Wiseman, *The Growth of Public Expenditure in the United Kingdom* (Princeton NJ, Princeton University Press, 1961); R Putnam, *Bowling Alone* (New York, Simon & Schuster, 2000); S Berman, *The Primacy of Politics: Social Democracy and the Making of Europe's Twentieth Century* (Cambridge, Cambridge University Press, 2006); P Collier, *The Future of Capitalism: Facing the New Anxieties* (London, Allen Lane, 2018). Additionally, the narrative that 'our way of life' was under threat during the Cold War may have fostered this sense of cohesion: T Besley, 'Is cohesive capitalism under threat?' (2021) 37 *Oxford Review of Economic Policy* 720.

37 Scheve and Stasavage (n 29).

38 K Scheve and D Stasavage, 'The Conscription of Wealth: Mass Warfare and the Demand for Progressive Taxation' (2010) 64 *International Organization* 529; 'Democracy, War, and Wealth: Lessons from Two Centuries of Inheritance Taxation' (2012) 106 *American Political Science Review* 81.

39 J Limberg, 'Banking crises and the modern tax state' (2020) *Socio-Economic Review*.

40 Technically, it was a re-introduction: illustratively in the light of the present argument, an income tax had previously been in place during the Civil War in the 1860s: *ibid*.

41 JJ Thorndike, '"The Unfair Advantage of the Few": The New Deal Origins of "Soak the Rich" Taxation' in Martin, Mehrotra and Prasad (n 2) *The New Fiscal Sociology*.

42 Schumpeter, 'An Economic Interpretation of Our Time: The Lowell Lectures' in Swedberg (n 5) 366.

the crisis or obtained financial benefits from it.<sup>43</sup> This applied particularly during the 2008 financial crisis: the rich were perceived as beneficiaries of the poorly regulated financial markets, while society bore the costs of bank bail-outs; many governments reacted by (moderately) increasing top personal income tax rates.<sup>44</sup>

The remaining pertinent question is how a deadly pandemic affects the tax state. The historical evidence from the modern era is scarce. Due to timing, it would be difficult to distinguish any fiscal policy responses to the 1918 'Spanish' flu from the tax increases related to World War I. However, it is telling that the 1918 pandemic, which killed 2.1 per cent of the world population and led to a 6 per cent GDP loss,<sup>45</sup> was largely ignored by economists.<sup>46</sup> This might reflect people's acquaintance with deadly diseases, or a wanting propensity of the tax state to alleviate social problems caused by macrolevel shocks. In any case, this lack of a fiscal response stands in stark contrast with the stimulus and support packages that governments implemented during the COVID-19 pandemic, which illustrated our demand for tax states that, as Schumpeter would say, penetrate 'deep into the flesh of the private economy'.<sup>47</sup> Besides serving macroeconomic goals, they functioned as insurance schemes that transferred risks and economic losses from the private to the public sector, and they acted as additional instruments of redistribution.<sup>48</sup> As after previous crises, a 'ratchet effect' would occur when they evolve into permanent budget instruments adapted for non-crisis circumstances.<sup>49</sup> For instance, it has been suggested that the EU's support packages provide a window of opportunity for introducing new fiscal competences at the supranational level.<sup>50</sup> Nevertheless, it is notable that state responses to the COVID-19 pandemic, at the time of writing, seem

43 J Limberg, 'What's fair? Preferences for tax progressivity in the wake of the financial crisis' (2020) 40 *Journal of Public Policy* 171.

44 J Limberg, "'Tax the rich'? The financial crisis, fiscal fairness, and progressive income taxation' (2019) 11 *European Political Science Review* 319; Limberg (n 39).

45 RJ Barro, JF Ursúa and J Weng, 'Macroeconomics of the Great Influenza Pandemic, 1918-1920' (2022) 76 *Research in Economics* 21.

46 M Boianovsky and G Erreygers, 'How Economists Ignored the Spanish Flu Pandemic in 1918-1920' (2021) 14 *Erasmus Journal for Philosophy and Economics* 89.

47 Schumpeter (n 5) 111. Through a Foucauldian lens, it seems that we have passed the 'threshold of biological modernity', at which 'the biological processes characterising the life of human beings as a species [become] a crucial issue for political decision-making': C Garbarino, 'Fiscal Evolution and the Syndemic' in de Cogan, Brassey and Harris (n 28).

48 Y Lind, 'How to Award Financial Aid Amidst a Pandemic Through the Lens of a Tax Scholar' in de Cogan, Brassey and Harris (n 28).

49 See text to nn 17 and 29.

50 Garbarino (n 47); FE Grisostolo and L Scarcella, 'The COVID-19 Crisis as a Momentum for the Creation of a European Tax System?' in de Cogan, Brassey and Harris (n 28); PA Hernández González-Barreda, 'The Role of Crisis in State-Building the European Union through Finance and Taxation: Will COVID and the Russian Attack Trigger Further Union?' in de Cogan, Brassey and Harris (n 28); E Scuderi, A Rizzo and A Loucaidou, 'A Case for Environmental Taxation as a Response to the COVID-19 Economic Crisis' in de Cogan, Brassey and Harris (n 28).

to have been largely debt-financed, and that income tax increases are still small in number and size compared with previous crises.<sup>51</sup> It is not our aim to disentangle the multitude of possible causes, such as Keynesian economic thinking, the recentness of the tax increases following the 2008 financial crisis, the lack of reasons to frame the rich as beneficiaries or culprits, or downward competitive pressure on tax rates. Instead, we will pay attention to one recurring factor in the relation between previous crises and the tax state, namely the social ties between citizens of democratic communities.

## 2.4 GLOBALISATION AND THE TAX STATE

It is clear that social ties have loosened as a result of globalisation, at least in some respects. This relates to much more than the salient issues of tax avoidance and evasion, which existed long before the onset of globalisation in the late twentieth century.<sup>52</sup> The key issue here is that globalisation, besides facilitating the avoidance and evasion of national tax liabilities, makes it less evident for individuals or corporations that they owe tax to a specific state or national community in the first place.<sup>53</sup>

This is exemplified first by individuals being increasingly mobile across borders without becoming full members of a community in their new places of residence. Many low-skilled migrant workers perform fungible labour in host jurisdictions where they might pay taxes but struggle to access welfare benefits or voting rights.<sup>54</sup> On the high-skilled end of the labour market, the success of the modern knowledge economy depends on the clustering of people and firms with complementary specialisms; jurisdictions therefore bid for such residents by providing them with high-quality public services and attractive tax regimes. As cosmopolitan individuals take into account these options in their location decisions, taxation transforms from a collective instrument that promotes the common goals of a community into a low price paid by mobile citizens for the public services that they enjoy in a particular place.<sup>55</sup> This may not only limit the ability of tax states to

51 OECD, *Revenue Statistics 2021: The Initial Impact of COVID-19 on OECD Tax Revenues* (Paris, OECD Publishing, 2021); 'Tax and fiscal policies after the COVID-19 crisis' (14 October 2021), [www.oecd.org/coronavirus/policy-responses/tax-and-fiscal-policies-after-the-covid-19-crisis-5a8f24c3/](http://www.oecd.org/coronavirus/policy-responses/tax-and-fiscal-policies-after-the-covid-19-crisis-5a8f24c3/).

52 Offshore tax havens and Swiss banking burgeoned during the high-trust, high-tax post-war decades: V Ogle, 'Archipelago Capitalism: Tax Havens, Offshore Money, and the State, 1950s–1970s' (2017) 122 *American Historical Review* 1431.

53 See generally W Schön, 'Taxation and Democracy' (2019) 72 *Tax Law Review* 235.

54 Y Lind, 'A Critical Analysis of How Formal and Informal Citizenships Influence Justice between Mobile Taxpayers' in D de Cogan and P Harris (eds), *Tax Justice and Tax Law: Understanding Unfairness in Tax Systems* (Oxford, Hart Publishing, 2020); H Ordower, 'Immigration, Emigration, Fungible Labour and the Retreat from Progressive Taxation' in de Cogan and Harris, *Tax Justice*. Similar issues arise with respect to the allocation of financial aid in times of crisis: see Lind (n 48).

55 T Dagan, 'Re-imagining Tax Justice in a Globalised World' in de Cogan and Harris (n 54).

raise their desired amounts of revenue, but also decrease electoral demand for progressive taxation. As noted by a recent strand of literature in identity economics, a possible underlying causal mechanism is the increasing salience of job-based identities and the rejection of place-based identities by cosmopolitan elites.<sup>56</sup> Because the existence of a shared identity is a strong determinant of people's reciprocal altruism,<sup>57</sup> the abandonment of a shared attachment to the nation by high-income individuals may be detrimental for the redistributive tax state.

A similar process is taking place – and more pronouncedly – at the level of corporations. The role of FDI in the world economy has continued its secular growth, and it is by now commonplace that the nature of globalisation has changed due to the emergence of e-commerce. As a result, economic life is now dominated by MNEs with limited ties to national 'tax states', that is, those MNEs have few observable 'common purposes' with specific states and the communities that these states represent.<sup>58</sup> This is not just a 'tax' problem – issues regarding ownership of data, access to, and quality of, information, control over AI, etc, are among the other important concerns. As to tax, we should distinguish between perception and empirical fact. It seems fair to say that the public perception of MNE tax behaviour is negative: newspaper items reading that MNE X pays hardly any tax over its huge profits can hardly be considered 'news' anymore. Empirical fact is more difficult. One reason – which is being addressed with stricter reporting and disclosure obligations – is lack of data. The more fundamental reason is lack of benchmark.<sup>59</sup> When an MNE is compliant with all relevant national rules and is entitled to the treaty benefits that it has – and as a result, pays less tax – what exactly is it avoiding, and to what amount? Obviously, we feel that it should pay (more) tax at the place where it creates value. And yet, it breaches none of its legal obligations. When instead, we claim that it has a moral obligation, we only return to where we started: the modern

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56 P Collier, 'Diverging identities: a model of class formation' (2020) 72 *Oxford Economic Papers* 567.

57 D Rueda, 'Food Comes First, Then Morals: Redistribution Preferences, Parochial Altruism, and Immigration in Western Europe' (2018) 80 *Journal of Politics* 225.

58 Illustratively, their reputation among the public appears to have no effect on their corporate tax behaviour: L Baudot and others, 'Is Corporate Tax Aggressiveness a Reputation Threat? Corporate Accountability, Corporate Social Responsibility, and Corporate Tax Behavior' (2020) 163 *Journal of Business Ethics* 197.

59 The economic literature tends to solve the benchmark problem by equating avoidance with reduction of tax burden – an approach that is clearly too broad to tax lawyers. See S Beer, R de Mooij and L Liu, 'International Corporate Tax Avoidance: A Review of the Channels, Magnitudes, and Blind Spots' (2020) 34 *Journal of Economic Surveys* 660; A Cobham and P Janský, *Estimating Illicit Financial Flows: A Critical Guide to the Data, Methodologies, and Findings* (Oxford, Oxford University Press, 2020).

MNE does not necessarily feel much moral obligation to any particular jurisdiction – it has become a ‘global enterprise’.<sup>60</sup>

Evidently, Schumpeter did not (and could not) identify the potential effects of economic globalisation and the emergence of huge MNEs. Perhaps, he would have applauded the role of modern MNEs in innovation (AI, settling on Mars, etc), rather than joining the ‘intellectuals’ in their criticism of increasing tax avoidance. But over the last decades, the emergence of a ‘global’ tax base not tied to any specific state has been recognised in the literature as a challenge to the Schumpeterian tax state.<sup>61</sup> The common theme is: if national states lose (some of) their grip on tax bases, how do we have to transform the tax state? Multilateral tax policy coordination is by now generally regarded as a logical adaptation. In the field of MNE corporate taxation, much has happened<sup>62</sup> – especially when compared to the taxation of private wealth (personal income, inheritance and estate taxes) where no international action is taking place yet.

## 2.5 THE TAX STATE: EFFECTIVENESS AND REDISTRIBUTION

It has been argued that in a world characterised by increasing base mobility and competitive tax rate setting, national governments face a ‘tragic choice ... between joining the game of global competition ... while renouncing their sovereign power to unilaterally set tax and expenditure policies, on the one hand, and barricading their borders so as to maintain their sovereign decision-making powers, yet encountering costs in terms of economic efficiency and in terms of their residents’ freedom, on the other’.<sup>63</sup> The question is how to broaden the options. Considering that the ‘barricading’ alternative is utterly unattractive, the core issue that remains is the loss of freedom to follow national preferences in the level and distributive effect of taxation.

In the remainder of this section, we aim to connect this issue with the aforementioned themes, using Schumpeter’s concept of the tax state as an analytical tool. We illustrate our argument using a two-dimensional vector space. One vector denotes the existence and effectiveness of a tax state in a Schumpeterian sense, that is, the link between state and market, run by a government based on political competition, as the organisation that matches

60 S Hebous, ‘Global Firms, National Corporate Taxes: An Evolution of Incompatibility’ in R de Mooij, A Klemm and V Perry (eds), *Corporate Income Taxes under Pressure: Why Reform Is Needed and How It Could Be Designed* (Washington DC, International Monetary Fund, 2021).

61 eg R Paris, ‘The Globalization of Taxation? Electronic Commerce and the Transformation of the State’ (2003) 47 *International Studies Quarterly* 153; P Genschel, ‘Globalisation and the transformation of the tax state’ (2005) 13 *European Review* 53; A Cameron, ‘Crisis? What crisis? Displacing the spatial imaginary of the fiscal state’ (2008) 39 *Geoforum* 1145; Mumford (n 2).

62 See de Mooij, Klemm and Perry (n 60).

63 T Dagan, ‘The tragic choices of tax policy in a globalized economy’ in Y Brauner and M Stewart (eds), *Tax, Law and Development* (Cheltenham, Edward Elgar, 2013) 67.

free-market capitalism and that addresses the common needs of a defined community. By definition, this tax state rests on the pretence (whether or not fully realistic) that it can set its own tax policy. That is to say, it can make choices concerning overall tax burden and distribution of that burden as it wishes; moreover, it is not in any important sense restricted in its choice of tax bases and rates. The second vector is the size of this tax state, that is, how deep it penetrates into the flesh of the private economy, and, strongly related to this, how much income it redistributes. We would expect both effectiveness and size/redistribution to increase with the strength of social ties that connect taxpayers. When people share a sense of ‘belonging’ they know where to pay tax (effectiveness) and they are prepared to engage in collective action (size/redistribution).<sup>64</sup>

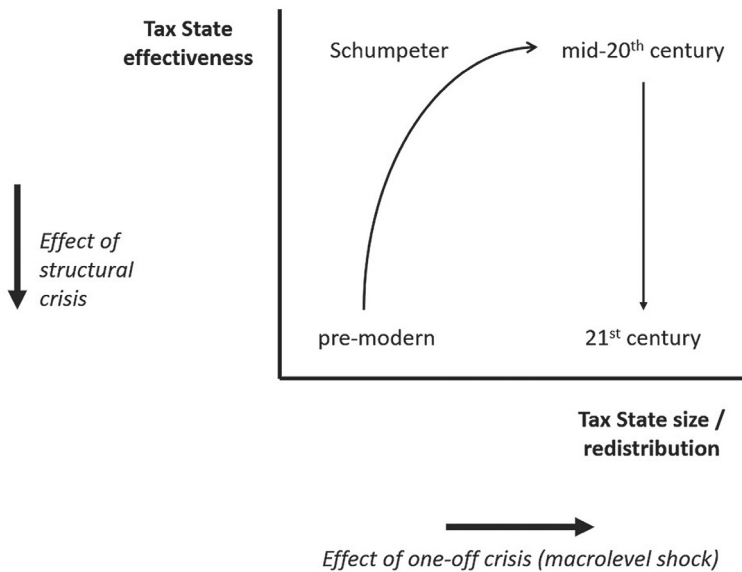


Figure 2.1 Size and effectiveness of the tax state.

Placing the two respective vectors along a y- and an x-axis, as illustrated in Figure 2.1, we get a linear space with four quadrants. In the lower left quadrant, denoting little to no existing tax state, we should locate the administrations of the medieval and pre-modern eras. By contrast, the effective, large and redistributive tax states of most western democracies during the decades after World War II are situated in the upper right quadrant. The

64 A somewhat similar view is taken by T Besley, ‘State Capacity, Reciprocity, and the Social Contract’ (2020) 88 *Econometrica* 1307, who argues that ‘a strong civic culture’ – comparable to our notion of social ties – ‘manifests itself as high tax revenues’ – similar to our second vector – ‘sustained by high levels of voluntary tax compliance’ – which is an aspect of our first vector.



path they took to reach that point was not a straight line; instead, they followed a curve through the upper left quadrant, which denotes the effective but small Schumpeterian tax state of 1918.

Prima facie, the reason is quite intuitive: a tax state must be effective before it can effectively redistribute. On a deeper sociological level, we learn from the foregoing that the curve through our vector space is shaped by social ties. At the pre-modern starting point of the curve, these ties were formalised by the creation of a public sphere and the centralisation and monopolisation of the means for coercion. In the nineteenth century, they were democratised and bureaucratised, and the tax state started to meet its Schumpeterian definition: a clearly recognisable public sphere now financed the common purposes that 'individual autonomies [were] unwilling or unable to take over',<sup>65</sup> and it finally penetrated 'so deeply into the consciousness of the people ... that it was really able to become something impersonal, a machine manner only by serving, not by dominating spirits'.<sup>66</sup> Although warfare did contribute to the development of the Schumpeterian tax state, it was only in this modern democratic context that crises, through identity formation and fairness norms, induced large-scale income redistribution and thus pushed the tax state into the upper right quadrant.

As explained, these crises were one-off macrolevel shocks, in particular wars and economic downturns. Schumpeter would distinguish them from more systemic crises that involve the disintegration of societal structures. In our vector space, the latter would move the tax state downwards, not rightwards. But Schumpeter argued that the most probable cause of a downward shift was, in fact, a rightward shift: the growth of the tax state would lead to its collapse, as the state/market distinction would disappear and the entrepreneurial social structure behind capitalist democracy would erode. In our vector space, this would visually result in a sort of Laffer curve (and perhaps there is a loose resemblance in meaning, as well). Schumpeter's prediction was wrong: the enfranchisement that coincided with the maturing of developed tax states neither lead to serious bourgeois hostility to the free market, nor to class struggle.<sup>67</sup> Illustratively, whenever left-wing political forces questioned the very viability of capitalism during the post-war decades, they failed to win electoral support.<sup>68</sup> Instead, the biggest successes of welfare state expansion were achieved by 'people's parties' that regarded the welfare state as a community project of which all co-nationals were members.<sup>69</sup> Public sectors continued to expand through the 1970s and capitalist tax states thrived in the form of mixed economies, thus persisting in the upper right quadrant of our vector space.

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65 Schumpeter (n 5) 110.

66 Schumpeter (n 5) 111.

67 But see F Caeldries, 'On the Sustainability of the Capitalist Order: Schumpeter's *Capitalism, Socialism and Democracy* Revisited' (1993) 22 *Journal of Socio-Economics* 163.

68 Berman (n 36).

69 *ibid*; Kymlicka (n 34).

However, it appears that tax states have completed a similar curve for a different reason. Since the late twentieth century, they fail to meet several aspects of their Schumpeterian definition. With MNEs and wealthy individuals being perceived to avoid large amounts of taxes,<sup>70</sup> and burdens increasingly falling on immobile taxpayers,<sup>71</sup> states can no longer fully address the collective needs of their communities or treat community members as equal democratic participants.<sup>72</sup> Tax states have therefore lost part of their sovereignty in setting their own policies, substantively due to increasing policy spill-overs, and formally because of a growing body of legal and semi-legal international commitments aimed at reducing those spill-overs.<sup>73</sup> We may safely assume that the size of policy spill-overs will continue to grow, as a corollary of further globalisation. And as many mobile taxpayers have lost their connection to particular countries, one may doubt whether the tax state still encompasses a defined community at all. As discussed, the latter issue appears to be a structural crisis of eroding social ties, going beyond tax avoidance and evasion. It also goes beyond class struggle or Schumpeter's prediction that economic development and enfranchisement would erode the structure of the capitalist society. Mobile taxpayers are not simply relocating to jurisdictions with social contracts that better fit their preferences, as a reaction to the excessive redistributive demands of their fully enfranchised co-nationals;<sup>74</sup> instead, they are disconnecting from the very concept of a tax state.

The large but weakened twenty-first-century tax states are, in sum, moving into the lower right quadrant of our vector space. Subsequently, in line with earlier crises, the COVID-19 pandemic and the recent geopolitical turmoil have pushed them further rightwards by necessitating a substantial increase in state expenses. Tragically, this has left them with large debt burdens that will have to be repaid sometime.<sup>75</sup> Although we are at a different

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70 Ignoring the legal debates on the meaning of the word 'avoidance', we refer to the public feeling (whatever its base in facts and figures) that MNEs and wealthy individuals do not take the share in the tax burden that they should. Especially relevant is the work of John Prebble, who relates the concept of avoidance to the nature of income taxation.

71 While revenue-to-GDP ratios have been fairly stable through the last decades, personal and corporate tax rates have declined and countries rely increasingly on regressive revenue sources such as payroll and consumption taxes: S Ganghof, *The Politics of Income Taxation* (Colchester, ECPR Press, 2006).

72 Dagan (n 55). In other words: there is 'a fiscal, sociological disconnect between what citizens expect from tax states ... and what tax states currently are capable of delivering': Mumford (n 2) 143.

73 For an application of Rawlsian 'state sovereignty' thinking in the field of international tax, see P Hongler, *Justice in International Tax Law* (Amsterdam, IBFD, 2019). See also A Christians, 'Sovereignty, Taxation and Social Contract' (2009) 18 *Minnesota Journal of International Law* 99; 'BEPS and the New International Tax Order' (2016) 6 *Brigham Young University Law Review* 1603.

74 We thank an anonymous reviewer for raising this point.

75 We ignore the Modern Monetary Theory debate, ie, we assume that governments need tax revenues to keep them moving. That is not to say that a balanced budget is an imperative: see Mumford (n 2).

point in our vector space and experience a different crisis than in 1918, a striking similarity is the combination of a macrolevel shock, an increased debt burden and the symptoms of a structural crisis. Whether or not we should label that as a 'crisis of the tax state' is a semantical issue. The real issue is whether and how we can steer our tax states safely into either of the upper quadrants, that is, the situation that states can pursue their own priorities whether these include heavy or low taxes, extensive or limited redistribution. We know what shifts the tax state rightwards (a macrolevel shock in a context of strong social ties) and downwards (a structural crisis of eroding social ties), but what shifts it upwards?

The finalisation of the Schumpeterian tax state during the late nineteenth century might give us the key to the answer, which, we argue, is strongly connected to the choice of tax instruments. This period was characterised by the rapid introduction of 'modern' taxes in developed economies: personal and corporate income taxes and social security contributions.<sup>76</sup> Given their low rates and the small size of the state, it is debatable what these taxes could do in reducing income inequality. The major difference between the taxes of the early nineteenth century and those of the post-World War II welfare state is how they were levied. Traditional taxes on 'observable facts' like windows and horses, distillery kettles and windmills required a daily battle (sometimes literally) in the streets and marketplaces. New taxes on wages, profits and consumption were accountants' taxes.<sup>77</sup> It might well be argued that the liberal bourgeoisie of the late nineteenth century welcomed the reduction of conflictual forms of taxation but hardly anticipated that the new taxes would reduce opposition to much higher levels of taxation. Schumpeter seems to recognise the point in his *Essays*: the income tax fitted in with the bourgeois limited state of the later nineteenth century.<sup>78</sup> He believed that it was already outdated in the twentieth century as state interference with economic life had grown – and an expenditure tax would be preferable.<sup>79</sup>

There is no reason to repeat the debate on income taxation in the later twentieth century here: whether income provides a reasonable measure of ability-to-pay, whether tax expenditures infringe upon fair burden distribution, how progressive the income tax should be, and indeed, whether a personal consumption tax would be preferable. The relevant issue is how income taxation is affected by globalising tax bases. The nineteenth-century battles in the streets have been replaced by bureaucratic battles of tax administrations with accountants and tax lawyers worldwide. Those battles are fuelled not just by differences in tax rates, but also by the fact that 'income' and 'profits' are abstract concepts compared to, for instance,

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76 Seelkopf and others (n 24).

77 See text to n 21.

78 See text to nn 20–22.

79 Musgrave (n 5) 95–96 summarises Schumpeter's views.

‘chimney’ and ‘steam engine’, resulting in many small differences in definitions between countries.

The question then is whether income taxation is the suitable framework to discuss the reduction of tax policy spill-overs through multilateral coordination. In the Schumpeterian long-run view, are we trying to save twentieth-century tax rules from twenty-first-century challenges? And would that help, or do we need to look for new tax bases? There is now a developing tradition of trying to save income taxes by specifying the obligations they confer on multinational taxpayers. The OECD/IF Pillar 1 and 2 proposals offer a fine example. Conceptually, both Pillars offer interesting answers to globalisation and the emergence of ‘global firms’. Pillar 1 is a clear departure from the arm’s length principle, allocating part of MNE excess profits to the place where customers reside. On the plausible assumption that customers are less geographically mobile than corporate assets (like IP and shareholdings), the result would be that states increase their grip on the MNE tax base.<sup>80</sup> The Pillar 2 proposal, at the same time, tries to fix the system of cross-border corporate income taxation by introducing an effective minimum rate worldwide.<sup>81</sup> The conceptual advantage is that the debate on ‘avoidance’ and its legal form, ‘abuse’, is replaced by an effective tax test.

These are indeed potentially important innovations in the taxation of MNE income. For their effective implementation, however, both proposals rely on the meticulous construction of new flows of information exchange and data sharing between states. Especially Pillar 2 seems to require sophisticated accountancy rules, which many states and their tax administrations may not be able to deal with.<sup>82</sup> The connected issue is how to find a balance between national tax preferences (bases, rates, revenues and distribution) and the increasing body of international tax obligations faced by states. We cannot draw a sharp line between a national tax system operated by a national tax administration, and a global tax system run by a global tax administration.<sup>83</sup> But we think it is a relevant line, and national states may not want to cross it.<sup>84</sup>

Both Pillars 1 and 2 follow from the BEPS project: a broader attempt to fix the international tax order (as far as MNE profits are concerned) undertaken by the international community since 2013. The results of that project have without doubt exceeded ex ante expectations. They show that OECD

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80 This is a quality that the Pillar 1 proposal may have in common with the (much more radical) proposal for a Destination-Based Cash Flow Tax.

81 MP Devereux and others, ‘The OECD Global Anti-Base Erosion (“GloBE”) Proposal’ (Oxford University Centre for Business Taxation, 2020).

82 See generally N Pushkareva ‘In Good Times and in Bad: Global Tax Governance During Economic Downturns’, in de Cogan, Brassey and Harris (n 28).

83 Or a European tax administration, for that matter; see generally Hernández González-Barreda (n 50).

84 This is not to negate the relevance of the ‘transnational context ... which transcends the conceptual limitations of tax as defined and controlled solely by individual states’, as stressed by Mumford (n 2) 193.

Member States, followed by a large number of other countries, feel commitment to 'repairing' international income taxation rather than 'replacing' it. It could hardly be different: any changes to the international tax order may be assumed to be piecemeal, never radical. But a feeling of 'crisis' remains. It is not uncommon for faltering institutions to be shored up by emergency measures – and perhaps that is what we are now witnessing in the field of MNE income taxation.

Again, relying on Schumpeter's long-run analysis of the social and economic context of taxation systems, the question whether new conditions require new taxes makes sense. We do not intend to argue that we should return to pre-income taxes on chimneys and horses. Instead, the appropriate shift in focus is the same one that policymakers in the nineteenth century made when they were confronted with new technologies and social changes:<sup>85</sup> a shift from asking 'how can we save the taxes that we have had for so many years?' towards 'how can we do something smart with the new conditions that we face?' The attractiveness of the Schumpeterian approach is that it does not assume some permanent 'system' of tax, but rather draws our attention to the ways in which we can adapt to the changing conditions of markets and states. Among those changing conditions we could mention (with no attempt to be exhaustive):

- changes in how wealth is created: increasingly by innovation of services – which shows up, for instance, in the value of intangibles on MNE balance sheets;
- changes in how wealth is spent: consumption of digital services of course, but also travel, and living in a limited number of high-end agglomerations worldwide;
- a notable increase in wealth accumulation, whether in terms of MNE book values, land values or in numbers of billionaires worldwide.

We could then consider apparently unconnected topics like agglomeration effects, digital and financial services to see where new tax handles may be found. Such new tax bases should, we think, cover the ground increasingly being vacated by income taxes: the profitability of cross-border economic activities and the accumulation of wealth. They would necessarily be second-best in comparison to income taxation – that is, *effective* income taxation. Preferably, the relevant tax base definitions should be clearer than the concept of income, thereby reducing perceptions of avoidance and the need for anti-abuse doctrines and/or moral arguments. And preferably, such new taxes, while requiring coordination between countries, would be suited to be run by national tax administrations. We do not claim that such taxes would be able to fully replace income taxation.<sup>86</sup> Indeed, when we want to address private wealth accumulation, we would need a Piketty-

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<sup>85</sup> See text to nn 21–22.

<sup>86</sup> See P Emerton and K James, 'The Justice of the Tax Base and the Case for Income Tax' in M Bhandari (ed), *Philosophical Foundations of Tax Law* (Oxford, Oxford University Press, 2017).

style effort to tax private wealth independent of the place where its owner happens to reside at a specific moment in time.<sup>87</sup>

What we do argue is that income taxation can no longer be relied upon to do the job we used it for – not in a world with states pursuing different interests and preferences. We also argue that the Schumpeterian perspective shifts our attention from tax design considerations – that is, the optimisation of tax systems with respect to context-independent benchmarks – to dynamism and pragmatism. Tax design is important, as it focuses on minimisation of economic distortions, and on explanation of the rationale underlying tax bases. But it overlooks the centrality of taxes to state-building,<sup>88</sup> their effect on the evolution of the state, and their public-law character as ‘the embodiment ... of those principles that shape the right ordering of the state’.<sup>89</sup> Therefore, it may cause us to stick to obsolete ideals.

We may expect governments to be naturally inclined to search for new tax bases, even if paying lip service to obsolete ideals. A recent example – inspired by the 2008 financial crisis – is the development of bank taxes and financial transaction taxes.<sup>90</sup> Whatever their merits in regulating the financial industry, these taxes could also be considered instruments to tackle some of the financial benefits of globalisation. And on the assumption that across the board, personal wealth correlates with pollution, even environmental taxes could qualify.<sup>91</sup> Two other examples deserve brief attention. One is digital services taxes.<sup>92</sup> These have proliferated in recent years as states have attempted to lay their hands on some part of big tech profits. Under a Pillar 1 agreement, such taxes should be phased out.<sup>93</sup> Our question (and probably, the question of many governments who now operate such a tax) is whether this is a clever idea at all. From the tax state’s perspec-

87 See T Piketty, *Capital in the Twenty-First Century* (Cambridge MA, Harvard University Press, 2014), who argues that his capital tax proposal, before being implemented globally, might serve as a reference point for national states. Mumford (n 2) 127 suggests that this reference point might function as a ‘tax principle’ in a transnational tax state.

88 See D de Cogan, *Tax Law, State-Building and the Constitution* (Oxford, Hart Publishing, 2020), who also takes Schumpeter’s essay as a starting point.

89 J Snape, *The political economy of the corporation tax: Theory, values and law reform* (Oxford, Hart Publishing, 2011) 11.

90 See Tandon (n 28). A financial transaction tax has also been proposed by the EU as a new revenue source: Grisostolo and Scarcella (n 50).

91 Of course, their main objective is to address the climate crisis, which, through a Schumpeterian lens, is another macrolevel shock that may shape the development of tax states, provided that those do not collapse as a result of a social crisis. We expect that green taxes are less sensitive than income taxes to the erosion of social ties within tax states. Addressing the mobility of polluters through international tax coordination is relatively easy, because pollution is better observable than income. For an analysis of EU coordination of environmental taxes, see S Geringer, ‘The Future of the EU’s Financing in Times of Disruption and Recovery: Normative and Technical Issues of Greening the EU’s Own Resources System’ in de Cogan, Brassey and Harris (n 28); Scuderi, Rizzo and Loucaidou (n 50).

92 See Grisostolo and Scarcella (n 50).

93 At least, the Communiqué of the G7 meeting in London, 5 June 2021, speaks of ‘the removal of all Digital Services Taxes, and other relevant similar measures, on all companies’.



tive, a DST collected over observable local turnover is more attractive than a tax base allocated by some multilateral formula that still has to prove its viability. The least that could be done is to maintain those DSTs and make them creditable against the P1 market state tax.

The other example is an agglomeration tax. It is not a new idea that agglomeration rents can and should be taxed. The nineteenth-century economist Henry George explains that they accrue as land value appreciations, arising not from the land owner's labour, but from others moving into the city.<sup>94</sup> Schumpeter notes that 'since the motive for the utilization of a piece of land lies in the return to labour and capital which it can yield and which remains even when the ground rent is taxed away, [a land tax] never reflects back on the productive process'.<sup>95</sup> There are no signs of agglomerations disappearing in our digital age; on the contrary, the world is urbanising. As evidence suggests that corporate profits can be taxed at higher rates in economically attractive areas, even under competitive pressure, it seems attainable a fortiori to implement land value taxes, which do not depend on individual income or profits.<sup>96</sup>

As argued elsewhere in this volume, short-term crises could perhaps provide windows of opportunity for the implementation of those new taxes. The housing and inflation crisis could increase political support for land (or perhaps, asset) taxes,<sup>97</sup> the climate crisis now finally paves the way for green taxation,<sup>98</sup> and a plausible consequence of the COVID-19 crisis might be an increased attention for quick personal wealth creation, for example in pharmaceuticals. Although Schumpeter would be the last to argue that history repeats itself, short-term crises might again drive the adaption, evolution and expansion of the tax state.

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94 H George, *Progress and poverty: An Inquiry into the Cause of Industrial Depressions and of Increase of Want with Increase of Wealth; The Remedy* (first published 1879, Cambridge, Cambridge University Press, 2011).

95 Schumpeter (n 5) 114.

96 H Garretsen and J Peeters, 'Capital Mobility, Agglomeration and Corporate Tax Rates: Is the Race to the Bottom for Real?' (2007) 53 *CESifo Economic Studies* 263; M Brühlhart, M Jametti and K Schmidheiny, 'Do Agglomeration Economies Reduce the Sensitivity of Firm Location to Tax Differentials?' (2012) 122 *The Economic Journal* 1069. However, in today's urban populations, significant shares of agglomeration rents are captured by high-skilled workers with low housing demands, rather than by landowners: P Collier and AJ Venables, 'Who gets the urban surplus?' (2018) 18 *Journal of Economic Geography* 523. It remains a challenge to tax those workers using other bases than income.

97 See generally A Brassey, 'The Implications of Intergenerational Issues on Tax Policy in a Post-COVID World. An Examination of Age Discrimination' in de Cogan, Brassey and Harris (n 28), who discusses the current asset price boom in the context of intergenerational fairness.

98 n 91.



## 2.6 CONCLUSION

The lasting heritage of Schumpeter's *Crisis of the Tax State* is that it draws our attention to the meaning of long-term trends for the way we tax. None of our taxes are written in stone; all reflect the social and economic conditions of a specific era.<sup>99</sup> From this perspective, we note that the most evident problem of income taxation is, that it results in suspicions of 'international tax avoidance' that are, in the end, untestable. Many legal rules may create moral leeway that is sizeable and perhaps unmanageable in the cross-border context. The challenge is to develop forms of taxation that, using well-defined legal obligations, address those who benefit from the new, globalised social order. We argue that this perspective helps to make sense of what governments are now doing (and perhaps, failing to do) in their tax policies.

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<sup>99</sup> See J Snape, 'The "Sinews of the State": Historical Justifications for Taxes and Tax Law' in Bhandari (n 86).

## ABSTRACT

This article aims to map the political economy of top personal income tax rate setting. A much-discussed driving factor of top rate setting is the corporate tax rate: governments may prefer to limit the differential between both rates in order to prevent tax-friendly saving of labour incomes inside corporations. Recent studies have highlighted several other driving factors, including budgetary pressure, partisan politics and societal fairness norms. I compare these and other potential determinants in the long run (1981-2018) by studying tax reforms of 226 cabinets in 19 advanced OECD countries using regression models. I find little evidence for the effects of economic, political and institutional factors; instead, the main determinant of the top rate is the corporate tax rate. As corporate tax rates are still declining under competitive pressure, the recently set minimum rate of 15% will not stop tax competition from constraining progressive income taxation.

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■ This chapter has been published in *Journal of Public Policy*, 43(3), 401-426, <https://doi.org/10.1017/S0143814X23000028>.

### 3.1 INTRODUCTION

The top personal income tax (PIT) rate is a visible element of the modern tax/welfare state and a good indicator of tax system progressivity (Scheve and Stasavage, 2016). The top income tax bracket not only raises tax revenues itself, but also indirectly affects the revenue-raising capacity of lower tax brackets by setting their maximum rates. Furthermore, the top rate is a useful instrument for limiting wealth accumulation by high-income earners (Piketty, 2014). As income inequality and taxing the rich are increasingly prominent academic research topics (Limberg, 2019), a relevant question is how much freedom national governments have in setting their desired top rates. The existing evidence is ambiguous.

On the one hand, scholars have argued that income taxation is constrained by globalisation. Economic openness forces countries to compete for mobile tax bases in a ‘race to the bottom’, especially in corporate income tax (CIT) rates (e.g., Tanzi, 1995; Sinn, 2003; Genschel and Schwarz, 2011). The CIT acts as a ‘backstop’ of the PIT, preventing high-income earners from avoiding taxes through incorporation (Gordon and MacKie-Mason, 1995). CIT reductions erode this backstop function, and they may spill over to PIT rates, as governments may prefer to limit the differential between both rates in order to preserve tax system integrity (Ganghof, 2006b).

On the other hand, there should be several domestic drivers of the top PIT rate, such as partisan politics and budgetary pressure. Additionally, increases in top rates in the aftermath of the 2008 financial crisis have been linked to fairness considerations among electorates (Limberg, 2019; 2020b). Moreover, the erosion of the CIT’s backstop function, as described above, may have been mitigated by a recent increase in shareholder-level dividend tax rates, facilitated by the successful combat of illegal capital flight (Ahrens et al., 2020).

The purpose of this article is to investigate the relative importance of these and other drivers of top PIT rate setting in the long run (1981–2018). To this end, I study tax reforms implemented by 226 cabinets in 19 OECD countries using linear regressions.<sup>1</sup>

This article makes several contributions to the existing literature. First, it re-stresses the importance of statutory CIT rates in backstopping top PIT rates. Convincing evidence of this relation follows from Ganghof’s (2006b) case studies of seven countries’ tax reforms between the 1980s and early 2000s. The present study makes a substantial contribution by including a larger number of countries and by extending the period of analysis further into the twenty-first century, covering the recent decline of CIT rates to a record low.

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1 The sample consists of: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Italy, Ireland, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, the United Kingdom and the United States.

It also makes a methodological contribution by quantifying the effect of the CIT in the long run. This overcomes a pitfall of qualitative policy analysis, namely the difficulty in discerning the primary driving factors behind tax reforms, especially when government statements list multiple reasons for a reform's implementation. Additionally, a regression approach allows me to quantify cross-country variation in potentially relevant institutional factors, such as redistribution preferences and labour market corporatism.

This paper also contributes to a broader literature on the political economy of tax systems. First, its integrated review of the determinants of top rate setting is of added value, because most of those factors have been tested only as determinants of average labour tax rates, labour/capital tax ratios or electoral redistribution preferences. Second, many existing studies fail to control for CIT rate setting. This paper, instead, puts the recent, crisis-related PIT increases in a long-term perspective, arguing that governments will have little room to manoeuvre in their top rate setting when CIT rates keep falling towards the recently set minimum level of 15%.

I proceed as follows. After reporting the trends in OECD countries' top rates during the last decades, I discuss the potential determinants of top rate setting, starting with domestic factors, then moving to transnational policy diffusion, and finally addressing the relation between the CIT and PIT. Next, I describe my dataset and empirical strategy, and I discuss the results, followed by several robustness checks. The final section concludes.

### 3.2 TOP RATES OVER TIME

Until the early 1980s, high top PIT rates were the norm in advanced OECD countries. Figure 3.1 shows that the average top rate in this study's data panel was 67% in 1981, and it documents a relatively small cross-national variability (measured by the coefficient of variation). Most OECD countries sharply reduced their top rates in the late 1980s or early 1990s. Cross-country differences in the timing of these reforms explain the divergence that is visible during this period. Rates continued to decline during the following decades but were increased in several countries after the 2008 financial crisis. By 2018, the average top rate stood at 49%. The small cross-national variability, comparable to the level in the early 1980s, suggests that rates have moved from a high-level equilibrium towards a new, lower-level equilibrium (cf. Swank, 2016, p. 573).

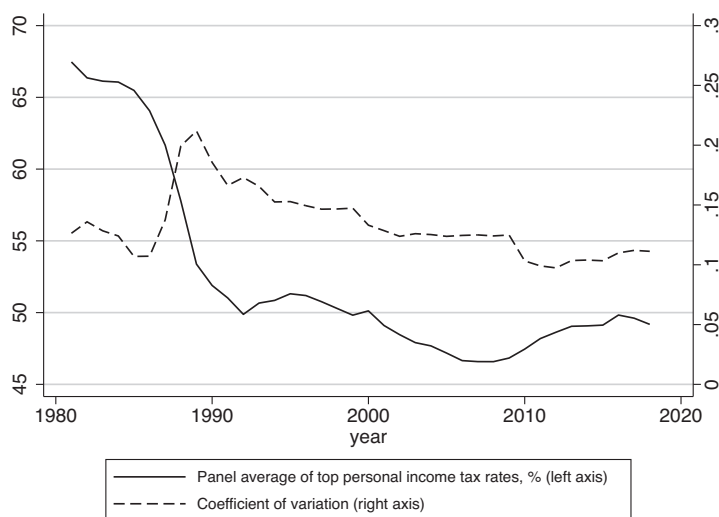


Figure 3.1 Panel average and variation of top PIT rates, 1981-2018.

### 3.3 DOMESTIC POLITICS, INSTITUTIONS AND ECONOMICS

The literature has identified several political, institutional and economic factors that may influence the top rate. Many of those are related to national policymaking, where the PIT is a relatively politicised tax.

In partisan politics, the left generally places more emphasis on income equality than the right, and left-wing voters are more supportive of tax progressivity (Roosma et al., 2016). One would therefore expect left-wing governments to raise the top rate. If the right, instead, prioritises economic efficiency, it might lower the top rate to reduce its work disincentive. There is some supportive evidence that left-wing governments (Cusack and Beramendi, 2006) or Christian democratic governments (Swank and Steinmo, 2002) tend to increase the average effective labour tax rate.

While government ideology may reflect short-term fluctuations in the electorate's redistributive preferences, countries also vary in their long-term electoral demand for income redistribution, as some cultures are more egalitarian than others. Egalitarian norms among the electorate affect capital tax rates by increasing the political costs of rate reductions (Basinger and Hallerberg, 2004; Plümper et al., 2009). It is plausible that those norms affect top labour tax rates in a similar way.

Recent studies have identified two main explanatory factors behind the electorate's redistributive preferences (see generally: Berens and Gelpeithis, 2021). On the one hand, taxpayers are economically self-interested and aim to maximise their lifetime income. Support for tax progressivity, therefore, decreases with income and increases with the risk of income loss (Barnes, 2015). Relatedly, support for tax progressivity is higher in welfare

states that emphasise insurance against income loss, as opposed to generic transfers to the poor (Berens and Gelepithis, 2019). On the other hand, tax preferences are also shaped by taxpayers' normative ideas about whether people deserve their incomes in the light of their efforts or contributions to society. For instance, Limberg (2019; 2020b) argues that demand for higher top rates increased in the aftermath of the 2008 financial crisis because the rich were perceived as unfair beneficiaries of the poorly regulated financial markets. Furthermore, taxpayers' willingness to fund the welfare state depends positively on the perceived work effort and reciprocal contributions of welfare beneficiaries, and on taxpayers and beneficiaries sharing a cultural background (Van Oorschot, 2006; Rueda, 2018). Taxpayers tend to stereotype elderly, sick and disabled people as the most deserving groups, the unemployed as less deserving, and immigrants as the least deserving (Van Oorschot, 2006). Thus, population composition and welfare spending may affect voters' tax preferences.

Zooming out from preferences and ideas, it has been argued that political institutions affect their translation into actual tax policy, with majoritarian and consensus democracies producing divergent outcomes. Consensus democracies are characterised by proportional representation, fragmented political landscapes and coalition governments. They generally allow for better representation of pro-welfare groups than majoritarian systems, which may produce right-wing landslide victories (Döring and Manow, 2017) or be dominated by big-tent parties that appeal to the median voter (Cusack and Beramendi, 2006). Additionally, Hays (2003) argues that coalition governments lead to higher labour/capital tax ratios, because they often include at least one right-wing party that aims to limit the capital tax burden. In sum, it is plausible that consensus democratic institutions have an upward effect on the top PIT rate.

Cross-country heterogeneity also exists in the institutional structure of economic systems, as measured by the degree of labour market corporatism (Hall and Soskice, 2001). The corporatist deal between labour and capital tends to involve job security, egalitarian wage setting and generous welfare provisions in return for wage moderation and relatively low capital taxes. This implies an expensive welfare state, financed primarily with high labour taxes (Cusack and Beramendi, 2006). Both labour and capital have an interest in maintaining their corporatist compromise, which makes tax reductions less likely (Swank, 2016). Thus, corporatism should positively affect the top PIT rate.

Finally, it is necessary to account for budgetary and economic factors. Not only a short-term budget deficit, but also a longer-term demographic burden (that is, the share of citizens dependent on social security transfers, such as the elderly) may limit a government's ability to cut taxes, or induce tax increases (Cusack and Beramendi, 2006). Temporal budget surpluses, instead, appear to be used predominantly to cut taxes (Haffert and Mehrtens, 2015). What matters here is the top bracket's relevance in the income tax system. The height of its income threshold determines the

number of affected taxpayers and hence the budgetary consequences of a reform (Ganghof, 2006b). Relatedly, top rate setting may be influenced by macroeconomic conditions. When economic growth is low, governments might cut marginal tax rates as a growth-friendly policy. On the other hand, as mentioned, severe economic crises may increase popular demand for tax progressivity, as they decrease people's perceptions of high incomes as deserved and fair (Limberg, 2019; 2020b).

### 3.4 TRANSNATIONAL POLICY DIFFUSION

While PIT policy should depend on domestic factors, it may also diffuse across borders. One possible mechanism is tax competition. Tax competition has been studied mainly in the context of CIT reductions, which are driven by the tax-sensitivity of investments and paper profits (Genschel and Schwarz, 2011). Although countries compete for corporate capital simultaneously, there is also evidence suggesting that countries react to the first move of a so-called Stackelberg leader, where the US plays that role (Swank, 2016; Altshuler and Goodspeed, 2015). In any case, competition is conditioned by several domestic factors. One is country size: smaller nations set lower rates, because they have less domestic tax revenues to lose (Kanbur and Keen, 1993). Countries' competitive policies are also mediated by fairness norms and budgetary pressure (Plümper et al., 2009). Furthermore, consensus democracy and corporatism inhibit the implementation of neo-liberal (low-rate and broad-base) tax reforms in response to US corporate tax cuts (Swank, 2016).

It is not entirely clear whether PIT competition exists and works analogously. One precondition would be that rich taxpayers' location decisions are sensitive to PIT rates. Most of the existing evidence comes from within-country migration being affected by unequal regional tax rates (e.g., Agrawal and Foremny, 2019), but arguably, regional migration should be less burdensome than emigration. Empirical research on international mobility is scant because of the lack of detailed data combining migration patterns with income levels and tax rate schedules (Kleven et al., 2020) – an issue that also affects the present study. Akcigit et al. (2016) do find a positive migration response of top inventors to the 1986 top rate reduction in the US, and Egger and Radulescu (2009) find that country-specific migration between 49 nations is higher when income tax progressivity is lower in the host country than in the home country. Kleven et al. (2020), however, find no negative relation between top marginal tax rates and the share of rich foreigners in the populations of 26 countries.

Even if people's location decisions are indeed tax-sensitive, it does not necessarily follow that governments will compete via PIT rates. For one thing, it is unlikely that revenue and human capital inflows would offset domestic revenue losses, as domestic taxpayers generally outnumber migrants and expatriates. Furthermore, competition through targeted tax



policies probably overshadows top rate competition. Many high-income nations have implemented preferential income tax regimes for high-skilled foreigners (Kleven et al., 2020), and those strongly affect those individuals' location decisions (e.g., Kleven et al., 2014; Akcigit et al., 2016). Arguably, the existence of those special regimes actually reduces countries' incentives to compete via general top rate setting, because the relatively elastic incomes of foreigners drop out of the general tax base. Second, many nations have fully or partially dualised their income taxes, removing personal capital income from their progressive labour tax rate schedules and taxing it at preferential rates instead. It is plausible that rich people's location decisions are guided more by those capital tax regimes than by the PIT – Kleven et al. (2020) provide anecdotal evidence. Wealth and gift taxes, as well as non-tax factors, may also play a larger role, but little is known about their effects.

A second important mechanism of transnational diffusion is the copying of tax policies adopted by other governments or promoted by policy experts. In particular, it has been argued that countries copied a neoliberal (low-rate and broad-base) tax reform model in the 1980s and 1990s, after they had become dissatisfied with the multitude of deductions and tax expenditures that made their existing systems unnecessarily complex and prone to tax avoidance (Steinmo, 2003). This neoliberal diffusion was fostered by the spread of efficiency ideas among tax policymakers in the OECD (Swank, 1998), but it is also plausible that countries directly responded to the 1986 US tax reform (Tanzi, 1987; Steinmo, 2003). In most nations, neoliberal ideas probably affected corporate and personal taxes alike, as both suffered from inefficiencies. Moreover, their rate-setting should be connected, because both share income as a tax base.

### 3.5 THE BACKSTOP ARGUMENT

The connection between the CIT and PIT is generally described as a back-stop function: the former supports the progressivity of the latter. When the CIT rate is set far below the top PIT rate, this incentivises high-income business owners and independent professionals to earn their income through corporations and reduce their tax burdens (Gordon and MacKie-Mason, 1995; Slemrod, 2004; Ganghof, 2006b). To illustrate, suppose that a country has a 20% CIT rate and a 60% PIT rate. It then needs an effective 50% tax rate on distributed corporate profits, in order to tax owner-managers on par with wage earners and sole proprietors:  $1 - (1 - 0.2) * 0.5 = 0.6$ . This situation creates two problems.

First, shareholder taxes have economic and political costs. Capital gains taxes and dividend taxes may discourage the distribution of profits and hence distort the reinvestment of capital (Auerbach, 1991; Zodrow, 1991). And inheritance taxes on the bequest of shares can reduce the profitability and longevity of family firms (Tsoutsoura, 2015). Unsurprisingly, most

countries tax owner-managers of corporations more leniently than wage earners and sole proprietors. In 2016, top marginal rates in the OECD, taking into account both corporate- and individual-level taxation, averaged 42.5% on wages (OECD, 2020b; own calculations), 40.4% on dividends, and 35.4% on capital gains (Harding and Marten, 2018). Furthermore, many countries treat the transfer of shares in family firms preferentially. If at least one shareholder tax is more lenient than the PIT, incorporation is an attractive tax avoidance strategy.

Second, even aligning top marginal wage and shareholder tax rates does not prevent owner-managers from retaining profits inside their corporations and avoiding the payment of shareholder taxes altogether. When an owner-manager needs their earnings for private consumption, one strategy to minimise taxable dividends is to borrow money from the firm. Alternatively, they can consume business-related goods within the firm (such as mobile phones, computers, meals, cars or business trips).

In systems with a large PIT-CIT differential, the only way to effectively prevent profit retention in corporations is to tax imputed dividends, regardless of actual dividend distributions. Fairness issues aside, such a tax requires complex calculations. And it works only for closely held corporations with active owners, because the government cannot observe all corporate profits behind citizens' world-wide passive shareholdings. Resultingly, shareholders may use avoidance strategies to remain below the legal threshold of active ownership and escape the imputed dividend tax. This was a reason why Norway abolished such a tax in 2006 (Alstadsæter, 2007).

In sum, to preserve tax system integrity, the only option is to limit the PIT-CIT differential. Governments have good reasons to do so: the above-mentioned avoidance strategies reduce horizontal equity, because wage earners, independent professionals and business owners are not equally able to incorporate; and they reduce vertical equity, because income shifting is primarily beneficial for people in the top tax bracket. These equity issues may cause voter resentment. Barring income shifting, voters may also disapprove of a tax rate differential in and of itself, because it signals unequal treatment.

On the other hand, governments may also deliberately maintain a tax rate differential. Taxes on various forms of capital income – e.g., interest, returns to owner-occupied housing, and corporate profits – have different political or economic costs, but setting unequal rates generally induces substantial tax arbitrage; governments may therefore choose to set a low and uniform capital and CIT rate, whereas equity and budget considerations may call for a higher rate on labour income (Ganghof, 2006b).

In some instances, governments may even prefer income shifting towards the corporate form. When income shifters have high labour supply elasticities, they should be more productive under a lenient CIT regime, and this may increase social welfare (Selin and Simula, 2020). And as the remaining labour tax base will then be less elastic, the revenue-maximising top PIT rate should increase (Kotakorpi and Matikka, 2017).

A government’s eventual tax rate setting will depend on its weighing of these considerations, such that every country has its own optimal tax rate differential in a closed-economy setting. However, a real-life open economy faces corporate tax competition. In this study’s data panel, the average CIT rate has declined from 48.1% in 1981 to 25.6% in 2018, meaning that the recent international agreement on a minimum rate of 15% will not immediately halt the continuous downward trend.

Ganghof (2006b) describes the resulting policy dilemma faced by governments as they cut their CIT rates: keeping the top PIT rate constant implies that the rate differential increases, which hurts tax system integrity; and maintaining the existing differential implies that the top rate must be reduced, which hurts tax system progressivity. Ganghof presents case-study evidence of seven countries’ responses to this dilemma between the mid-1980s and early 2000s. He shows that many top rate reductions were indeed related to CIT rate setting. To ensure optimal tax system integrity, New Zealand even aligned both rates at 33% (see also: Christensen, 2012). Other countries implemented less radical reforms, generally because of budgetary and political constraints. As their CIT rates declined due to international competitive pressure, their tax rate differentials increased. Figure 3.2 documents the average tax rate differential in this study’s data panel through time. Starting at 19.3 percentage points in 1981, it was sharply reduced to 9.6 percentage points in 1989 as countries cut their top rates. Since then, it has risen steadily to 23.5 percentage points in 2018, with cross-country variation sharply declining. The latter may indicate that countries’ PIT rates similarly experience the downward pull of the CIT on the one hand, and upward budgetary and political pressure on the other.

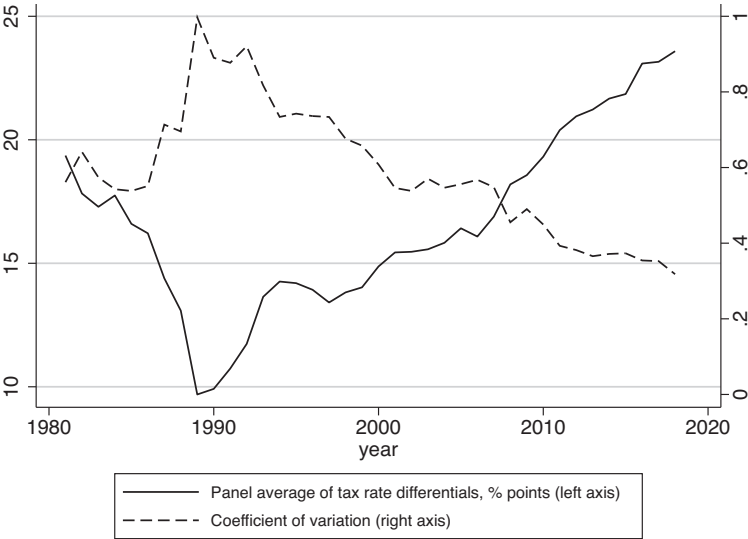


Figure 3.2 Panel average and variation of PIT-CIT rate differentials, 1981-2019.

Unsurprisingly, recent empirical evidence shows that owner-managers both exploit differences between taxes on dividends, capital gains and wages, and retain profits inside corporations (Alstadsæter and Jacob, 2012, p. 58). De Mooij and Nicodème (2008) estimate that these strategies account for 12 to 21% of total CIT revenues in a panel of 17 European countries. Profit retention appears to be the main strategy (Le Maire and Schjærning, 2013; Bettendorf et al., 2017; Miller et al., 2021). It follows that the differential between PIT and CIT rates, rather than shareholder tax rates, should be at the heart of the issue, because shareholder taxes become less relevant when corporate profits are retained (especially when owner-managers consume goods within the firm). Illustratively, while the alignment of top marginal dividend and labour tax rates in Norway should prevent income shifting to the corporate form, Alstadsæter et al. (2014) find evidence of substantial tax-free saving and consumption in holding corporations, precisely because the CIT rate is relatively low.

Anecdotal evidence illustrates that PIT avoidance remains a contributing factor in tax policymaking. For instance, the Norwegian government addressed it in its 2015 tax reform proposal, arguing that employers' social security contributions made earning wages less attractive than earning shareholder income. The government was reluctant to increase the marginal tax rate on dividends, fearing tax avoidance and even emigration (Solberg government, 2015, p. 13). Since 2016, it has implemented some moderate cuts in the PIT rate of around 0.2 percentage points each year. In Sweden, where the top PIT rate was already reduced by 5 percentage points in 2020, an advisory committee attached to the Ministry of Finance proposed another reduction of the same magnitude, which would tackle income shifting towards corporations (Eklund, 2020, p. 17). The Dutch government implemented a stepwise top rate reduction of 2.45 percentage points between 2018 and 2021. The importance of aligning marginal rates on wage and shareholder incomes had been stressed by an independent advisory committee, and it was explicitly mentioned in the reform's explanatory memorandum (Rutte III government, 2018, para. 5.9). This rate alignment had been a main goal of the current system (Kok II government, 1999, para. 5), and tax scholars stressed that it had been undermined by several CIT reductions (e.g., Caminada and Stevens, 2017). However, the government publicly sold the reform with arguments relating to "making work pay" (e.g., Rutte III government, 2018, para. 5.1).

The latter example illustrates the difficulty in distinguishing a reform's primary goals from its coincidental advantages as listed in explanatory memorandums and government statements, and thus in obtaining convincing qualitative evidence about the drivers of PIT rate setting using case studies. This difficulty highlights the complementary added value of this study's regression approach: it can quantify the effects of these drivers relatively easily.

### 3.6 HYPOTHESES

To this end, I translate the discussed theory and evidence on the backstop argument into six hypotheses. As highlighted by Ganghof (2006b), governments that cut the CIT rate generally choose a policy option on a continuum between two extremes: keeping the PIT rate constant, or keeping the tax rate differential constant and hence reducing both rates parallelly. When several subsequent governments choose the former option, the differential increases. A large differential should eventually incentivise the government to cut the PIT rate in order to improve tax system integrity. Thus, my first two hypotheses are as follows.

Hypothesis 1: The size of the tax rate differential encountered by a government at its investiture is negatively related to the change in the top PIT rate during this government's incumbency.

Hypothesis 2: Government-specific changes in CIT and PIT rates are positively related.

These hypotheses are premised on the exogeneity of CIT rate setting. In reality, however, the CIT-PIT relation may be bidirectional, or it may be influenced by third factors, causing endogeneity problems. For instance, governments may find it politically costly to reduce one tax without cutting the other, or they may be favourably disposed towards cutting taxes in general – recall the spread of neoliberal policy ideas. Furthermore, governments could reduce the tax rate differential by raising the CIT rate instead of cutting the PIT rate. In that case, large differentials could have a dampening effect on CIT competition. Finally, small businesses could theoretically avoid corporate taxes by switching to the personal tax base, which would stimulate governments to cut the CIT rate. I apply a twofold strategy to mitigate these endogeneity concerns. First, I exploit the time dimension of the data to test the unidirectionality of the CIT-PIT relation.

Hypothesis 3: The size of the tax rate differential encountered by a government at its investiture has no effect on this government's subsequent CIT rate setting.

Evidence in favour of both hypotheses 1 and 3 would suggest that past CIT rate setting, through the size of the tax rate differential, Granger-causes PIT rate setting, but not vice versa.<sup>2</sup> Such evidence would leave intact the possibility that a third factor influences the relation between government-specific changes in both rates. However, the latter scenario is less likely when that relation is absent in a large sub-group of countries. In particular, I expect the relation to hold only in countries that aim to tax corporate and personal income comprehensively at an (approximately) equal rate. Those countries must adjust both rates parallelly to maintain their (approximate) tax rate alignment. In that case, their top rate reductions should not be caused by the rate differential but by the change in the CIT rate. In countries

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2 This does illustrate the need to deal with autocorrelation – see *infra*.

with a large tax rate differential, instead, there should be less urgency to adjust both rates simultaneously; any cuts in the PIT rate are likely to result from the differential having increased over time (as formulated in hypothesis 1). I translate these assumptions into the following hypotheses.

Hypothesis 4: A smaller tax rate differential at the beginning of a government's term causes a stronger positive relation between this government's changes in CIT and PIT rates.

Hypothesis 5: In countries with large tax rate differentials, government-specific changes in CIT and PIT rates are unrelated.

Any evidence in favour of the latter hypothesis further mitigates the abovementioned endogeneity concerns.

Finally, I expect that changes in the top rate are not driven by top marginal rates on shareholder income. Admittedly, in the examples above, Norway and the Netherlands seem to be interested primarily in aligning their top labour and dividend tax rates, rather than their labour and corporate rates. But as explained, this is a surrogate solution for tax system integrity, as profit retention will remain a problem. The real reason behind PIT avoidance, and resultingly, behind top rate reductions, should be the low CIT rate. The lack of detailed, internationally comparable data on capital gains taxes confines the focus of my hypothesis to dividend taxation.

Hypothesis 6: The differential between the top rate on dividend income (including corporate taxes) and the top PIT rate, encountered by a government at its investiture, does not affect this government's top PIT rate setting.

### 3.7 METHOD AND DATA

#### 3.7.1 Dependent variable and model structure<sup>3</sup>

I estimate the effects of the theoretical determinants of top PIT rate setting in 19 OECD countries between 1981 and 2018. Following Schmitt (2016), Garritzmann and Seng (2016) and Ahrens et al. (2020), I estimate regression models with cabinet periodisation. These should conform better to political reality than conventional country-year models, because governments generally draft one tax plan, instead of deciding on new reforms each year (Ahrens et al., 2020). Country-year data incorrectly record reforms that involve stepwise tax cuts over several years (Jensen and Lindstädt, 2012). They do capture reforms with a one-year time frame, but in these cases, the other cabinet years will add redundant observations with no variance in several variables. This may bias the coefficients (Garritzmann and Seng, 2016). Moreover, governments tend to schedule reforms at dissimilar time points during their terms; they may delay reform implementations (Jensen and Lindstädt, 2012); and their reaction speed to changed economic circum-

3 Descriptive statistics of all variables are reported in tables A.3.1 and A.3.2 of the appendix.

stances may differ. Country-year models need a complex and error-prone lag structure to capture such differences for all countries and variables, whereas the timing of reforms is less important in cabinet-based models (Schmitt, 2016).

Still, cabinet-based models would fail to capture long-term reforms over multiple governments. This would be especially problematic when the speed of PIT and CIT reforms differs. For instance, the Granger causality between CIT cuts and subsequent PIT cuts would be false when PIT cuts were decided upon much earlier.<sup>4</sup> Therefore, I briefly examine whether tax cut announcements and implementations substantially deviate on an aggregate level.<sup>5</sup> As reported in the supplementary material to the published version of this chapter, retrievable via the website of the *Journal of Public Policy*, almost all PIT and CIT rate changes occur in the first two years following a tax cut announcement, and their average reforms are completed in 1.71 and 1.57 years, respectively.<sup>6</sup> This finding reduces concerns about biases resulting from implementation lags, especially because I exclude cabinets that have served for less than one year – those are often caretaker governments which are unlikely to implement major reforms (Schmitt, 2016).

The dependent variable measures the change in the top PIT rate during a government's incumbency. I use the statutory rate faced by individuals in the highest income tax bracket, at the combined central and sub-central government level, including uncapped surcharges, social premiums and payroll taxes.<sup>7</sup> Data are retrieved from the OECD's Tax Database (OECD, 2020b); a special OECD project collecting pre-2000 tax data (Johansson et al., 2008); Piketty et al. (2014); and government statistics agencies or tax administrations.

The abovementioned sources provide conventional country-year panel data. To obtain cabinet-periodised data, I combine them with cabinet composition data (Armingeon et al., 2020b). In parliamentary systems, a cabinet is defined as a government with constant parliamentary support and portfolio division among coalition partners. For example, Tony Blair's ten-year Labour government in the UK consisted of three cabinets, because two elections changed the government's initial parliamentary majority. I follow the same definition for semi-presidential systems in which the government depends on the approval of the legislature. In full presidential systems, I classify presidencies as single-party cabinets. I assign country-year data to cabinets, based on their years of incumbency: a cabinet taking office in 2014

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4 I thank an anonymous reviewer for raising this point.

5 Announcement dates are retrieved from the Tax Policy Reform Database (Amaglobeli et al., 2018) and from additional sources which I report online: <https://doi.org/10.1017/S0143814X23000028>. I measure a reform's implementation by looking at the actual yearly tax rate changes after its announcement. As tax cuts and tax increases offset each other, I look at tax cuts only.

6 <https://doi.org/10.1017/S0143814X23000028>

7 For instance, the US tax rate includes uncapped Medicare taxes for data years since 1994, when their maximum taxable base was removed.



and leaving office in 2016 would have the country-years 2014, 2015 and 2016 assigned to it, and the dependent variable would measure the change in the top rate between 2014 and 2016 (see Ahrens et al., 2020, p. 573). As this merging process retains the information on countries and investiture years, the resulting panel data allow for the use of country and year dummies when appropriate.

### 3.7.2 Tax system variables

Two main explanatory variables measure the effect of the CIT rate. One denotes the positive differential between the PIT and CIT rate in a cabinet's first year of incumbency (to test hypothesis 1).<sup>8</sup> The other denotes the change in the CIT rate during this cabinet's term (hypothesis 2). To test whether this CIT rate change has a stronger effect on the dependent variable in countries with a smaller tax rate differential (hypotheses 4 and 5), I will add an interaction term of both explanatory variables in a separate estimation. In another set of models, I estimate these relations in the opposite direction to test hypothesis 3: I regress the change in the CIT rate on the PIT-CIT rate differential and on the change in the PIT rate. CIT rate data are retrieved from the OECD (2020b), Johansson et al. (2008) and Devereux et al. (2002), and reflect the combined central and sub-central rate.

To measure the effect of dividend tax rate setting (hypothesis 6), I include the positive differential between the top PIT rate and the top statutory rate on dividend income in a cabinet's first year of incumbency. This measure includes taxes at both the corporate and the shareholder level and takes into account relief systems that prevent double taxation. Furthermore, I add the change in the shareholder-level dividend tax rate during a cabinet's incumbency. Data are retrieved from the OECD (2020b) and Johansson et al. (2008). Note that these are two separate time series: the 1981-1999 data from Johansson et al. have not been verified by the OECD, which provides data for the years 2000-2018. Although the time series align very well, the results should thus be treated with some caution. I will test the effects of the dividend tax rate in separate regressions.<sup>9</sup>

I include two control variables that describe other relevant aspects of the tax system. First, to control for the top bracket's relevance, I include the income share of taxpayers that it affects in the government's year of investiture. This income share depends not only on the top bracket's income threshold relative to the average income, but also on the shape of the

8 This denotes the extent to which the CIT rate is below the PIT rate. When it is above the PIT rate, I code the differential as 0. The reason is that the CIT is unlikely to 'pull up' PIT rates, given the scant evidence of CIT avoidance through the labour tax base. Re-estimations of the models presented below using a variable that captures both positive and negative differentials do not produce substantially different results.

9 The same caution applies for personal and corporate tax rates retrieved from Johansson et al. (2008), but those data could largely be verified with other sources, unlike the dividend tax rates.

income distribution. Following Akgun et al. (2017), I use a virtual income distribution that is similar in all countries; this proxy avoids endogeneity, as real-life income distributions are affected by the top rate through labour supply decisions. The income share of taxpayers who are affected by the top rate equals:

$$\text{Income share} = \frac{\alpha}{\alpha - 1} * \frac{x_0^\alpha}{\left( \frac{\text{top rate income threshold}}{\text{GDP per capita}} \right)^{\alpha - 1}}$$

This equation follows a Pareto law; the Pareto coefficient  $\alpha$  equals 2 (following Ruiz and Woloszko, 2016, as cited in Akgun et al., 2017), and the term  $x_0$  is a scaling parameter, set to 0.1. The Pareto law describes the right end of an income distribution: a downward, convex curve with an asymptotic tail. Hence, for the number of affected taxpayers, it makes a much larger difference whether the top bracket starts at 2 versus 3 times the average income, than whether it starts at 12 versus 13 times the average income. This makes the income share equation a more realistic control variable than the tax bracket threshold in and of itself, which would imply a linear effect. And because of the Pareto parameter that describes the income distribution, the equation is also more realistic than the ratio of GDP per capita over the top bracket's income threshold. Threshold data are retrieved from the same sources as PIT data. GDP per capita in current local currency units is retrieved from the World Bank (2020).

Second, it is necessary to control for convergence of the dependent variable, as high taxes are more likely to be reduced than low taxes. I include the PIT rate in a cabinet's first year of incumbency, transformed into a standardised index based on yearly averages.<sup>10</sup> Given the evolution of tax policy ideas (Steinmo, 2003) and the possibility of PIT competition, its relative height should be more important than its absolute height in a context of convergence. Furthermore, including its absolute height would cause a multicollinearity problem with the PIT-CIT rate differential. When the CIT rate is low, a high PIT rate necessarily implies a large rate differential, such that one variable may absorb the effect of the other.<sup>11</sup> It turns out that the standardised index of the PIT rate is less correlated with the tax rate differential.<sup>12</sup>

While the top rate's standardised start value controls for countries' simultaneous convergence towards the sample mean, potentially as a result

10 That is, for each data year in the initial country-year panel, I convert the 19 countries' PIT rates into z-scores. To denote the standardised PIT rate in a cabinet's first year, I use a country's z-score of that year.

11 The correlation coefficient of the tax rate differential and the top PIT rate is 0.49. But for cabinets with a CIT rate of 35% or lower in their first year, it is 0.81.

12 In regression model 1 outlined below, the variance inflation factor (VIF) of the standardised start value of the top rate is 3.99. Replacing it with the non-standardised start value, the VIF becomes 7.13.

of competition or policy emulation, I will also test the role of the US as a Stackelberg leader in separate models (Swank, 2016). To this end, I include the positive differential between a country's top rate and the US top rate in a government's first year, and the preceding yearly change in the US top rate.

### 3.7.3 Socio-economic variables

Given the budgetary consequences of top rate adjustments, I include the government's budget balance (Armingeon et al., 2020a). To control for longer-term demographic pressure on the budget, I follow Cusack and Beramendi (2006) by adding a measure of a country's demographic burden, that is, the added shares of elderly people and unemployed people (Armingeon et al., 2020a). I relegate the testing of alternative measures of population composition and welfare spending to the appendix, in order to prevent overspecification – see *infra*. To capture short-term and long-term economic performance, respectively, I include the GDP growth rate and the natural log of GDP per capita (World Bank, 2020). As competitive tax policy may depend on country size (Kanbur and Keen, 1993), I include the natural log of the total population (Armingeon et al., 2020a).

### 3.7.4 Political and institutional variables

A final set of control variables accounts for political and institutional factors. Assuming that the aggregate amount of income redistribution reflects the structural redistributive preferences of an electorate, I follow Plümpert et al. (2009) by including the absolute difference between the Gini coefficients before and after taxes and transfers (Solt, 2020). To account for the effects of government ideology, I include the share of left-wing cabinet positions (Armingeon et al., 2020b). I also add an index of consensus democracy by Armingeon et al. (2020a).<sup>13</sup> I measure corporatism by constructing an index that closely resembles the one used by Van Vliet et al. (2012). The index adds standardised scores of four variables, denoting: country-wide wage coordination; routine involvement of unions and employers in social and economic policymaking; an index denoting the centralised power of the main union confederation; and the union density rate. These data are retrieved from Visser (2019).

### 3.7.5 Cabinet duration, time trends and endogeneity

Assuming that a longer period of incumbency increases a government's ability to implement tax reforms, I include the natural log of its days in

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13 This index is a time-variant proxy for the first (executives-parties) dimension of Lijphart's consensus democracy index. It is variable *lfirstp* in the Comparative Political Data Set (Armingeon et al., 2020a).

power (Ahrens et al., 2020). I control for time trends by adding period dummies that each cover three years.<sup>14</sup> To prevent endogeneity and reverse causation, the control variables refer to values in a cabinet’s first year.

3.8 RESULTS

As a prelude to the regression results, Table 3.1 reports the directions in which the panel’s 226 governments have changed their PIT and CIT rates. It shows that tax reform is rather common, with over 77% of governments changing one or both rates. The distribution of reform patterns tentatively points in the direction of the hypotheses. The most common pattern is a simultaneous reduction of both rates (by 46 governments), in line with hypothesis 2. Additionally, 32+30=62 governments cut either of both, as follows from hypothesis 1. Those three patterns comprise 48% of the sample. The shaded cells denote patterns that negate the hypotheses, and comprise 25% of the sample.<sup>15</sup>

Table 3.1 Distribution of cabinets’ reform patterns.

	PITR increase	PITR unchanged	PITR reduction	Total
CITR increase	11	7	12	30
CITR unchanged	20	51	30	101
CITR reduction	17	32	46	95
Total	48	90	88	226

Table 3.2 reports the regression results of changes in top PIT rates. Model 1 shows that the CIT is a strong determinant of top rate setting, as predicted in hypotheses 1 and 2. First, an existing differential between the two rates is related to a remarkably large decline of the PIT rate: the average differential of 16.6 percentage points would result in a 2.4 percentage-point reduction. Second, every percentage-point change in the CIT rate is related to a simultaneous 0.34 percentage-point change in the PIT rate in the same direction.<sup>16</sup>

Model 2 adds an interaction term between these variables to test hypotheses 4 and 5. Its marginal effects are plotted in Figure 3.3 and conform to the expectations. In countries with a tax rate alignment (at the left

14 This time frame ensures that enough cabinets are included under each dummy, and it approximates the average cabinet duration. The last dummy covers four years: 2014-2017.  
15 Their rate increases are often small: when ignoring changes below 0.5 percentage points, which may be caused by fluctuations in sub-central rates, these patterns only comprise 18% of the sample.  
16 Multicollinearity does not appear to be a big problem: corporatism has the largest VIF, of 5.53. The results do not change substantially when excluding corporatism.

end of the x-axis), a 1 percentage-point decline in the CIT rate is related to a substantial PIT rate reduction of 0.56 percentage points. In countries with a larger tax rate differential, the relation is weaker and pales into insignificance. Thus, as predicted, it is less urgent in systems with a large tax rate differential to adjust both rates simultaneously. Of course, this does not negate the backstop argument: when one government reduces only the CIT rate, a subsequent government may cut the PIT rate because it finds the differential too large. Notably, the effect of the differential remains significant in model 2.

Table 3.2 Effects on cabinets' changes in top PIT rates.

	(1)	(2)	(3)	(4)	(5)
<i>Tax system variables</i>					
PIT-CIT rate differential	-0.1464** (0.0675)	-0.1658** (0.0700)	-0.1018* (0.0584)	-0.1022* (0.0583)	-0.1199** (0.0595)
$\Delta$ CIT rate	0.3410*** (0.0956)	0.5564*** (0.1284)	0.2600*** (0.0855)	0.2624*** (0.0856)	0.4451*** (0.1059)
$\Delta$ CIT rate * PIT-CIT rate differential		-0.0187** (0.0081)			-0.0156** (0.0072)
PIT – US PIT rate differential			-0.0519 (0.0828)		
$\Delta$ US PIT rate, year 1			0.1282 (0.0783)	0.1387* (0.0725)	0.1402* (0.0717)
Relevance of top PIT bracket	78.9686 (77.9249)	79.9126 (76.4460)	37.9359 (46.9907)	39.7513 (46.9690)	41.9590 (47.1221)
PIT rate start value	-1.5097*** (0.5563)	-1.5353*** (0.5554)	-1.2593** (0.5787)	-1.5175*** (0.4839)	-1.5380*** (0.4840)
<i>Socio-economic variables</i>					
Budget balance	-0.1255 (0.0952)	-0.1441 (0.0941)	-0.1006 (0.1023)	-0.1044 (0.1007)	-0.1219 (0.0998)
Demographic burden	0.1314 (0.0902)	0.1586* (0.0881)	0.1298 (0.0875)	0.1302 (0.0877)	0.1526* (0.0856)
Ln population	-0.0814 (0.5255)	-0.1440 (0.5207)	-0.1490 (0.3896)	-0.1048 (0.3908)	-0.1548 (0.3963)
GDP growth	-0.1872 (0.1574)	-0.2121 (0.1479)	-0.1492 (0.1512)	-0.1548 (0.1488)	-0.1771 (0.1405)
Ln GDP per capita	4.1859* (2.2464)	4.7178** (2.2591)	3.8409* (2.2268)	3.8456* (2.2142)	4.3063* (2.2343)
<i>Political and institutional variables</i>					
Corporatism	0.1723 (0.1576)	0.1512 (0.1603)	0.1001 (0.1416)	0.1229 (0.1441)	0.1066 (0.1477)
Redistribution	0.2784** (0.1348)	0.2713** (0.1336)	0.2736*** (0.1049)	0.2691** (0.1050)	0.2642** (0.1063)

	(1)	(2)	(3)	(4)	(5)
Left government	-0.0019 (0.0071)	0.0004 (0.0069)	-0.0019 (0.0069)	-0.0025 (0.0069)	-0.0006 (0.0067)
Consensus democracy	-0.0656 (0.3156)	-0.1068 (0.3182)	0.0092 (0.2871)	-0.0428 (0.2964)	-0.0760 (0.2945)
Cabinet duration	-0.1856 (0.5938)	-0.2389 (0.5962)	-0.1569 (0.5873)	-0.1240 (0.5949)	-0.1547 (0.5930)
Constant	-48.8231** (24.1430)	-53.4444** (24.9419)	-44.7063* (24.4344)	-45.5263* (24.8864)	-50.1342** (24.7181)
Observations	226	226	216	216	216
Adjusted r-squared	0.3852	0.4012	0.3917	0.3934	0.4063

Period dummies included. Eicker-White standard errors in parentheses.

\*\*\*  $p < 0.01$ , \*\*  $p < 0.05$ , \*  $p < 0.1$

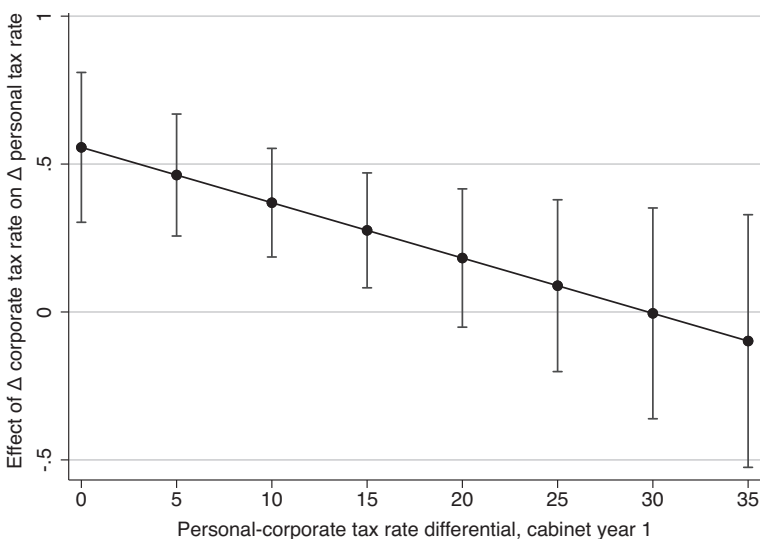


Figure 3.3 Effect of  $\Delta$  CIT rate on  $\Delta$  PIT rate, conditional on the tax rate differential.

In both models, the significant and negative coefficient of the top rate's start value shows that higher rates are reduced more than lower rates. Due to a lack of migration data, it is difficult to test whether this convergence is driven by competition or policy emulation, though the discussed literature suggests the latter. The insignificant and wrongly-signed coefficient of the population variable also negates the positive relation between tax rates and country size that would be indicative of tax competition (Kanbur and Keen, 1993). To additionally test US Stackelberg leadership, model 3 adds the

domestic-US PIT rate differential and the change in the US PIT rate.<sup>17</sup> The coefficients are insignificant, but this may result from multicollinearity, as three variables in this model depend on the height of the top rate.<sup>18</sup> Models 4 and 5 therefore exclude the domestic-US PIT rate differential, and only include the change in the US PIT rate, which now turns weakly significant. The effect seems to depend on variable specification: replacing the one-year change with a two-year change, or the change during a government's term, yields insignificant coefficients (not reported). I thus regard the evidence for US Stackelberg leadership as weak.<sup>19</sup>

The coefficients of most control variables point in the expected directions. Redistributive preferences have a significant and upward effect on top rate adjustments, and richer countries set higher rates. Moreover, it is plausible that government budget deficits and populations with large shares of elderly or unemployed people also have some upward effect, as their coefficients are close to the 10% significance level in most models. These findings partially confirm the financial and political constraints that governments face in reducing PIT rates, as identified by Ganghof (2006b). The government ideology variable has no significant effect, which is notable, because partisan effects should be particularly pronounced in cabinet-based models (Schmitt, 2016).

Table 3.3 presents the Granger causality tests, which reverse the original model, estimating the effect of the tax rate differential and the government-specific change in the PIT rate on CIT rate setting (hypothesis 3). In these models, I control for levels and changes of the US CIT rate, because there is strong evidence of US Stackelberg leadership in CIT policy (e.g., Swank, 2016). Model 6 shows that CIT rate changes are not driven by the prior tax rate differential. They do coevolve with changes in the PIT rate. However, as the interaction term in model 7 shows, this effect is partially driven by countries with a small tax rate differential changing both rates together: in a country with a 24.33 percentage-point differential, the estimated effect of PIT on CIT rate changes is zero ( $0.7178 - 0.0295 \times 24.33$ ). Following the approach of the original models 4 and 5, models 8 and 9 drop the domestic-US CIT rate differential, to prevent multicollinearity. The coefficient of the

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17 Again, I use positive differentials and code negative differentials as 0 – see note 8. In the abovementioned context of neoliberal tax policy diffusion, I do not expect the US PIT rate to pull up other countries' PIT rates if it happens to be higher, i.e., if the differential is negative. As a robustness check, I use a variable that allows for both positive and negative differentials instead; the results are similar.

18 In model 3, the respective VIFs of the domestic-US top rate differential, the PIT-CIT rate differential, and the top rate's start value are 5.69, 4.44, and 6.36. In model 4, the latter two are 4.44 and 4.06, respectively.

19 Also, it does not depend on domestic circumstances. Following Swank (2016), who finds substantial Stackelberg leadership of the US in corporate tax policy, with a mediating effect of domestic institutions, I subsequently interact the change in the US PIT rate with all socio-economic, political and institutional control variables (not reported). None of these interaction terms are significant.



PIT-CIT differential turns weakly significant in model 8 (p-value 0.100), but it is highly insignificant in model 9 with the interaction term (p-value 0.532).<sup>20</sup> Model 10 drops all non-tax and non-domestic control variables, to check whether these substantially affect the results – they do not. In sum, I find very weak evidence of CIT rates being influenced by the tax rate differential. This finding tentatively suggests that the differential has an exogenous effect in the original models.

Models 11-14 in Table 3.4 test the effect of dividend tax regimes (hypothesis 6).<sup>21</sup> Model 11 includes the differential between the PIT rate and the combined corporate- and shareholder-level dividend tax rate in a cabinet's first year. Model 12 additionally controls for the cabinet-specific change in the shareholder-level dividend tax rate. The reason for estimating these models separately is that PIT and dividend tax rates are likely to coevolve during a cabinet's term, especially in synthetic systems that include labour and dividend income in one tax base (Ahrens et al., 2020) – this causes endogeneity problems which may affect the results of model 12. In both models, the PIT-dividend tax differential has no significant effect on PIT rate setting, while the coefficients of the CIT variables remain highly significant.<sup>22</sup> In models 13 and 14, I exclude the CIT variables to prevent any overspecification. The effects of the PIT-dividend tax differential remain insignificant. In sum, it appears that dividend tax regimes are unable to mitigate the downward effect of CIT competition on top PIT rates.

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20 Dropping the change in the US CIT rate as well, while retaining the control variables, yields similar results.

21 The estimations of these models have slightly fewer observations, because of missing data on dividend tax rates for Finland and Greece in the 1980s and 1990s. To check whether this influences the results of the other variables, I re-estimate models 1 and 2, omitting the same governments. The results are unaffected.

22 Again, I use positive differentials – see note 8. Allowing for negative differentials as a robustness check, the results of models 11 and 13 are unchanged. In models 12 and 14, the PIT-dividend tax differential turns significant, which would suggest that high dividend tax rates pull up PIT rates. The effect of the PIT-CIT differential remains significant. Comparing their effects in this re-estimated model 12, the CIT overshadows the dividend tax: the product of the coefficient and sample mean of the PIT-dividend tax differential would be a  $-0.097 \times 2.62 = 0.25$  percentage point PIT rate increase, compared to a  $-0.09 \times 16.96 = -1.53$  percentage point PIT rate decline caused by the PIT-CIT differential. Thus, in any model specification, dividend tax regimes are unable to mitigate the downward effect of CIT competition on PIT rates. Incidentally, the effect of the dividend tax variable, which captures both corporate- and shareholder-level taxation, may partially run through the CIT rate anyway. When controlling for the height of the CIT rate, the PIT-dividend tax differential indeed turns insignificant, while the PIT-CIT differential remains significant (not reported).

Table 3.3 Effects on cabinets' changes in CIT rates (Granger causality tests).

	(6)	(7)	(8)	(9)	(10)
<i>Tax system variables</i>					
PIT-CIT rate differential	0.0940 (0.0572)	0.0318 (0.0509)	0.0929* (0.0562)	0.0286 (0.0500)	0.0336 (0.0372)
$\Delta$ PIT rate	0.2229** (0.0878)	0.7178*** (0.1420)	0.2282** (0.0919)	0.7414*** (0.1468)	0.2423*** (0.0820)
$\Delta$ PIT rate * PIT-CIT rate differential		-0.0295*** (0.0062)		-0.0307*** (0.0061)	
CIT – US CIT rate differential	-0.2053 (0.1433)	-0.1484 (0.1314)			
$\Delta$ US CIT rate, year 1	0.4892** (0.2480)	0.3181 (0.2735)	0.5343** (0.2284)	0.3434 (0.2621)	
Relevance of top PIT bracket	-91.7929 (78.5025)	-75.1733 (76.0675)	-97.3085 (79.2560)	-78.4365 (76.3993)	-148.3691** (58.0234)
CIT rate start value	-0.8092* (0.4340)	-0.9172** (0.4160)	-1.2898*** (0.4671)	-1.2636*** (0.4196)	-1.3781*** (0.3979)
<i>Socio-economic variables</i>					
Budget balance	0.0361 (0.0830)	0.0007 (0.0832)	0.0493 (0.0850)	0.0087 (0.0843)	
Demographic burden	-0.0479 (0.0764)	-0.0360 (0.0723)	-0.0489 (0.0776)	-0.0362 (0.0726)	
Ln population	0.5851 (0.4210)	0.4309 (0.4142)	0.6313 (0.4298)	0.4577 (0.4241)	
GDP growth	0.0303 (0.1792)	-0.0244 (0.1744)	0.0448 (0.1748)	-0.0162 (0.1709)	
Ln GDP per capita	-0.4923 (1.7961)	0.2884 (1.7391)	-0.8989 (1.8970)	0.0302 (1.8026)	
<i>Political and institutional variables</i>					
Corporatism	-0.0410 (0.1484)	-0.0033 (0.1489)	-0.0246 (0.1505)	0.0099 (0.1509)	
Redistribution	-0.1330 (0.1207)	-0.1399 (0.1203)	-0.1559 (0.1263)	-0.1565 (0.1236)	
Left government	-0.0004 (0.0070)	0.0002 (0.0067)	0.0002 (0.0070)	0.0007 (0.0066)	
Consensus democracy	0.1830 (0.2850)	0.1136 (0.2734)	0.1397 (0.2839)	0.0800 (0.2705)	
Cabinet duration	-1.3200** (0.5759)	-1.4739*** (0.5280)	-1.1536* (0.5922)	-1.3616** (0.5408)	-1.0468* (0.5615)
Constant	11.0371 (19.4332)	5.2962 (18.6239)	14.2808 (20.4674)	7.4130 (19.2232)	7.2817* (4.0006)
Observations	216	216	216	216	226
Adjusted r-squared	0.3379	0.3994	0.3284	0.3959	0.3211

Period dummies included. Eicker-White standard errors in parentheses.

\*\*\* p<0.01, \*\* p<0.05, \* p<0.1

Table 3.4 Effects on cabinets' changes in top PIT rates.

	(11)	(12)	(13)	(14)
<i>Tax system variables</i>				
PIT-CIT rate differential	-0.1497** (0.0681)	-0.1056** (0.0529)		
Δ CIT rate	0.3658*** (0.1013)	0.2434*** (0.0792)		
PIT-(CIT + shareholder dividend tax) rate differential	0.0203 (0.0614)	-0.0868 (0.0611)	0.0283 (0.0662)	-0.0913 (0.0644)
Δ shareholder dividend tax rate		0.2395*** (0.0356)		0.2605*** (0.0399)
Relevance of top PIT bracket	102.1515 (90.2274)	34.0884 (76.6318)	75.7641 (99.5979)	12.2414 (82.6977)
PIT rate start value	-1.4012** (0.5693)	-1.1454** (0.4741)	-2.3208*** (0.5386)	-1.7458*** (0.4175)
<i>Socio-economic variables</i>				
Budget balance	-0.1775* (0.0999)	-0.1592* (0.0838)	-0.1453 (0.0931)	-0.1347* (0.0800)
Demographic burden	0.1203 (0.0999)	0.1107 (0.0764)	0.1063 (0.1043)	0.1000 (0.0761)
Ln population	-0.0227 (0.5777)	-0.1038 (0.4881)	0.2485 (0.5392)	0.0844 (0.4599)
GDP growth	-0.1394 (0.1577)	-0.1201 (0.1231)	-0.2031 (0.1679)	-0.1601 (0.1295)
Ln GDP per capita	4.0781* (2.2951)	3.4941** (1.6473)	3.5704 (2.3773)	3.0573* (1.6404)
<i>Political and institutional variables</i>				
Corporatism	0.1985 (0.1608)	0.2461* (0.1473)	0.1948 (0.1717)	0.2522 (0.1635)
Redistribution	0.2447* (0.1403)	0.1150 (0.1162)	0.1787 (0.1360)	0.0576 (0.1130)
Left government	-0.0009 (0.0072)	0.0023 (0.0057)	-0.0012 (0.0076)	0.0025 (0.0058)
Consensus democracy	-0.1981 (0.3293)	-0.2021 (0.2810)	-0.0888 (0.3492)	-0.1288 (0.2867)
Cabinet duration	-0.2528 (0.5685)	-0.1412 (0.4808)	-0.6034 (0.5925)	-0.3522 (0.5014)
Constant	-47.4824* (24.5625)	-37.9193** (17.1756)	-43.9810* (26.3892)	-34.4200* (17.5156)
Observations	219	219	219	219
Adjusted r-squared	0.3726	0.5681	0.2977	0.5374

Period dummies included. Eicker-White standard errors in parentheses.

\*\*\* p&lt;0.01, \*\* p&lt;0.05, \* p&lt;0.1

### 3.9 ROBUSTNESS, ADDITIONAL VARIABLES AND ALTERNATIVE MODEL SPECIFICATIONS

Supplementary tables A.3.3 through A.3.6 report the results of several robustness checks and alternative model specifications. Models 15 through 22 add further control variables (tables A.3.3 and A.3.4). I first test Limberg's (2019) claim that economic crises trigger top rate increases by activating societal fairness norms, especially when government debt rises. To this end, model 15 adds a dummy variable coded 1 if a government experiences a banking crisis during its term (Laeven and Valencia, 2018), and interacts it with the change in the debt-to-GDP ratio (Armingeon et al., 2020a). Model 16 includes the interest rate on 10-year government bonds, which was found by Lierse and Seelkopf (2016) to be a driver of tax reforms, as higher bond yields constrain debt-financed government spending. Model 17 controls for the effect of trade openness, which may stimulate the government to increase taxation and redistribution in order to protect citizens from the risks of globalisation (Rodrik, 1998). Trade openness is measured by the sum of imports and exports as a percentage of GDP (Armingeon et al., 2020a). Following Swank and Steinmo (2002), model 18 measures the strength of Christian democratic parties instead of left-wing parties.<sup>23</sup> The remaining models control for determinants of redistribution preferences, as discussed in the theoretical section. Model 19 includes the share of expenditures directed to welfare schemes that mainly benefit the poor (Berens and Gelepithis, 2019), retrieved from the OECD's Social Expenditure Database (OECD, 2020a).<sup>24</sup> Model 20 includes an index of ethnic fractionalisation as a proxy for shared cultural backgrounds (Drazanova, 2020),<sup>25</sup> and model 21 splits the demographic burden into two variables measuring the respective shares of unemployed and elderly people (Armingeon et al., 2020a). Building on model 21, model 22 replaces the level of unemployment with its yearly change, to better capture fiscal stress. None of the additional variables have significant coefficients and the other results do not change substantially.

Next, I run alternative model specifications (tables A.3.5 and A.3.6). In models 23 and 24, I check whether the coefficients of the tax variables in models 1 and 2 change when excluding the non-tax control variables; they do not, except for the interaction term in model 2 dropping slightly below the 10% significance level. To further check the exogeneity of the tax rate dif-

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23 I code parties as Christian democratic when they are categorised as both 'centrist' and 'religious' by Armingeon et al. (2020b). As I lack data on Christian democratic cabinet positions, I approximate their relative strength in government using the ratio of their parliamentary seat share over governing parties' total seat share.

24 Following Berens and Gelepithis (2019), I classify family and housing benefits, active labour market policies and miscellaneous spending as pro-poor, as opposed to unemployment, incapacity, old age, health and survivors' benefits, which mainly fulfil insurance functions. A small number of missing data years are linearly interpolated.

25 Due to data availability, this reduces the period of analysis to 1981–2013.

ferential, I run a 2SLS instrumental variables regression in model 25, using as an instrument the differential between a country's top PIT rate and an unweighted spatial lag of other countries' CIT rates.<sup>26</sup> Its coefficient remains negative and highly significant. As a Wooldridge test detects country-specific autocorrelation in the original models,<sup>27</sup> I replace the Eicker-Huber-White standard errors with country-clustered standard errors in model 26. I have opted against this in the original models because of the relatively small number of countries. The results remain unchanged. As an alternative, in model 27, I use country dummies to perform a fixed-effects regression with heteroskedasticity-robust standard errors. The coefficients of the CIT variables remain highly significant. Model 28 accounts for slightly unbalanced panel data, due to missing values of the consensus democracy index for Greece, Portugal and Spain in the early 1980s. The results do not change substantially when excluding these countries. In model 29, the non-tax control variables, except for the level of redistribution, refer to values in the first half of a cabinet's term instead of its first year, following Schmitt (2016) and Ahrens et al. (2020).<sup>28</sup> This model specification is less effective in preventing endogeneity, but it allows for more relevant variation. The results are similar. Models 30 and 31 use country-year data instead of cabinet-periodised data, with one-year lags for all control variables.<sup>29</sup> The results hold.

### 3.10 CONCLUSION

Countries' differentials between their PIT and CIT rates increase as a result of corporate tax competition. Recent evidence shows that those differentials induce substantial PIT avoidance through the corporate form. Governments should have multiple political and economic reasons to prevent such tax avoidance and limit the PIT-CIT differential. Thus, CIT competition should put downward pressure on PIT rates. Building on the evidence presented by Ganghof (2006b), I have shown that CIT rate setting is indeed the main driving factor of top PIT rate setting by 226 cabinets in 19 OECD countries between 1981 and 2018. It has a more pronounced and more significant

26 Its correlation coefficient with the domestic PIT-CIT differential is 0.75 and its first-stage F-statistic is 9.74. Due to multicollinearity of this instrument with the top rate's standardised start value (correlation coefficient 0.85), I use the top rate's unstandardised start value in this model (correlation coefficient 0.65). Note that no proper instrument exists for the cabinet-specific change in the CIT rate: a spatial lag of other countries' changes in CIT rates would not suffice (correlation coefficient 0.25; first-stage F-statistic 0.02), because countries reform their corporate taxes at very dissimilar points in time.

27 Test statistic 51.1.

28 Odd numbers of incumbency years are rounded down. For instance, for a cabinet in office between 2012 and 2016 (5 years), I use the data years 2012 and 2013 to capture the first half.

29 Due to missing data for 2018, the period of analysis is 1981–2017. This issue does not affect the cabinet-based models, because most variables refer to values in a cabinet's first year, and no cabinet starts in 2018.

effect than several political, economic and institutional control variables. It also overshadows the effects of dividend tax rates. The latter finding implies that the erosion of the CIT's backstop function is unlikely to be mitigated by the recent dividend tax increases seen in several countries. Together with increasing tax rate differentials and converging top PIT rates in advanced OECD countries, these results suggest that governments have little room to manoeuvre in their top rate setting.

While this study's regression approach complements the existing qualitative evidence on top rate setting, it also has some limitations. First, regression models cannot assess all relevant details of the political process, including the influence of veto players, which are difficult to capture in a single index. This calls for additional qualitative case studies of recent tax reforms. Second, while this study has shown that countries' PIT rates converge, it could not fully disentangle the underlying processes of international policy diffusion, mainly due to a lack of migration data. In particular, identifying the channels of international competition for rich individuals is a fruitful area of future research. Another limitation is the measurement of shareholder taxes, which was confined to dividend taxation for reasons of data availability. However, shareholders may exploit lenient capital gains tax regimes instead of distributing dividends. Furthermore, statutory shareholder tax rates do not capture the presence of legal provisions preventing profit retention inside corporations. Thus, opportunities for future research include elucidating the effectiveness of such legal provisions in supporting PIT progressivity, and compiling internationally comparable data on capital gains tax rates.

## SUPPLEMENTARY MATERIAL TO CHAPTER 3

Table A.3.1 Descriptive statistics at the government level.

	N	Mean	Std. dev.	Min	Max
PIT rate, year 1	226	52.54	9.97	33.00	85.00
CIT rate, year 1	226	35.90	10.10	12.50	61.50
Dividend tax rate, year 1	219	32.28	18.41	-0.01	86.70
Combined CIT+PIT rate on dividends, year 1	219	54.92	14.59	25.00	93.70
Relevance of top PIT bracket, year 1	226	0.01	0.01	0.00	0.04
Budget balance, year 1	226	-2.96	4.70	-16.21	15.06
Demographic burden, year 1	226	23.17	5.12	13.07	47.77
Unemployed, year 1	226	8.04	4.03	2.00	27.50
Elderly, year 1	226	15.13	2.70	9.86	22.18
Population * 1000, year 1	226	35294.95	57710.42	3164.83	325219.90
Pro-poor public expenditure, year 1	226	0.18	0.07	0.04	0.30
GDP growth, year 1	226	2.17	2.42	-7.30	10.90
GDP per capita, year 1	226	38692.97	13479.86	12598.92	88444.88
Crisis (dummy)	226	0.17	0.38	0.00	1.00
$\Delta$ government debt	226	2.81	12.56	-37.51	46.02
Interest rate on government bonds, year 1	226	7.33	4.81	0.32	29.03
Trade openness, year 1	226	69.57	34.48	16.60	226.04
Corporatism, year 1	226	0.11	3.37	-5.38	6.52
Redistribution, year 1	226	17.75	3.28	11.00	24.70
Left government	226	36.31	41.14	0.00	100.00
Christian democratic government	224	12.49	24.45	0.00	100.00
Consensus democracy, year 1	226	0.00	1.10	-2.36	2.25
Days of cabinet duration	226	1038.54	404.83	368.00	1885.00



Table A.3.2 Descriptive statistics at the country-year level.<sup>30</sup>

	N	Mean	Std. dev.	Min	Max
PIT rate	692	52.25	9.32	33.00	85.00
CIT rate	692	36.04	9.81	12.50	61.80
Dividend tax rate	664	31.61	17.34	-0.01	86.70
Combined CIT+PIT rate on dividends	664	54.56	13.89	25.00	93.70
Relevance of top PIT bracket	692	0.01	0.01	0.00	0.04
Budget balance	692	-2.72	4.77	-32.07	18.63
Demographic burden	692	23.09	5.07	13.07	47.77
Unemployed	692	7.95	3.97	2.00	27.50
Elderly	692	15.14	2.66	9.59	22.44
Population * 1000	692	37881.41	62148.90	3164.83	325220.00
Pro-poor public expenditure	692	0.17	0.06	0.03	0.30
GDP growth	692	2.29	2.47	-9.13	25.16
GDP per capita	692	38618.84	13796.39	12598.91	91565.73
Crisis	692	0.10	0.29	0.00	1.00
$\Delta$ government debt	676	1.30	6.10	-32.97	55.09
Interest rate on government bonds	692	7.05	4.49	0.09	29.03
Trade openness	692	70.19	34.21	16.60	226.04
Corporatism	692	0.03	3.37	-5.38	7.37
Redistribution	690	17.80	3.34	11.00	25.00
Left government <sup>31</sup>	692	36.29	38.99	0.00	100.00
Consensus democracy	692	-0.11	1.08	-2.48	2.34

30 This table shows the country-year data used for models 30 and 31, i.e., observations between 1981 and 2017 where the value of the consensus democracy index is available.

31 Data on the strength of Christian democratic parties are not available at the country-year level.

Table A.3.3 Additional variables.

	Baseline (1)	(15)	(16)	(17)	(18)
<i>Tax system variables</i>					
PIT-CIT rate differential	-0.1464** (0.0675)	-0.1391** (0.0656)	-0.1436** (0.0669)	-0.1487** (0.0687)	-0.1468** (0.0684)
Δ CIT rate	0.3410*** (0.0956)	0.3295*** (0.0906)	0.3453*** (0.0955)	0.3425*** (0.0962)	0.3379*** (0.0965)
Relevance of top PIT bracket	78.9686 (77.9249)	88.6381 (78.1579)	80.3952 (78.0523)	75.7450 (81.1239)	80.3547 (78.3042)
PIT rate start value	-1.5097*** (0.5563)	-1.5922*** (0.5586)	-1.4332** (0.5641)	-1.5123*** (0.5570)	-1.4772*** (0.5525)
<i>Socio-economic variables</i>					
Budget balance	-0.1255 (0.0952)	-0.1409 (0.0995)	-0.1294 (0.0969)	-0.1177 (0.0965)	-0.1143 (0.0949)
Demographic burden	0.1314 (0.0902)	0.1410 (0.0913)	0.1332 (0.0909)	0.1337 (0.0926)	0.1372 (0.0916)
Ln population	-0.0814 (0.5255)	-0.0457 (0.5197)	-0.1781 (0.5597)	-0.0483 (0.5167)	-0.0970 (0.5363)
GDP growth	-0.1872 (0.1574)	-0.1899 (0.1585)	-0.2114 (0.1611)	-0.1936 (0.1585)	-0.1848 (0.1602)
Ln GDP per capita	4.1859* (2.2464)	4.3327* (2.2720)	3.7162* (1.9752)	4.1454* (2.2176)	4.1132* (2.1896)
<i>Political and institutional variables</i>					
Corporatism	0.1723 (0.1576)	0.1863 (0.1623)	0.1380 (0.1688)	0.1740 (0.1575)	0.1566 (0.1580)
Redistribution	0.2784** (0.1348)	0.2749** (0.1336)	0.2509* (0.1362)	0.2695** (0.1307)	0.2661** (0.1326)
Left government	-0.0019 (0.0071)	-0.0008 (0.0072)	-0.0011 (0.0073)	-0.0016 (0.0073)	
Consensus democracy	-0.0656 (0.3156)	-0.0589 (0.3209)	-0.0159 (0.3168)	-0.0746 (0.3182)	-0.0820 (0.3326)
Cabinet duration	-0.1856 (0.5938)	-0.1440 (0.5985)	-0.2929 (0.5989)	-0.1897 (0.5965)	-0.2454 (0.6263)
<i>Additional variables</i>					
Crisis		-1.0200 (1.2056)			
Crisis * Δ government debt		0.0394 (0.0504)			
Interest rate on government bonds			-0.1195 (0.1520)		
Trade openness				0.0034 (0.0086)	
Christian democratic government					0.0091 (0.0104)
Constant	-48.8231** (24.1430)	-51.1636** (25.3326)	-41.1703* (21.3255)	-48.3286* (25.1774)	-51.4806** (23.3675)
Observations	226	226	226	226	224
Adjusted r-squared	0.3852	0.3828	0.3856	0.3824	0.3861

Period dummies included. Eicker-White standard errors in parentheses.

\*\*\* p&lt;0.01, \*\* p&lt;0.05, \* p&lt;0.1

Table A.3.4 Additional variables.

	Baseline (1)	(19)	(20)	(21)	(22)
<i>Tax system variables</i>					
PIT-CIT rate differential	-0.1464** (0.0675)	-0.1462** (0.0673)	-0.1549** (0.0776)	-0.1483** (0.0701)	-0.1297* (0.0684)
Δ CIT rate	0.3410*** (0.0956)	0.3401*** (0.0963)	0.3483*** (0.1053)	0.3419*** (0.0958)	0.3394*** (0.0965)
Relevance of top PIT bracket	78.9686 (77.9249)	92.4955 (89.0974)	88.4570 (84.7463)	77.1611 (82.6051)	93.1476 (78.4265)
PIT rate start value	-1.5097*** (0.5563)	-1.4948*** (0.5608)	-1.7181** (0.6988)	-1.5087*** (0.5573)	-1.4759*** (0.5612)
<i>Socio-economic variables</i>					
Budget balance	-0.1255 (0.0952)	-0.1209 (0.0936)	-0.1521 (0.1031)	-0.1226 (0.0987)	-0.1379 (0.1000)
Demographic burden	0.1314 (0.0902)	0.1246 (0.0933)	0.1057 (0.0983)		
Ln population	-0.0814 (0.5255)	-0.1554 (0.5164)	-0.0572 (0.6067)	-0.0590 (0.5250)	0.0091 (0.5234)
GDP growth	-0.1872 (0.1574)	-0.1862 (0.1579)	-0.1724 (0.1717)	-0.1870 (0.1578)	-0.1491 (0.1988)
Ln GDP per capita	4.1859* (2.2464)	4.6590* (2.3635)	4.0270 (2.4517)	4.1556* (2.2840)	3.2075 (2.0485)
<i>Political and institutional variables</i>					
Corporatism	0.1723 (0.1576)	0.1423 (0.1577)	0.2890 (0.1891)	0.1860 (0.1867)	0.1584 (0.1910)
Redistribution	0.2784** (0.1348)	0.3144** (0.1316)	0.2995* (0.1530)	0.2840* (0.1461)	0.2569* (0.1436)
Left government	-0.0019 (0.0071)	-0.0021 (0.0071)	-0.0066 (0.0084)	-0.0019 (0.0071)	-0.0018 (0.0072)
Consensus democracy	-0.0656 (0.3156)	-0.1217 (0.3341)	-0.0736 (0.3631)	-0.0677 (0.3146)	-0.0030 (0.3174)
Cabinet duration	-0.1856 (0.5938)	-0.2132 (0.5979)	-0.5684 (0.7300)	-0.1979 (0.6092)	-0.1481 (0.6071)
<i>Additional variables</i>					
Pro-poor public expenditure		-4.6786 (8.2550)			
Ethnic fractionalisation			1.3790 (1.6696)		
Elderly				0.1073 (0.1856)	0.1433 (0.1940)
Unemployment				0.1383 (0.0977)	
Δ unemployment					0.1947 (0.3458)
Constant	-48.8231** (24.1430)	-52.5732** (24.8690)	-44.1869 (27.5245)	-47.9553* (25.6781)	-38.3101* (23.1111)
Observations	226	226	186	226	226
Adjusted r-squared	0.3852	0.3836	0.4006	0.3822	0.3759

Period dummies included. Eicker-White standard errors in parentheses.

\*\*\* p<0.01, \*\* p<0.05, \* p<0.1

Table A.3.5 Alternative model specifications.

	Baseline (1)	(23)	(24)	(25)	(26)	(27)
<i>Tax system variables</i>						
PIT-CIT rate differential	-0.1464** (0.0675)	-0.0875* (0.0496)	-0.0997** (0.0488)	-0.4868* (0.2532)	-0.1464* (0.0731)	-0.2060*** (0.0791)
Δ CIT rate	0.3410*** (0.0956)	0.3296*** (0.1007)	0.4950*** (0.1294)	0.4803*** (0.1656)	0.3410*** (0.1047)	0.3604*** (0.0994)
Δ CIT rate * PIT-CIT rate differential			-0.0143 (0.0092)			
Relevance of top PIT bracket	78.9686 (77.9249)	127.5540** (56.7910)	124.9626** (57.5380)	35.0757 (69.4140)	78.9686 (51.4180)	154.4987 (108.7424)
PIT rate start value	-1.5097*** (0.5563)	-0.5527 (0.4144)	-0.5881 (0.4202)	-0.0108 (0.1889)	-1.5097*** (0.5145)	-1.9238*** (0.6939)
<i>Socio-economic variables</i>						
Budget balance	-0.1255 (0.0952)			-0.2321* (0.1232)	-0.1255 (0.0817)	0.0057 (0.1184)
Demographic burden	0.1314 (0.0902)			0.2354** (0.1079)	0.1314* (0.0672)	0.2135 (0.1433)
Ln population	-0.0814 (0.5255)			-1.1072 (0.8450)	-0.0814 (0.4113)	4.0168 (10.8544)
GDP growth	-0.1872 (0.1574)			-0.1430 (0.1548)	-0.1872 (0.1626)	-0.3590** (0.1670)
Ln GDP per capita	4.1859* (2.2464)			8.0542** (3.1516)	4.1859*** (1.4166)	10.6124** (5.1129)
<i>Political and institutional variables</i>						
Corporatism	0.1723 (0.1576)			0.0988 (0.1645)	0.1723 (0.1643)	-0.2795 (0.3523)
Redistribution	0.2784** (0.1348)			0.5217*** (0.1772)	0.2784** (0.1027)	0.1722 (0.3841)
Left government	-0.0019 (0.0071)			-0.0058 (0.0076)	-0.0019 (0.0071)	0.0026 (0.0074)
Consensus democracy	-0.0656 (0.3156)			-0.3589 (0.4145)	-0.0656 (0.2740)	-0.7336 (0.6417)
Cabinet duration	-0.1856 (0.5938)	-0.6529 (0.6338)	-0.7383 (0.6301)	0.3355 (0.6610)	-0.1856 (0.5661)	-0.0785 (0.7085)
Constant	-48.8231** (24.1430)	-1.7942 (4.6904)	6.3238 (4.2142)	-82.0980** (35.3941)	-48.8231*** (16.2739)	-160.3007* (94.8895)
Country dummies	No	No	No	No	No	Yes
Observations	226	226	226	219	226	226
Adjusted r-squared	0.3852	0.3425	0.3506	0.2660	0.3852	0.4088

Period dummies included. Models 23, 24, 25 and 27: Eicker-White standard errors in parentheses. Model 26: country-clustered standard errors in parentheses.

\*\*\* p<0.01, \*\* p<0.05, \* p<0.1

Table A.3.6 Alternative model specifications.

	Baseline (1)	(28)	(29)	(30)	(31)
<i>Tax system variables</i>					
PIT-CIT rate differential	-0.1464** (0.0675)	-0.1756** (0.0819)	-0.1472** (0.0689)	-0.0558* (0.0289)	-0.0610** (0.0282)
Δ CIT rate	0.3410*** (0.0956)	0.3202*** (0.1024)	0.3367*** (0.0946)	0.3012*** (0.0767)	0.4442*** (0.0875)
Δ CIT rate * PIT-CIT rate differential					-0.0124* (0.0064)
Relevance of top PIT bracket	78.9686 (77.9249)	67.6873 (78.6943)	81.4062 (78.8965)	-0.1935 (20.7377)	-0.7158 (20.5915)
PIT rate start value	-1.5097*** (0.5563)	-1.6336*** (0.6016)	-1.5036*** (0.5593)	-0.7417*** (0.1940)	-0.7469*** (0.1940)
<i>Socio-economic variables</i>					
Budget balance	-0.1255 (0.0952)	-0.1831* (0.1043)	-0.1514 (0.0998)	-0.0595 (0.0403)	-0.0627 (0.0401)
Demographic burden	0.1314 (0.0902)	-0.0437 (0.1179)	0.1342 (0.0897)	0.0666* (0.0400)	0.0717* (0.0396)
Ln population	-0.0814 (0.5255)	0.1692 (0.5698)	-0.1523 (0.5468)	-0.1613 (0.1847)	-0.1773 (0.1820)
GDP growth	-0.1872 (0.1574)	-0.0376 (0.1434)	-0.2782 (0.1975)	-0.0775 (0.0631)	-0.0819 (0.0623)
Ln GDP per capita	4.1859* (2.2464)	5.0341** (1.9849)	4.4792** (2.2473)	1.7969* (1.0178)	1.8941* (1.0140)
<i>Political and institutional variables</i>					
Corporatism	0.1723 (0.1576)	0.2278 (0.1514)	0.1503 (0.1641)	0.0857 (0.0612)	0.0817 (0.0613)
Redistribution	0.2784** (0.1348)	0.4615*** (0.1755)	0.2831** (0.1384)	0.1277** (0.0499)	0.1242** (0.0494)
Left government	-0.0019 (0.0071)	-0.0106 (0.0069)	-0.0015 (0.0071)	-0.0018 (0.0028)	-0.0009 (0.0027)
Consensus democracy	-0.0656 (0.3156)	0.1068 (0.3310)	-0.0728 (0.3139)	-0.0700 (0.1271)	-0.0657 (0.1247)
Cabinet duration	-0.1856 (0.5938)	-0.4321 (0.6083)	-0.0773 (0.6157)		
Constant	-48.8231** (24.1430)	-61.9272*** (22.3289)	-52.2111** (23.9548)	-21.0693** (10.4230)	-21.8159** (10.4430)
Observations	226	196	226	671	671
Adjusted r-squared	0.3852	0.3523	0.3938	0.2292	0.2372

Period dummies included. Eicker-White standard errors in parentheses.

\*\*\* p<0.01, \*\* p<0.05, \* p<0.1

### ABSTRACT

Tax mixes are important components of welfare systems, affecting income inequality, labour market outcomes and economic performance. Still, they are relatively under-examined in the literature studying the convergence of EU welfare states. Most existing analyses of tax mix convergence are limited to Western Europe, mainly use twentieth-century data and do not control for domestic determinants of tax policy. I therefore study the determinants of tax mix composition and convergence in a panel of 30 EU and OECD countries between 1980 and 2019 using linear regressions. I find that tax mixes converge, and I observe a shift from personal income taxes towards more regressive revenue sources. Contrary to theoretical predictions, both observations are almost unrelated to proxies of tax competition. Instead, the main driving factor is EU membership. Tax mixes of Central and Eastern European member states, however, do not Europeanise: they constitute a distinct group with low and persistently regressive taxation.

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■ This chapter has been published in *Journal of European Integration* 47(1), 1-21, <https://doi.org/10.1080/07036337.2024.2374575>.

#### 4.1 INTRODUCTION

The founding fathers of the EU set themselves the objectives of economic and social progress,<sup>1</sup> envisioning that European economic integration would foster both the development and the cross-country homogeneity of domestic social welfare systems. A large body of literature has studied this hypothesis of upward social policy convergence by looking at various indicators of welfare spending (e.g., Caminada et al., 2010; Censolo & Colombo, 2016). However, the convergence and determinants of the composition of government revenues have been relatively under-examined. This is remarkable, because tax mixes are important components of welfare states. One reason is that the progressivity of a tax-welfare system partially hinges upon the relative revenue shares of different taxes: personal income taxes tend to moderate the burden on low incomes, whereas social security contributions and indirect consumption taxes have less redistributive capacity. On the other hand, the latter two ‘regressive’ taxes have proven to be powerful revenue generators that can finance generous social expenditure systems (Ganghof, 2006a). Tax mixes, furthermore, have been shown to affect labour market outcomes, such as employment and unemployment (Kemmerling, 2005), and they may influence long-term economic output (Akgun et al., 2017). Thus, tax mix composition is a relevant variable in analyses of European economic and welfare state convergence.

Existing convergence analyses have identified a shift in European tax mixes towards regressive revenue sources that fall mainly on labour, such as social premiums and VAT (e.g., Delgado & Presno, 2017). However, most of these analyses focus on the late twentieth century and are based on western European nations only, while currently more than a third of EU Member States are Central and Eastern European (CEE) countries. Furthermore, most studies employ crude measures of panel-wide convergence, which yield inconsistent results when countries actually converge into dispersed ‘clubs’ (Plümper & Schneider, 2009). Delgado and Presno (2017) indeed detect such club convergence in 15 EU countries’ tax mixes, but it falls outside the scope of their analysis to determine the conditional factors behind it. For instance, a plausible conditional factor is economic openness, as the tax mixes of open economies might converge into a particular direction under competitive pressure.

Those determinants of tax mix composition are also relevant objects of study themselves. The literature has separately identified many domestic determinants, such as partisan and interest group politics, and electoral and labour market institutions (Kemmerling & Truchlewski, 2021), which may co-exist beside international factors such as competitive pressure (e.g., Ganghof, 2006b) and European harmonisation (e.g., Kemmerling, 2010; Genschel et al., 2011). Given the economic and redistributive effects of the

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1 eg Consolidated version of the Treaty on European Union, article 3(3).



tax mix, a relevant question in the light of common European social progress is whether domestic politics and institutions are still able to shape tax mix composition, or whether they are overshadowed by tax competition.

Therefore, this article studies both the convergence and the determinants of OECD countries' tax mixes using linear regressions. Applying an error correction model, I measure the effects of several domestic and international factors that may condition both the current composition of countries' tax mixes and their speed of adjustment. I focus on four categories of taxes: personal income taxation (PIT), corporate income taxation (CIT), social security contributions (SSCs) and general consumption taxation. The studied country panel covers 30 EU and OECD countries.<sup>2</sup> Among them are 23 EU member states, 8 of which are Central and Eastern European (CEE) countries. The additional inclusion of 7 non-EU OECD countries controls for the difference between global and European integration. Data for the full panel are available from 1996 to 2019, and an analysis excluding the CEE countries covers available data from 1980 to 2019.

This study's contribution to the literature is threefold. First, this study extends the research on European tax mix convergence by including a larger number of countries and data years, testing whether convergence has continued during the twenty-first century and whether the tax systems of the newer CEE member states partake in any convergence process. These are relevant questions in the light of common European social progress. Second, this study's regression approach improves the consistency of existing convergence analyses by controlling for political, institutional and economic factors that may shape both tax mix composition and the convergence process. Third, its focus on the determinants of tax mixes connects this article with the broader literature on the political economy of taxation. Quantifying the relative importance of these determinants helps to answer the question whether countries are still able to shape their own tax systems in an increasingly globalised economy.

I proceed as follows. First, I present some descriptive statistics denoting tax mix composition and cross-country variation in my country panel. I subsequently review the theoretical causes of those observations. Then, I develop empirical models that estimate the degree of convergence and measure the effects of the theoretical determinants of tax mixes. I summarise my findings and their implications in the final section.

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2 Australia, Austria, Belgium, Canada, Czechia, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Japan, Latvia, Lithuania, Luxembourg, the Netherlands, New Zealand, Norway, Poland, Portugal, Slovakia, Slovenia, Spain, Sweden, Switzerland, the United Kingdom and the United States. Other OECD nations were excluded for reasons of data availability.

## 4.2 DEVELOPMENTS IN TAX MIX COMPOSITION

Tables 4.1 and 4.2 document the developments in tax mix composition in the studied countries (OECD, 2023). While data from 1980 onwards are available for most ‘old’ EU Member States and non-EU countries, I additionally report their values in 1996 for comparison with CEE Member States.

The most substantial changes are visible between 1980 and 1996, with especially the EU-15 increasing their total tax revenues – from 33.8 to 38.0 per cent of GDP. A shift from PIT to consumption tax revenues is visible in both EU and non-EU countries, and non-EU countries additionally increased their SSCs. Changes after 1996 are relatively moderate, with the most substantial change being a further increase in consumption tax revenues in EU countries.

Changes in CEE tax mixes are also moderate, but their directions are noteworthy. In a slightly decreasing tax intake, the CEE-8 reduced their reliance on the PIT, which was already a small revenue generator, by 1.4 percentage points or 8 per cent. They further increased their large shares of regressive SSCs and consumption taxes.

Additionally, the tables show the respective coefficients of variation. Their decline in almost all variables and groups is a preliminary indicator of convergence, and for non-CEE countries it largely corresponds with earlier findings of Kemmerling (2010) and Delgado and Presno (2017). In most tax mix categories, coefficients of variation for the CEE-8 are smaller than those for the combined group of CEE-8 and EU-15 Member States. Moreover, the CEE-8 show stronger declines in variation in total taxation, SSC reliance and consumption tax reliance. This tentatively indicates the existence of a convergence club.

However, coefficients of variation are crude measures of convergence which disregard any conditionality (Plümper & Schneider, 2009). To enable a more consistent estimation of convergence, the remainder of this section aims to disentangle the driving factors behind the observed trends.

*Table 4.1 Total taxation and revenue shares of PIT and CIT.*

	Total taxation (% GDP)				PIT (% revenues)				CIT (% revenues)			
	1980	1996	2019	change '96-'19	1980	1996	2019	change '96-'19	1980	1996	2019	change '96-'19
<b>OECD7</b>												
Australia	26.2	28.9	27.7	-1.2	44.0	41.3	42.0	0.7	12.2	15.0	17.1	2.1
Canada	30.3	34.9	33.1	-1.8	34.1	37.4	36.1	-1.3	11.6	8.8	11.3	2.5
Japan	24.0	25.3	31.5	6.2	24.3	21.0	18.8	-2.2	21.8	17.1	12.0	-5.1
New Zealand	31.7	33.8	31.3	-2.5	61.6	44.4	39.7	-4.7	7.8	9.6	12.5	2.9
Norway	41.9	39.3	40.1	0.8	28.5	26.2	25.9	-0.3	13.3	10.7	15.0	4.3
Switzerland	22.6	25.4	27.3	1.9	38.9	33.3	30.7	-2.6	6.4	6.6	11.2	4.6
US	25.6	27.0	25.2	-1.8	39.1	37.8	40.7	2.9	10.8	9.3	5.4	-3.9
Mean OECD7	28.9	30.7	30.9	0.2	38.6	34.5	33.4	-1.1	12.0	11.0	12.1	1.1
CV OECD7	0.23	0.18	0.16	-0.02	0.31	0.24	0.26	0.02	0.42	0.34	0.30	-0.03

	Total taxation (% GDP)				PIT (% revenues)				CIT (% revenues)			
	1980	1996	2019	change '96-'19	1980	1996	2019	change '96-'19	1980	1996	2019	change '96-'19
<b>EU15</b>												
Austria	38.6	42.6	42.6	0.0	23.2	21.2	22.6	1.4	3.5	4.3	6.4	2.1
Belgium	40.7	43.4	42.4	-1.0	36.4	31.6	26.6	-5	4.7	6.0	8.7	2.7
Denmark	41.5	46.7	46.9	0.2	52.3	54.0	52.2	-1.8	3.3	5.3	6.7	1.4
Finland	35.3	45.7	42.3	-3.4	35.7	32.7	29.0	-3.7	3.4	6.0	6.0	0
France	39.5	43.6	44.9	1.3	11.6	11.6	20.7	9.1	5.1	5.2	4.9	-0.3
Germany	36.4	35.7	38.6	2.9	29.6	24.8	27.4	2.6	5.5	3.8	5.2	1.4
Greece	20.8	28.5	39.5	11.0	14.9	11.1	15.2	4.1	3.8	7.4	5.6	-1.8
Ireland	30.1	32.3	21.9	-10.4	32.0	31.9	31.6	-0.3	4.5	9.3	14.0	4.7
Italy	28.6	40.2	42.3	2.1	23.1	25.0	25.8	0.8	7.8	9.2	4.6	-4.6
Luxembourg	35.4	36.5	39.6	3.1	27.0	22.0	24.0	2	16.2	18.3	15.2	-3.1
Netherlands	39.7	37.3	39.3	2.0	26.3	17.9	21.6	3.7	6.6	10.1	9.4	-0.7
Portugal	21.9	29.9	34.5	4.6		18.5	18.4	-0.1		8.9	9.0	0.1
Spain	21.9	31.1	34.7	3.6	20.4	23.4	22.7	-0.7	5.1	5.8	5.9	0.1
Sweden	43.1	46.8	42.8	-4.0	41.0	33.8	28.7	-5.1	2.5	5.3	7.0	1.7
UK	33.4	29.1	32.2	3.1	29.4	27.3	27.6	0.3	8.4	9.3	7.1	-2.2
Mean EU15	33.8	38.0	39.0	1.0	28.8	25.8	26.3	0.5	5.7	7.6	7.7	0.1
CV EU15	0.22	0.18	0.16	-0.02	0.37	0.41	0.32	-0.09	0.60	0.47	0.41	-0.06
Mean OECD7 & EU15	32.2	35.6	36.4	0.8	32.1	28.6	28.5	0.0	7.8	8.7	9.1	0.4
CV OECD7 & EU15	0.23	0.20	0.19	-0.01	0.37	0.37	0.31	-0.06	0.63	0.45	0.42	-0.03
<b>CEE/EU8</b>												
	1996	2019	change		1996	2019	change		1996	2019	change	
Czechia	33.1	34.8	1.7		13.2	12.7	-0.5		9.3	10.1	0.8	
Estonia	33.8	33.5	-0.3		22.4	16.5	-5.9		4.6	5.5	0.9	
Hungary	39.4	36.4	-3.0		17.5	14.2	-3.3		4.5	3.4	-1.1	
Latvia	29.2	30.9	1.7		16.7	20.9	4.2		6.0	0.5	-5.5	
Lithuania	27.3	30.3	3.0		22.7	23.9	1.2		6.4	5.1	-1.3	
Poland	36.6	35.1	-1.5		21.3	15.1	-6.2		7.2	6.3	-0.9	
Slovakia	38.6	34.6	-4.0		10.1	10.9	0.8		10.9	8.9	-2.0	
Slovenia	38.1	37.0	-1.1		15.3	14.2	-1.1		2.3	5.3	3.0	
Mean CEE/EU8	34.5	34.1	-0.4		17.4	16.1	-1.4		6.4	5.6	-0.8	
CV CEE/EU8	0.13	0.07	-0.06		0.26	0.27	0.01		0.43	0.53	0.10	
Mean CEE/EU8 & EU15	36.7	37.3	0.5		22.9	22.7	-0.2		7.2	7.0	-0.2	
CV CEE/EU8 & EU15	0.17	0.15	-0.02		0.42	0.38	-0.04		0.46	0.46	-0.01	

Source: OECD (2023) and own calculations. PIT and CIT revenues are unavailable for Portugal before 1989.

Table 4.2 Revenue shares of SSCs and general consumption taxes (GCT).

	SSCs & payroll (% rev.)				GCT (% revenues)			
	1980	1996	2019	change '96-'19	1980	1996	2019	change '96-'19
<b>OECD7</b>								
Australia	5.0	6.8	4.7	-2.1	5.3	8.3	12.0	3.7
Canada	10.5	16.2	16.5	0.3	11.5	13.9	14.2	0.3
Japan	29.1	33.8	41.1	7.3	0.0	5.5	13.2	7.7
New Zealand	0.0	0.0	0.0	0	10.2	24.3	30.4	6.1
Norway	21.1	23.4	26.5	3.1	18.2	21.3	21.6	0.3
Switzerland	23.4	26.5	23.7	-2.8	10.3	11.3	11.5	0.2
US	21.9	24.4	24.3	-0.1	7.0	8.0	8.2	0.2
Mean OECD7	15.9	18.7	19.5	0.8	8.9	13.2	15.9	2.6
CV OECD7	0.68	0.63	0.71	0.08	0.64	0.54	0.48	-0.06
<b>EU15</b>								
Austria	38.0	41.1	41.3	0.2	20.1	18.9	18.0	-0.9
Belgium	28.8	32.5	31.1	-1.4	16.9	15.5	15.8	0.3
Denmark	0.4	0.6	0.7	0.1	22.7	19.7	20.0	0.3
Finland	23.5	28.9	27.9	-1	17.3	17.1	21.7	4.6
France	44.9	44.1	37.0	-7.1	21.1	18.0	17.7	-0.3
Germany	34.5	40.3	37.9	-2.4	16.6	17.7	18.2	0.5
Greece	34.7	31.8	30.8	-1	13.2	21.3	21.4	0.1
Ireland	14.5	13.6	17.8	4.2	14.8	21.1	19.6	-1.5
Italy	38.7	34.2	31.2	-3	15.6	13.0	14.7	1.7
Luxembourg	29.4	26.7	27.8	1.1	11.6	12.4	14.7	2.3
Netherlands	38.1	37.9	34.2	-3.7	15.8	16.6	18.2	1.6
Portugal	32.1	25.3	27.9	2.6	16.2	23.7	25.4	1.7
Spain	48.6	35.6	35.3	-0.3	10.2	16.4	18.8	2.4
Sweden	31.4	31.0	33.8	2.8	13.4	17.3	21.3	4
UK	21.0	17.6	20.1	2.5	14.7	19.5	21.3	1.8
Mean EU15	30.6	29.4	29.0	-0.4	16.0	17.9	19.1	1.2
CV EU15	0.40	0.39	0.35	-0.05	0.21	0.17	0.15	-0.02
Mean EU15 & OECD7	25.9	26.0	26.0	0.0	13.8	16.4	18.1	1.7
CV EU15 & OECD7	0.52	0.48	0.46	-0.02	0.39	0.31	0.27	-0.03
<b>CEE8/EU8</b>								
		<b>1996</b>	<b>2019</b>	<b>change</b>		<b>1996</b>	<b>2019</b>	<b>change</b>
Czechia		43.0	44.1	1.1		17.8	21.6	3.8
Estonia		34.0	35.0	1.0		27.4	26.7	-0.7
Hungary		34.6	34.9	0.3		20.7	31.9	11.2
Latvia		35.3	30.7	-4.6		26.9	29.3	2.4
Lithuania		28.2	31.9	3.7		27.4	26.2	-1.2
Poland		31.7	38.3	6.6		18.6	22.6	4.0

	SSCs & payroll (% rev.)				GCT (% revenues)			
	1980	1996	2019	change '96-'19	1980	1996	2019	change '96-'19
Slovakia		40.3	43.3	3.0		19.3	21.0	1.7
Slovenia		42.5	42.3	-0.2		29.9	21.6	-8.3
Mean CEE8		36.2	37.6	1.4		23.5	25.1	1.6
CV CEE8		0.15	0.14	-0.01		0.21	0.16	-0.04
Mean CEE/EU8 & EU15		31.8	32.0	0.2		19.8	21.2	1.4
CV CEE/EU8 & EU15		0.32	0.30	-0.02		0.23	0.21	-0.02

Source: OECD (2023) and own calculations.

#### 4.3 TAX COMPETITION

One of the most discussed determinants of tax policy is international tax competition. Its only direct effect in the tax mix should be on CIT revenues: any cross-border mobility of consumers in response to VAT rate differentials does not appear to affect governments' consumption tax rate setting (Genschel & Schwarz, 2011); and competition for highly qualified workers mainly occurs through special income tax regimes for expatriates, rather than through general PIT policy, such that overall effects on PIT revenues should be limited (see Kleven et al., 2020). Capital's cross-border mobility and its sensitivity to tax treatment, however, does induce strategic CIT policy-setting by national governments in attempts to attract investments and paper profits (Genschel & Schwarz, 2011). This strategic competition has most visibly manifested itself in the lowering of statutory rates (Zohnhöfer et al., 2017). The average CIT rate in the OECD currently stands at approximately 23% (OECD, 2023; own calculations), which means that its downward trend will not be halted by the recent Pillar 2 harmonisation efforts that establish a 15% minimum rate.

Still, CIT revenues have been rather stable over the years, possibly because tax bases have been broadened. Even if revenues would in fact be jeopardised by tax competition, the direct impact on the tax mix would be minor, because the CIT raises less than 10 per cent of revenues in most OECD countries (see Table 4.1). Its limited role as a revenue generator is also illustrated by Slemrod (2004), who finds that its statutory rates are unrelated to government revenue needs.

However, a race to the bottom in CIT rates may also affect the tax mix indirectly. A large discrepancy between top PIT and CIT rates encourages entrepreneurs to incorporate their businesses and for workers to receive their income in dividends (Gordon & MacKie-Mason, 1995; Slemrod, 2004; Ganghof, 2006b). This allows them to postpone individual income taxation

by retaining income inside corporations and financing personal consumption through loans. Once the owners distribute their income through dividends or capital gains, the applicable shareholder taxes are usually more lenient than labour taxes (Harding and Marten, 2018). De Mooij and Nicodème (2008) estimate that such avoidance strategies account for 12 to 21% of CIT revenues in a panel of 17 EU countries. This magnitude implies a substantial loss of PIT revenues. Additionally, case-study and quantitative evidence shows that governments resultingly cut their PIT rates to preserve the integrity of their tax systems (Ganghof, 2006b; Van Ganzen, 2023). Indeed, there is a correlation between CIT and PIT rates (Slemrod, 2004; Loretz, 2008). Base broadening can only partially compensate the resulting revenue losses, because at some point no further exemptions and deductions can be abolished. Furthermore, a falling top PIT rate always constrains the revenue-raising capacity of the tax by determining the maximum rate of lower tax brackets. Eventually, the spill-over of CIT competition to PIT rates could induce a shift towards SSCs and payroll taxes in the tax mix. These are less prone to arbitrage, because they are closely linked to one's place of employment. Alternatively, countries may increase consumption taxes, evidence of which is found by Loretz (2008).

#### 4.4 REVENUE REQUIREMENTS

Such shifts in the tax mix are more likely to occur when the government's revenue requirement is high. Logically, when the revenues of one tax decline, be it the result of domestic factors or of external competitive pressure, a high and rigid level of government spending necessitates a simultaneous increase in another tax, leaving aside the possibility of running a deficit. Lierse and Seelkopf (2016) provide a concrete example of this, linking the simultaneous decline in CIT rates and increase in VAT rates after the global financial crisis to fiscal pressure.

There is also a more general positive correlation between government size and regressivity of the tax mix, which Ganghof (2006a) relates to the abovementioned competitive pressure on direct taxes that wholly or partially fall on capital – CITs and PITs. He also notes that any high tax has high efficiency costs, such that high-tax countries are better off with diversified tax mixes, necessarily including regressive taxes. Although the framing of VAT as an economically efficient tax varies from country to country, the general view is that indirect taxes are able to raise substantial amounts of revenues without excessively hurting economic growth or employment (Kemmerling, 2017).

If government size is indeed a determinant of tax mix composition, it may also be a driver of tax mix convergence, as average government spending in EU and OECD countries has both increased and converged since the 1980s (Bertarelli et al., 2014).

#### 4.5 EU MEMBERSHIP

Discussing VAT reliance brings us to the importance of the EU in shaping countries' tax mixes. The VAT Directive is the embodiment of the most substantial harmonisation of taxes in the Union, establishing an obligatory common tax base and minimum rate. Hence, EU membership should be a strong driver of upward convergence in general consumption tax revenues. Kemmerling (2010) even argues that the trends in VAT rates and revenues 'overshoot harmonisation efforts'. Noting that the nine EEC countries adopting VAT around 1972 increased their consumption tax rates by much more than the Directive required them to, both at its introduction and long thereafter, he infers that the EU may have been a good legitimacy device for governments to increase VAT reliance.

EU influence in other components of the tax mix occurs more obliquely, for instance through the jurisprudence of the Court of Justice. Kemmerling (2010) and Maier and Schanz (2016) note that the Court effectively abolished the CIT imputation system, under which domestically resident shareholders were granted a PIT relief for the CIT paid at the corporate level. Member states reacted by scrapping the relief and lowering statutory CIT rates, which contributed to the race to the bottom. While statutory rates do not necessarily affect tax mix composition, recall that discrepancies between CIT and PIT rates may induce tax arbitrage, adversely affecting PIT revenues.

A second channel of influence is soft law, including the EU's Code of Conduct for business taxation. The Code of Conduct may have reduced harmful competition through preferential tax regimes, creating a common perception amongst policymakers about the acceptability of CIT provisions (Radaelli, 2003). On the other hand, curbing preferential regimes shifted competitive policymaking to the area of statutory rate-setting, accelerating the race to the bottom; Genschel et al. (2011) find that statutory CIT rate competition is stronger within the single market than elsewhere.

Thirdly, European integration may affect countries' expenditure levels and revenue requirements, as it fosters the funding of domestic social protection systems by stimulating economic growth (Goudswaard & Van Riel, 2004). Government spending and revenues in western Europe have indeed converged upwards (Bertarelli et al., 2014). Hypothetically, therefore, revenues from SSCs and/or VAT may converge upwards as well, insofar it is true that large governments require balanced and partially regressive tax mixes. In CEE member states, however, economic integration appears to be negatively related to welfare state generosity (Leibrecht et al., 2011). This is probably the result of these countries' desire to attract mobile production factors to their post-communist economies (Appel & Orenstein, 2016). Resultingly, total social expenditure – and hence the necessity of a balanced tax mix – is much lower and does not seem to converge towards Western European levels (Draxler & Van Vliet, 2010).

Finally, competitive pressure should be more pronounced in the deeply integrated single market. Mobility of tax bases is not only enabled by the



four freedoms, but it is also fostered by the absence of exchange rate risks and the harmonisation of CIT provisions in the Parent-Subsidiary and Merger Directives. While tax competition is already strong in western Europe, the CEE countries again constitute a distinct group. Most of these countries have implemented CIT rates below EU average, as a signal of a business-friendly investment climate (Appel & Orenstein, 2016). Simultaneously, some have implemented low and flat rate schedules on labour income, which in most cases limited the revenue-raising capacity of their PIT systems (Evans & Aligica, 2008). Thus, although their low tax levels might not necessitate a shift towards SSCs and VAT for efficiency purposes, it is likely that tax mixes in CEE countries have converged towards these revenue streams because of those countries' meagre direct income taxes.

#### 4.6 POLITICAL AND INSTITUTIONAL FACTORS

The eventual effect of economic integration and EU membership on tax mix composition is likely to be mediated by domestic political, institutional and economic factors. Many areas of tax policy, in the end, are still in the hands of national governments.

As shown in a recent review of those domestic factors by Kemmerling and Truchlewski (2021), an important determinant of tax policy is partisan politics. Some studies have found a positive influence of left-wing cabinet ideology on government size (Potrafke, 2017), although a considerable number have found no significant effect (Zohlnhöfer et al., 2017). Sakamoto (2008) finds that left-wing governments set higher PIT and general consumption taxes and lower SSCs than right-wing governments. Osterloh and Debus (2012) find a positive effect of left-wing government on statutory and effective CIT rates, which however diminishes with increasing tax competition.

Proportional representation may contribute to these forces because it fosters the inclusion of pro-welfare interests, whereas majoritarian systems are often dominated by right-wing parties that favour a less generous welfare state (Döring & Manow, 2017) or big-tent parties that do not specifically target pro-welfare voters (Cusack and Beramendi, 2006). Simultaneously, however, the fragmented political landscape in some proportional electoral systems may produce broad coalition governments including right-wing parties, which demand lower capital taxes. This may lead to a higher labour-capital tax ratio in consensus democracies than in majoritarian systems (Hays, 2003).

Relatedly, fragmented political landscapes contribute to the number of veto points in policymaking, and so do constitutional courts, strong upper houses and decentralised legislatures (e.g., Ganghof, 2006b). Veto players may, on the one hand, block tax reforms. On the other hand, electorates may find it harder to organise resistance against tax reforms in an institutionally fragmented system (Swank, 2002).

Several studies have stressed that national tax policy also depends on institutional factors related to countries' labour markets and economic growth models. For instance, dualised labour markets with a high number of structurally unemployed 'outsiders' should foster the demand for SSCs, as contribution-financed welfare schemes allow the median voter – being an employed 'insider' – to ring-fence benefits for himself (O'Reilly, 2014). Additionally, high structural unemployment seems to generate consensus between politicians about the employment-friendliness of VAT (Kemmerling, 2017). Furthermore, corporatist traditions of centrally coordinated wage bargaining are positively related to VAT reliance, especially under social-democratic government. According to Beramendi and Rueda (2007), this is the result of the corporatist deal between labour and capital, which includes a generous welfare state in return for low capital taxes, necessitating relatively high labour and consumption taxes. But besides resolving conflicts of interest, labour and capital may also defend their common interests: Haffert and Mertens (2021) show that sectoral coalitions of labour and capital may favour or oppose VAT, depending on their sector being based on export or domestic consumption, respectively. Resultingly, VAT rates should be higher in export-based economies.

Finally, it is important to account for a country's economic situation. As mentioned, high structural unemployment puts VAT in an employment-friendly light (Kemmerling, 2017). An ageing population puts long-term pressure on the government's budget and may increase the need for high tax and spending levels. It is also plausible that an increasing share of pensioners limits the revenue-raising capacity of taxes that fall on labour. In the shorter run, severe banking crises seem to foster societal fairness norms, inducing increases in PIT rates (Limberg, 2019). In more prosperous times, economic growth may facilitate the funding of a larger government (Goudswaard & Van Riel, 2004), although temporal budget surpluses appear to be used predominantly to cut taxes (Haffert & Mehrtens, 2015). Furthermore, a country's size may determine its strategy in tax competition: small economies benefit more from lowering their rates, as they have little domestic revenues to lose and much foreign tax base inflows to gain (Kanbur & Keen, 1993).

## 4.7 METHOD AND DATA

### 4.7.1 Dependent variables

The dependent variables in this study are the revenue shares in the tax mix of four respective tax categories: PIT, CIT, the sum of SSCs and payroll taxes, and general consumption taxes (VAT/GST). SSCs and payroll taxes are aggregated because both are closely linked to employed labour and both are theoretical substitutes for the PIT. Consumption taxes on specific goods and services are not included, because they comprise a large number

of taxes with very diverse political economies, including alcohol taxes, energy taxes, other excises, customs duties, export duties, taxes on fiscal monopolies, gambling taxes and banking taxes. Their aggregate revenue share in this study's data panel in 2019 is approximately 9%, but there is no single political economy behind this figure that can be captured in one model. On an individual level, instead, these taxes are relatively unimportant in the tax mix, which limits their added value to the present study. The same applies to the small and internally diverse category of property taxes. Tax revenue data are retrieved from the OECD's Revenue Statistics (2023), which categorise countries' taxes using standardised criteria and therefore provide internationally comparable figures.

While earlier studies have analysed the convergence of tax-to-GDP ratios (Kemmerling, 2010; Delgado & Presno, 2017), this study expresses tax revenues as a percentage of total taxation. This measure better captures the relative importance of the studied categories in the tax mix. It also allows for an easier comparison between high-tax and low-tax countries, and it is less affected by economic shocks. To also capture the magnitude of the tax burden, I include the total tax-to-GDP ratio as an additional dependent variable (OECD, 2023).

#### 4.7.2 Explanatory variables

The selection of explanatory variables is aimed to reflect the main determinants of tax mix composition as identified in the preceding literature review: tax competition; EU membership; revenue requirements; and domestic politics, institutions and economics.<sup>3</sup>

As a proxy for tax competition, I use trade openness, measured by the sum of imports and exports as a percentage of GDP (Armingeon et al., 2022). Alternative proxies will be tested as robustness checks. To assess EU influence, I include a time-variant dummy variable for EU membership. A dummy coded 1 for CEE countries controls for the potentially distinct political economies of post-communist nations. I control for revenue requirements by including the tax-to-GDP ratio.

To control for domestic politics, the estimations include the percentage of cabinet posts held by left-wing parties (Armingeon et al., 2022). Also included is an index of political constraints, measuring veto power over policy change by independent branches of government (Henisz, 2002). The electoral system is captured in a dummy variable coded 1 for proportional representation (Armingeon et al., 2022; own calculations).

To express the institutional structure of the labour market, I include a

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3 To prevent overspecification of the models, the selection of political, institutional and economic variables is restricted to relatively common variables in political economic analysis. A small number of potential determinants, such as the occurrence of a banking crisis and the value added in domestically oriented production sectors, are tested as robustness checks only.

five-point scale indicating the degree of coordination in wage bargaining, where 5 denotes economy-wide bargaining and 1 means no coordination (OECD & AIAS, 2021). Additionally, the annual unemployment rate is included (Armington et al., 2022).

I control for the government's budget surplus to capture the effect of budgetary room on tax reforms (Armington et al., 2022).<sup>4</sup> To account for the effects of an ageing population, I include the share of elderly people (Armington et al., 2022). GDP growth and the natural log of GDP per capita are added because an increase in economic output may facilitate the funding of a larger government, which may also affect tax mix composition (Feenstra et al., 2015). Finally, I control for the size of the economy by including the natural log of GDP (Feenstra et al., 2015).

#### 4.7.3 Models

In order to capture the development of tax mixes since the onset of globalisation, I first estimate a set of regression models using data between 1980 and 2019.<sup>5</sup> These regressions exclude the CEE countries and Luxembourg, Portugal and Switzerland for reasons of data availability. Next, I run regressions using the full country panel with data years 1996–2019. I use the following empirical model:

$$\Delta y_{it} = \alpha + \beta y_{it-1} + \sum \gamma_j \Delta X_{it} + \sum \delta_j X_{it-1} + \omega_i + \varepsilon_{it} \quad (1)$$

This model regresses a dependent variable's first difference ( $\Delta y_{it}$ ) on its lagged level ( $y_{it-1}$ ). A negative  $\beta$  coefficient would indicate convergence, as it would show that cases in the low end of the distribution have relatively high growth rates, and vice versa. A vector of the abovementioned control variables is included, both using their first differences ( $\Delta X_{it}$ ) and their lagged levels ( $X_{it-1}$ ), so that the model captures both their long-term and short-term effects (De Boef & Keele, 2008). I enter some variables as lagged levels only, namely those that are relatively time-invariant and those that denote economic circumstances. The latter would otherwise yield multicollinearity, for instance GDP growth and the first difference of GDP.

In this form, the regression constitutes an error correction model, which is widely used in convergence analysis.<sup>6</sup> To control for panel-heteroscedas-

4 The 1980–1983 government budget data for New Zealand are retrieved from RBNZ (1983); the 1984 value comes from Evans et al. (1996, p. 1896).

5 Whereas tax revenue data are available until 2021, data availability for several control variables restricts the period of analysis to 2019. An incidental advantage is that the one-off shock to tax mixes during the COVID pandemic is excluded.

6 Im-Pesaran-Shin unit-root tests, allowing for time series-specific trends and lag structures, indicate stationarity in all time series, except for the variable denoting the share of elderly people in the 1996–2019 panel. Kao tests indicate cointegration in all models. Hence, the use of error correction models should be appropriate (Keele et al., 2016). Incidentally, the results also hold when excluding the elderly variable.

ticity and contemporaneous spatial correlation, panel-corrected standard errors are used. An AR(1) disturbance term accounts for autocorrelation (Beck & Katz, 2011). Year dummies are included to control for time trends ( $\omega_t$  in equation 1).

Although the model includes control variables for the various factors that may determine tax mix composition, the estimation in the form of equation 1 will not show whether these factors affect the speed of convergence. However, determining the conditionality of convergence speed is necessary for identifying 'convergence clubs'. The discussed literature suggests that four clubs plausibly exist, namely: tax mixes of open economies converging under competitive pressure; convergence towards regressive revenue sources being present primarily among high-tax nations; the Europeanisation of tax mixes; and CEE countries converging into a specific direction because of their distinct political economies. The existence of such clubs may lead to inconsistent estimations of panel-wide convergence (Plümper and Schneider, 2009). For example, the  $\beta$  coefficient in equation 1 may turn negative and significant because a club's outlier values move toward the panel mean, even if tax mixes outside the club remain divergent. In that case, the estimation falsely indicates panel-wide convergence. Alternatively, consider two clubs of nations with steeply declining internal variation, which however converge into opposite directions, such that panel-wide variation remains the same or increases. Here, an insignificant or positive  $\beta$  would correctly negate panel-wide convergence, but it would not paint the full picture. Hence, controlling for convergence clubs not only makes the estimations of convergence more consistent, but it also contributes to this study's aim of disentangling the effects of tax competition, Europeanisation, and domestic spending choices.

Following Plümper and Schneider (2009), the regressions are therefore re-run with interaction terms between the lagged dependent variable and several control variables. Including the interaction term, the model is formally expressed as follows.

$$\Delta y_{it} = \alpha + \beta y_{it-1} + \sum \gamma_j \Delta X_{it} + \sum \delta_j X_{it-1} + \theta y_{it-1} x_{it-1} + \omega_t + \varepsilon_{it} \quad (2)$$

In this model,  $\theta \neq 0$  would indicate that convergence speed wholly or partially depends on control variable  $x_i$ . If  $\theta < 0$ , convergence is accelerated under the influence of increasing  $x_i$ , whereas  $\theta > 0$  denotes that higher  $x_i$  values lead to slower convergence. Interactions are included with trade openness (as a proxy for tax competition), total taxation (as a proxy for revenue requirements), the EU dummy, and the CEE dummy. These terms are not estimated simultaneously but subsequently, in order to preserve the statistical power of the model.

## 4.8 RESULTS

### 4.8.1 Regression results, 1980-2019

Table 4.3 reports the regression results between 1980 and 2019. Especially CIT and consumption tax revenues show a strong and significant convergence, with rates of adjustment of approximately 7 per cent. Convergence in total taxation, PIT and SSCs is slower, with 2.2, 1.6 and 1.1 per cent, respectively.

Turning to the control variables, most of the significant coefficients are found in the model for total taxation. For instance, economic openness leads to lower taxation in both the short run and long run, but it does not explain tax mix composition. Its long-term effects on total taxation are substantial: an increase in the ratio of imports and exports over GDP by one standard deviation (36 percentage points) is associated with a 6.9 percentage point decrease in the tax-to-GDP ratio.<sup>7</sup> As expected, countries with ageing populations raise more taxes, and budget surpluses are used to cut taxes, but again no effects on tax mix composition are found. The short-term increase in total taxation when a left-wing government comes to power is the only effect of the government ideology variable in all models.

Cross-country differences in tax mixes are unexplained by most of the control variables. An unsurprising exception is the positive effect of the EU dummy variable on consumption tax reliance. Additionally, EU Members raise more PIT and less CIT revenues. High-tax nations also have lower shares of CIT revenues, as predicted, but there is no evidence of higher SSCs and consumption taxes as a result. There is weak evidence that corporatist nations raise less PIT and consumption taxes and more CIT, which is contrary to theoretical predictions. It appears that stronger political constraints inhibit the reduction of taxes and the shift towards regressive revenue sources, but a drawback of the present regression approach is that a single veto player index does not reveal the underlying political processes.

As explained, the effects of certain control variables on the speed of convergence are given by their respective interaction terms. Their coefficients are presented below the main regression results in Table 4.3. Every interaction term is estimated separately by adding it to the main model. Because the results for the control variables closely resemble those of the main model, they are left out for the sake of simplicity. The main driver of convergence appears to be EU membership. As expected, its significant interaction term with consumption tax reliance shows a substantial rate of adjustment, namely 7 per cent. This EU convergence club exists beside a panel-wide convergence of 5 per cent. CIT revenues in the EU converge as well, and there is weak evidence (close to the 10 per cent significance level) of convergence in tax-to-GDP ratios. PIT revenues, instead, slightly diverge

7 The long-term effect is given by  $\delta_j / -\beta$  (Iversen & Cusack, 2000, p. 330). In this case,  $-0.0042 / -(-0.0220) \times 36 = -6.9$ .

in the EU. Despite the many theoretical channels through which economic integration may influence tax mixes, it seems that trade openness does not drive the convergence process. Neither does the magnitude of the tax burden. The most substantial and significant interaction term with the tax-to-GDP ratio (namely, consumption tax reliance) turns insignificant when simultaneously including the EU interaction (not reported).

*Table 4.3 Regression results, EU-15 and OECD-7 excluding Luxembourg, Portugal and Switzerland, 1980-2019.*

	Tax-to-GDP	PIT (% revenues)	CIT (% revenues)	SSCs & payroll (% revenues)	GCT (% revenues)
LDV	-0.0220*** (0.0085)	-0.0157*** (0.0058)	-0.0652*** (0.0213)	-0.0111** (0.0046)	-0.0687*** (0.0141)
EU (t-1)	0.0595 (0.1146)	0.2249* (0.1169)	-0.2543** (0.1120)	-0.0547 (0.1482)	0.2074* (0.1258)
Tax-to-GDP (t-1)		-0.0070 (0.0089)	-0.0199* (0.0106)	0.0124 (0.0108)	-0.0042 (0.0084)
Δ Trade	-0.0366*** (0.0123)	-0.0105 (0.0138)	0.0058 (0.0127)	-0.0047 (0.0106)	0.0058 (0.0108)
Trade (t-1)	-0.0042** (0.0018)	-0.0028 (0.0021)	-0.0010 (0.0023)	0.0018 (0.0022)	-0.0010 (0.0014)
Δ Left government	0.0043** (0.0017)	-0.0001 (0.0023)	0.0028 (0.0026)	-0.0017 (0.0018)	-0.0022 (0.0018)
Left government (t-1)	0.0014 (0.0010)	0.0016 (0.0013)	-0.0007 (0.0014)	-0.0005 (0.0011)	-0.0002 (0.0010)
Political constraints (t-1)	1.8114*** (0.4819)	1.4223** (0.6746)	0.6856 (0.5755)	-1.4356* (0.7827)	-1.5716*** (0.4534)
PR electoral system (t-1)	0.0042 (0.1030)	-0.0558 (0.1442)	-0.1367 (0.1340)	0.1502 (0.1144)	0.1650* (0.0979)
Wage coordination (t-1)	0.0100 (0.0373)	-0.0708+ (0.0436)	0.0847* (0.0488)	0.0267 (0.0387)	-0.0770* (0.0418)
Δ Unemployment	-0.0399 (0.0453)	0.0741 (0.0562)	-0.1773*** (0.0513)	0.0573 (0.0512)	-0.0607 (0.0523)
Unemployment (t-1)	0.0072 (0.0115)	-0.0035 (0.0163)	0.0179 (0.0135)	-0.0198 (0.0171)	-0.0134 (0.0171)
Elderly (t-1)	0.0501** (0.0201)	-0.0202 (0.0268)	0.0016 (0.0308)	0.0113 (0.0270)	0.0132 (0.0192)
Budget surplus (t-1)	-0.0382*** (0.0114)	-0.0031 (0.0137)	-0.0117 (0.0150)	0.0207+ (0.0127)	0.0195* (0.0114)
Ln GDP per capita (t-1)	0.2204 (0.2988)	0.4959 (0.4182)	0.3654 (0.4916)	-0.2893 (0.3102)	-0.2720 (0.2896)
Ln GDP (t-1)	-0.1033** (0.0498)	-0.0227 (0.0716)	-0.1357* (0.0704)	0.1257* (0.0737)	-0.1982*** (0.0581)
GDP growth (t-1)	0.0378+ (0.0240)	0.0193 (0.0288)	0.0294 (0.0288)	0.0230 (0.0213)	-0.0024 (0.0250)



	Tax-to-GDP	PIT (% revenues)	CIT (% revenues)	SSCs & payroll (% revenues)	GCT (% revenues)
Constant	-0.8935 (2.6176)	-3.8083 (3.9969)	-1.1224 (4.4344)	1.6442 (2.8177)	6.9728** (2.9436)
R <sup>2</sup>	0.2326	0.1274	0.2620	0.1633	0.1326
Observations	760	760	760	760	760
Countries	19	19	19	19	19
<i>Interactions</i>					
LDV * EU (t-1)	-0.0238+	0.0286**	-0.0624**	-0.0014	-0.0727***
LDV (t-1)	-0.0041	-0.0350***	-0.0575**	-0.0101	-0.0521***
LDV * trade (t-1)	0.0000	0.0002	-0.0005	-0.0100	-0.0002
LDV (t-1)	-0.0255*	-0.0317***	-0.0394+	-0.0000	-0.0594***
LDV * tax-to-GDP (t-1)		0.0014+	0.0001	-0.0008+	-0.0026*
LDV (t-1)		-0.0707**	-0.0699	-0.0435**	0.0122

Notes: Models include year dummies, panel-corrected standard errors and autoregressive disturbances.

\*\*\*Significant at the 0.01 level; \*\*Significant at the 0.05 level; \*Significant at the 0.10 level; +Significant at the 0.15 level.

#### 4.8.2 Regression results including CEE countries, 1996-2019

Table 4.4 displays the panel-wide regression results for the period 1996-2019, including the CEE-countries, and Luxembourg, Portugal and Switzerland. There is convergence in all categories, at roughly similar rates of adjustment.

To determine whether the results can be attributed to the inclusion of 11 additional countries or to the exclusion of 16 data years, the 1996-2019 estimations are re-conducted using only the 1980-2019 country panel. To explicitly control for the influence of the CEE-8, they are also re-estimated excluding only those nations. The results of these auxiliary estimations, provided the supplementary tables A.4.1 and A.4.2, largely replicate those presented in Table 4.4. This means that convergence in the EU-15 and OECD-7 remains existent after 1996 and is not mainly driven by the added countries.

In the 1996-2019 estimations, the determinants of total taxation are largely the same as those found in the 1980-2019 panel, but the control variables are slightly better able to explain variation in tax mixes. For instance, richer nations have less regressive tax mixes (also when the CEE-8 are excluded: see supplementary table A.4.2). The significant short-term effect of the unemployment variable is probably the result of economic shocks; long-term effects are absent.

Notably, the government ideology variable is significant in all models. In line with earlier findings, left-wing government ideology leads to higher tax-to-GDP ratios, more PIT and CIT, and less SSCs and consumption taxes,



though the effect on CIT and SSCs only exists in the short run. Most of these effects remain present when excluding the CEE-8 and/or Luxembourg, Portugal and Switzerland. Given the variable's insignificant coefficients in the 1980 models, it appears that the effect of government ideology on tax mix composition has increased through time. This contrasts with its diminishing effect on CIT rates as found by Osterloh and Debus (2012). Perhaps, left-wing governments have realised that competitive pressure on CIT rates and its spill-over effect on PIT progressivity are inescapable (see, e.g., Ganghof, 2006b), and have since then worked to reduce tax system regressivity through SSCs and consumption taxes. Indeed, left-wing governments are more opposed to VAT when income inequality is a salient political issue (Kemmerling, 2017).

Table 4.4 also displays the interaction terms. Notably, EU membership is not a significant driver of consumption tax convergence anymore when the CEE countries are included. In the auxiliary regression excluding the CEE-8, provided in supplementary table A.4.2, the EU interaction term becomes significant again for CIT and consumption tax reliance. Hence, Western European nations still converge. Looking at the interactions with the CEE dummy in Table 4.4, it seems that the CEE-8 constitute a convergence club in terms of consumption tax reliance, with a cohesion so strong that EU-wide convergence pales into insignificance. Additionally, the CEE-8 converge in tax-to-GDP ratios and SSC reliance at substantial rates of adjustment (6.8 and 4.3 per cent), though the latter effect is slightly above the 10 per cent significance level. Again, virtually no evidence is found for convergence clubs of open economies and high-tax nations.

*Table 4.4 Regression results, entire panel, 1996-2019.*

	Tax-to-GDP	PIT (% revenues)	CIT (% revenues)	SSCs & payroll (% revenues)	GCT (% revenues)
LDV	-0.0247*** (0.0074)	-0.0251*** (0.0072)	-0.0691*** (0.0229)	-0.0115** (0.0054)	-0.0628*** (0.0154)
EU (t-1)	0.1333 (0.1059)	-0.0954 (0.1296)	-0.3228*** (0.1212)	0.1029 (0.1165)	0.2146* (0.1215)
CEE	0.0847 (0.1663)	-0.3098 (0.2313)	-0.1630 (0.2313)	0.1920 (0.2041)	-0.1067 (0.1860)
Tax-to-GDP (t-1)		0.0015 (0.0098)	-0.0084 (0.0089)	-0.0004 (0.0100)	0.0071 (0.0083)
Δ Trade	-0.0282*** (0.0071)	0.0107 (0.0085)	-0.0108 (0.0087)	-0.0056 (0.0077)	0.0028 (0.0072)
Trade (t-1)	-0.0005 (0.0011)	-0.0018 (0.0015)	-0.0003 (0.0016)	0.0021* (0.0011)	-0.0010 (0.0013)
Δ Left government	0.0027+ (0.0017)	-0.0001 (0.0024)	0.0083*** (0.0027)	-0.0036* (0.0022)	-0.0045*** (0.0017)
Left government (t-1)	0.0029*** (0.0010)	0.0040** (0.0016)	0.0012 (0.0014)	-0.0014 (0.0014)	-0.0026** (0.0011)

	Tax-to-GDP	PIT (% revenues)	CIT (% revenues)	SSCs & payroll (% revenues)	GCT (% revenues)
Political constraints (t-1)	0.7485+ (0.5163)	1.2734* (0.7537)	0.3352 (0.5248)	-1.3001+ (0.8211)	-1.9165*** (0.5739)
PR electoral system (t-1)	0.0209 (0.0985)	-0.2038 (0.1911)	0.0762 (0.0923)	0.0579 (0.1890)	0.1542+ (0.1044)
Wage coordination (t-1)	-0.0244 (0.0376)	-0.0289 (0.0350)	-0.0007 (0.0473)	0.0773** (0.0381)	-0.0252 (0.0388)
Δ Unemployment	0.0195 (0.0398)	-0.0853 (0.0619)	-0.1928*** (0.0438)	0.2137*** (0.0571)	-0.1248*** (0.0440)
Unemployment (t-1)	0.0026 (0.0115)	-0.0168 (0.0168)	0.0078 (0.0124)	-0.0148 (0.0170)	-0.0148 (0.0140)
Elderly (t-1)	0.0672*** (0.0185)	-0.0356 (0.0249)	0.0042 (0.0167)	0.0059 (0.0225)	-0.0260+ (0.0177)
Budget surplus (t-1)	-0.0234* (0.0132)	-0.0115 (0.0159)	-0.0194 (0.0164)	0.0334** (0.0141)	0.0179 (0.0135)
Ln GDP per capita (t-1)	0.4261* (0.2257)	0.1738 (0.3383)	0.6293** (0.2723)	-0.5582** (0.2434)	-0.5954** (0.2565)
Ln GDP (t-1)	-0.0347 (0.0432)	-0.0443 (0.0628)	-0.0790* (0.0420)	0.1239** (0.0551)	-0.1221** (0.0528)
GDP growth (t-1)	0.0122 (0.0210)	-0.0053 (0.0283)	0.0438* (0.0228)	0.0301 (0.0227)	-0.0452** (0.0195)
Constant	-4.5203** (2.2281)	-0.4929 (3.2364)	-4.8693* (2.7878)	4.6752* (2.6698)	10.2510*** (3.0150)
R <sup>2</sup>	0.1911	0.1161	0.2731	0.2139	0.1363
Observations	720	720	720	720	720
Countries	30	30	30	30	30
<i>Interactions</i>					
LDV * EU	-0.0006	0.0189+	-0.0526+	-0.0102+	-0.0118
LDV (t-1)	-0.0242*	-0.0393***	-0.0513*	-0.0033	-0.0589***
LDV * trade (t-1)	0.0002	0.0001	-0.0003	-0.0002	-0.0001
LDV (t-1)	-0.0439**	-0.0306**	-0.0446	0.0018	-0.0540**
LDV * tax-to-GDP (t-1)		0.0016+	-0.0001	0.0002	-0.0015
LDV (t-1)		-0.0876**	-0.0657	-0.0177	-0.0161
LDV * CEE	-0.0674**	-0.0379	-0.0063	-0.0428+	-0.0745**
LDV (t-1)	-0.0125+	-0.0219***	-0.0677**	-0.0080	-0.0401***

Notes: Models include year dummies, panel-corrected standard errors and autoregressive disturbances.

\*\*\*Significant at the 0.01 level; \*\*Significant at the 0.05 level; \*Significant at the 0.10 level; +Significant at the 0.15 level.

## 4.9 ROBUSTNESS

I conduct several sensitivity analyses. I first examine the trade variable, because of its surprising insignificance. As noted by Bretschger and Hettich (2002), it might be biased by country size: smaller countries naturally have higher trade shares, for instance as a result of production specialisation. Following their methodology, I remove this bias by regressing trade openness on relative GDP and using the residuals as trade values. The results, including the interaction terms, are similar.

I follow the same procedure to separate the potentially overlapping effects of globalisation and the European common market on trade openness, which could cause multicollinearity of the trade variable and the EU dummy.<sup>8</sup> I regress the trade variable on the EU dummy to remove EU influence, and subsequently I add the abovementioned control variable for relative GDP. When using the residuals of these regressions instead of the respective original variables, the results do not change substantially.

As alternative proxies for tax competition, I subsequently use the Chinn-Ito index for de-jure capital account openness (Armingeon et al., 2022), net inflows of foreign direct investment as a percentage of GDP (World Bank, 2023), and the statutory CIT rate at the combined central and sub-central level (OECD, 2023). All are insignificant.

The results are also robust for the subsequent inclusion of four potential determinants of tax policy that were initially left out to prevent overspecification. One is the interaction between wage coordination and left government, following Beramendi and Rueda (2007). Second, following Limberg (2019), I add a dummy variable coded 1 when a country experiences a banking crisis (Nguyen et al., 2022), and interact it with the budget variable. Third, given the finding of Haffert and Mertens (2021) that opposition against VAT should be more pronounced in economies based on domestic consumption, I follow the authors by including an index of value added in the most important domestically oriented sectors, being wholesale and retail trade, restaurants, hotels, finance, insurance, real estate and business services, as a share of total value added in the economy (OECD, 2022). Finally, I include a dummy coded 1 for members of the Economic and

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8 I thank an anonymous referee for raising this issue. Multicollinearity between the EU dummy and trade openness does not seem to be a big problem, however: their correlation coefficient in the 1996 panel is 0.34 and their variance inflation factors are 1.92 and 3.51, respectively.

Monetary Union (EMU), as countries in the eurozone have stronger fiscal constraints. The effects of the EU dummy do not change substantially.<sup>9</sup>

Finally, from the insignificance of several control variables, it follows that tax mixes and their convergence are probably conditioned by unquantifiable factors, such as political culture and redistribution preferences. It is problematic to control for such unobserved heterogeneity using country dummies, since fixed-effects regressions generate inconsistent estimators in models that include a lagged dependent variable. Therefore, country dummies are not used in the main models and only as a sensitivity analysis. The results, provided in supplementary tables A.4.3 and A.4.4, indicate even stronger convergence than displayed in Tables 4.3 and 4.4. For instance, all dependent variables in the 1980-2019 regressions converge yearly by approximately 12 to 18 per cent. Unobserved factors apparently play a large conditioning role. Still, the effects of the control variables are largely similar. Moreover, the interaction terms with trade openness and total taxation remain insignificant (the interactions with the partially time-invariant EU dummy and completely time-invariant CEE dummy make less sense in fixed-effects models).<sup>10</sup> This leaves intact the conclusion that tax mix convergence is unrelated to tax competition or high spending.

#### 4.10 CONCLUSION

This study has extended the analysis of tax mix convergence in the OECD with a substantial number of years, and has supplemented it with data from Central and Eastern EU member states. Furthermore, it has aimed to elucidate the conditional factors that determine both the current state of tax mixes and their speed of adjustment, in order to make convergence estimates more consistent and identify convergence clubs.

The results show that tax revenues and tax mixes in OECD nations continue to converge. The underlying downward trend in PIT revenues and upward trends in CIT and consumption tax revenues have continued but

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9 The EMU dummy's coefficient is significant in two models in the 1996 regressions, suggesting that Euro members have lower CIT revenues (its long-term effect is -3.3 percentage points of tax revenues) and lower consumption tax revenues (-2.8 percentage points). In the 1980 regressions, only the CIT's effect is significant. When simultaneously adding interaction terms of the lagged dependent variable with the EU, EMU and CEE dummies to the 1996 regressions, almost all interaction effects resemble those in Table 4.4. However, CIT and SSC convergence driven by the EU turn insignificant. Instead, it is EMU membership that appears to drive a 7 per cent CIT convergence and a 2 per cent SSC convergence – though CEE countries' SSC convergence remains stronger, at 5 per cent. These results should be treated with some caution, due to potential multicollinearity between the EU and EMU dummies.

10 The only exception is the interaction term between SSC reliance and the tax-to-GDP ratio (coefficient -0.0026 and -0.0048 in the respective 1980 and 1996 panels), which however becomes insignificant when adding an interaction term with the EU dummy.

moderated through the 21st century, though several Western EU countries are slightly increasing their PIT revenue shares.

While economic openness has a long-run negative effect on total taxation, this variable and several other proxies of tax competition are unable to explain cross-country differences in tax mix composition. Instead, tax mixes are largely determined by unexplained cross-country heterogeneity. Government ideology, however, does significantly affect tax mixes in line with earlier empirical findings, and its influence appears to have increased over the years. These results contrast with the often-heard hypothesis that international economic integration, through competitive pressure, reduces domestic governments' leeway in tax policymaking. Whereas income tax progressivity may be under competitive pressure, tax mix progressivity is not.

Neither economic openness nor the tax-to-GDP ratio is able to explain the speed of convergence, which negates the existence of convergence clubs of competitive or high-tax nations that rely on regressive revenue sources like SSCs and VAT. Instead, the main driver of convergence is EU membership. While the Europeanisation of tax mixes is an unsurprising finding, this study emphasises that it trumps the effects of global tax competition. However, only the tax mixes of Western European countries converge. Central and Eastern European countries, instead, constitute a separate convergence club with lower tax burdens and more regressive tax mixes.

Considering the European goal of common social progress,<sup>11</sup> this might be a worrying observation. A regressive tax mix may not only increase income inequality, but it may also have adverse effects on labour markets. Low PITs and high regressive taxes make it more difficult to lower the tax burden of low-wage earners in efforts to increase employment. Furthermore, financing the welfare state with SSCs may dualise the labour market, leading to structural unemployment. Thus, when it comes to tax mix composition, the EU's ambition of 'upward' convergence is not being realised.

Although this study's models provide more reliable convergence tests than conventional measures of cross-country variation, and although they help to quantify the relative importance of tax mix determinants, the method of regression analysis also has several drawbacks, especially in the analysis of 'soft' data. For example, an ideology index will not fully capture a government's considerations underlying tax policies; and it is impossible to capture the pluriform influence of veto players in a single index. Thus, there remains a need for qualitative analyses of the politics of taxation, especially regarding the newer CEE Member States. Also, future quantitative studies could further disentangle the channels through which EU membership continues to affect national tax policies, given that increased competition does not appear to be a significant determinant of tax mixes.

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11 See n 1.

## SUPPLEMENTARY MATERIAL TO CHAPTER 4

Table A.4.1 Re-estimations of 1996-2019 regressions using the country panel from the 1980-2019 regressions.

	Tax-to-GDP	PIT (% revenues)	CIT (% revenues)	SSCs & payroll (% revenues)	GCT (% revenues)
LDV	-0.0285** (0.0111)	-0.0201** (0.0079)	-0.1135*** (0.0411)	-0.0094* (0.0052)	-0.0421** (0.0168)
EU (t-1)	0.1276 (0.1428)	0.2437 (0.1736)	-0.8781*** (0.2637)	0.0205 (0.1887)	0.1784 (0.1710)
Tax-to-GDP (t-1)		-0.0084 (0.0123)	-0.0251 (0.0182)	0.0001 (0.0118)	-0.0025 (0.0084)
Δ Trade	-0.0262* (0.0137)	-0.0081 (0.0146)	0.0017 (0.0156)	0.0004 (0.0121)	-0.0016 (0.0088)
Trade (t-1)	-0.0032* (0.0018)	-0.0028 (0.0024)	0.0007 (0.0029)	0.0010 (0.0017)	-0.0016 (0.0013)
Δ Left government	0.0047** (0.0020)	-0.0026 (0.0026)	0.0096*** (0.0034)	-0.0020 (0.0020)	-0.0049*** (0.0017)
Left government (t-1)	0.0015 (0.0012)	0.0041** (0.0017)	0.0009 (0.0019)	-0.0004 (0.0013)	-0.0023** (0.0010)
Political constraints (t-1)	1.4963** (0.6087)	1.4820+ (1.0272)	0.5465 (0.8135)	-1.8020* (1.0644)	-1.4375** (0.6002)
PR electoral system (t-1)	-0.0520 (0.1086)	-0.1297 (0.1707)	-0.2074 (0.2087)	0.1352 (0.1546)	0.0845 (0.1053)
Wage coordination (t-1)	0.0010 (0.0600)	-0.0767 (0.0636)	0.0504 (0.0834)	0.0802 (0.0596)	0.0576 (0.0512)
Δ Unemployment	-0.0046 (0.0605)	0.0514 (0.0673)	-0.1606** (0.0758)	0.0517 (0.0671)	-0.1212** (0.0596)
Unemployment (t-1)	0.0083 (0.0139)	-0.0245 (0.0173)	0.0327* (0.0191)	-0.0136 (0.0199)	-0.0085 (0.0161)
Elderly (t-1)	0.0760*** (0.0281)	-0.0253 (0.0365)	0.0535 (0.0392)	0.0099 (0.0346)	-0.0381+ (0.0232)
Budget surplus (t-1)	-0.0187 (0.0159)	-0.0036 (0.0200)	-0.0099 (0.0221)	0.0285* (0.0150)	0.0264** (0.0133)
Ln GDP per capita (t-1)	0.4720 (0.3622)	0.4100 (0.4307)	1.1139* (0.6191)	-0.4182 (0.3450)	-0.7596*** (0.2690)
Ln GDP (t-1)	-0.1056* (0.0559)	-0.0160 (0.0940)	-0.2790** (0.1158)	0.1119+ (0.0759)	-0.0834+ (0.0571)
GDP growth (t-1)	-0.0072 (0.0316)	0.0081 (0.0316)	0.0184 (0.0361)	0.0283 (0.0260)	-0.0018 (0.0215)
Constant	-3.9324 (3.6241)	-3.5346 (4.3583)	-6.4987 (5.9304)	3.3850 (3.5584)	11.1184*** (2.8239)
R <sup>2</sup>	0.2672	0.1764	0.3438	0.2323	0.1736
Observations	456	456	456	456	456
Countries	19	19	19	19	19

	Tax-to-GDP	PIT (% revenues)	CIT (% revenues)	SSCs & payroll (% revenues)	GCT (% revenues)
<i>Interactions</i>					
LDV * EU (t-1)	-0.0268	0.0212	-0.0909+	-0.0161+	-0.0654**
LDV (t-1)	-0.0038	-0.0378*	-0.0977**	0.0047	-0.0339**
LDV * trade (t-1)	0.0002	0.0004*	-0.0003	-0.0001	-0.0001
LDV (t-1)	-0.0522**	-0.0526***	-0.0938*	-0.0031	-0.0377+
LDV * tax-to-GDP (t-1)		0.0020+	0.0025	-0.0002	-0.0022
LDV (t-1)		-0.1028*	-0.2077**	-0.0028	0.0249

Notes: Models include year dummies, panel-corrected standard errors and autoregressive disturbances.

\*\*\*Significant at the 0.01 level; \*\*Significant at the 0.05 level; \*Significant at the 0.10 level; +Significant at the 0.15 level.

Table A.4.2 Re-estimations of 1996-2019 regressions excluding CEE countries.

	Tax-to-GDP	PIT (% revenues)	CIT (% revenues)	SSCs & payroll (% revenues)	GCT (% revenues)
LDV	-0.0244*** (0.0094)	-0.0197*** (0.0071)	-0.0865*** (0.0313)	-0.0081+ (0.0050)	-0.0514*** (0.0145)
EU (t-1)	0.0823 (0.1340)	0.1344 (0.1481)	-0.6177*** (0.2081)	0.0795 (0.1515)	0.2760+ (0.1685)
Tax-to-GDP (t-1)		-0.0021 (0.0112)	-0.0136 (0.0141)	-0.0011 (0.0103)	-0.0042 (0.0088)
Δ Trade	-0.0336*** (0.0080)	0.0017 (0.0098)	-0.0227* (0.0119)	0.0040 (0.0065)	0.0019 (0.0078)
Trade (t-1)	-0.0001 (0.0012)	-0.0017 (0.0018)	0.0009 (0.0020)	0.0015 (0.0011)	-0.0017 (0.0012)
Δ Left government	0.0044** (0.0019)	-0.0020 (0.0025)	0.0082*** (0.0032)	-0.0020 (0.0019)	-0.0047*** (0.0017)
Left government (t-1)	0.0017+ (0.0011)	0.0038** (0.0017)	0.0002 (0.0017)	-0.0006 (0.0011)	-0.0028*** (0.0010)
Political constraints (t-1)	1.1313** (0.5462)	1.1704 (0.9330)	0.7078 (0.7257)	-1.6108* (0.9570)	-1.0718** (0.5436)
PR electoral system (t-1)	-0.1217 (0.0994)	-0.1343 (0.1475)	-0.1943 (0.1896)	0.0774 (0.1306)	0.0847 (0.1029)
Wage coordination (t-1)	-0.0215 (0.0446)	-0.0571 (0.0506)	0.0698 (0.0549)	0.0472 (0.0447)	0.0049 (0.0380)
Δ Unemployment	-0.0036 (0.0538)	0.0823 (0.0610)	-0.1606** (0.0671)	0.0589 (0.0592)	-0.1025* (0.0585)
Unemployment (t-1)	0.0101 (0.0130)	-0.0140 (0.0158)	0.0255* (0.0152)	-0.0178 (0.0164)	-0.0129 (0.0147)
Elderly (t-1)	0.0818*** (0.0205)	-0.0337 (0.0281)	0.0127 (0.0230)	0.0207 (0.0302)	-0.0220 (0.0182)
Budget surplus (t-1)	-0.0138 (0.0148)	0.0001 (0.0183)	-0.0110 (0.0198)	0.0324** (0.0139)	0.0264** (0.0124)

	Tax-to-GDP	PIT (% revenues)	CIT (% revenues)	SSCs & payroll (% revenues)	GCT (% revenues)
Ln GDP per capita (t-1)	0.3552 (0.2716)	0.2855 (0.3599)	0.2950 (0.3538)	-0.4121* (0.2381)	-0.6127*** (0.2152)
Ln GDP (t-1)	-0.0890* (0.0489)	0.0202 (0.0888)	-0.1924** (0.0929)	0.0880 (0.0619)	-0.1282*** (0.0495)
GDP growth (t-1)	-0.0140 (0.0276)	0.0053 (0.0286)	0.0359 (0.0334)	0.0350+ (0.0225)	0.0013 (0.0210)
Constant	-3.0496 (2.7355)	-2.7648 (3.3232)	0.5607 (3.6787)	3.4729 (2.5751)	10.1265*** (2.4954)
R <sup>2</sup>	0.2620	0.1526	0.3090	0.2557	0.1501
Observations	528	528	528	528	528
Countries	22	22	22	22	22
<i>Interactions</i>					
LDV * EU (t-1)	-0.0156	0.0182	-0.0858*	-0.0155+	-0.0595***
LDV (t-1)	-0.0111	-0.0348*	-0.0605+	0.0052	-0.0355**
LDV * trade (t-1)	0.0002+	0.0001	-0.0001	-0.0001	-0.0003
LDV (t-1)	-0.0483***	-0.0293**	-0.0745+	-0.0017	-0.0291
LDV * tax-to-GDP (t-1)		0.0021*	0.0029	-0.0003	-0.0022
LDV (t-1)		-0.1049**	-0.1970**	0.0051	0.0159

Notes: Models include year dummies, panel-corrected standard errors and autoregressive disturbances.

\*\*\*Significant at the 0.01 level; \*\*Significant at the 0.05 level; \*Significant at the 0.10 level; +Significant at the 0.15 level.

Table A.4.3 Re-estimations of 1980-2019 regressions using country dummies.

	Tax-to-GDP	PIT (% revenues)	CIT (% revenues)	SSCs & payroll (% revenues)	GCT (% revenues)
LDV	-0.1272*** (0.0237)	-0.1462*** (0.0273)	-0.1802*** (0.0427)	-0.1289*** (0.0235)	-0.1393*** (0.0253)
EU (t-1)	-0.0683 (0.2004)	-0.0876 (0.2068)	0.0953 (0.1901)	0.1209 (0.2193)	0.0240 (0.1657)
Tax-to-GDP (t-1)		0.0440* (0.0268)	-0.0006 (0.0257)	0.0086 (0.0280)	-0.0387+ (0.0250)
Δ Trade	-0.0360*** (0.0122)	-0.0082 (0.0137)	0.0103 (0.0125)	-0.0076 (0.0103)	-0.0012 (0.0108)
Trade (t-1)	-0.0088* (0.0053)	-0.0046 (0.0053)	0.0183** (0.0074)	-0.0106** (0.0043)	-0.0111** (0.0046)
Δ Left government	0.0035** (0.0017)	-0.0003 (0.0023)	0.0032 (0.0026)	-0.0012 (0.0017)	-0.0028+ (0.0018)
Left government (t-1)	0.0013 (0.0011)	0.0033** (0.0014)	-0.0022+ (0.0015)	0.0001 (0.0011)	-0.0006 (0.0011)
Political constraints (t-1)	0.8119 (0.6842)	0.7855 (0.9590)	0.4509 (0.7262)	-1.4045+ (0.9697)	-1.0421* (0.6119)



	Tax-to-GDP	PIT (% revenues)	CIT (% revenues)	SSCs & payroll (% revenues)	GCT (% revenues)
PR electoral system (t-1)	-0.1044 (0.2575)	-0.7111** (0.3550)	0.5220* (0.2755)	0.2682 (0.2476)	0.4328+ (0.2787)
Wage coordination (t-1)	0.0134 (0.0625)	-0.0752 (0.0690)	0.1341* (0.0710)	-0.0507 (0.0521)	-0.0576 (0.0508)
Δ Unemployment	-0.0026 (0.0472)	0.0463 (0.0580)	-0.1484*** (0.0511)	0.0703 (0.0505)	-0.0636 (0.0529)
Unemployment (t-1)	0.0270 (0.0200)	-0.0315 (0.0243)	0.0156 (0.0226)	0.0035 (0.0252)	0.0239 (0.0264)
Elderly (t-1)	0.0533* (0.0273)	-0.0694* (0.0370)	-0.0761* (0.0418)	0.0544+ (0.0347)	0.0630** (0.0309)
Budget surplus (t-1)	-0.0291** (0.0148)	-0.0239 (0.0168)	-0.0068 (0.0171)	0.0262* (0.0157)	0.0156 (0.0147)
Ln GDP per capita (t-1)	1.7225 (1.4297)	2.0792 (1.7132)	-5.6114*** (1.8786)	2.9366** (1.2395)	1.3831 (1.2742)
Ln GDP (t-1)	-2.5067*** (0.9631)	-1.5192 (1.3278)	4.0500*** (1.5325)	-0.6301 (0.8080)	-0.5371 (0.9807)
GDP growth (t-1)	0.0593** (0.0252)	0.0102 (0.0295)	0.0544* (0.0285)	0.0004 (0.0207)	0.0023 (0.0257)
Constant	17.7986** (7.1745)	4.7857 (8.3786)	6.9531 (7.7747)	-20.7352*** (7.5646)	-5.1041 (8.4465)
R <sup>2</sup>	0.2766	0.1944	0.3303	0.2447	0.1826
Observations	760	760	760	760	760
Countries	19	19	19	19	19
<i>Interactions</i>					
LDV * trade (t-1)	-0.0003	-0.0001	-0.0002	-0.0003	-0.0000
LDV (t-1)	-0.1121***	-0.1417***	-0.1687***	-0.1164***	-0.1389***
LDV * tax-to-GDP (t-1)		0.0019	0.0026	-0.0026*	-0.0025
LDV (t-1)		-0.0818	-0.2775**	-0.0534	-0.0607

Notes: Models include country dummies, year dummies, panel-corrected standard errors and autoregressive disturbances. \*\*\*Significant at the 0.01 level; \*\*Significant at the 0.05 level; \*Significant at the 0.10 level; +Significant at the 0.15 level.

Table A.4.4 Re-estimations of 1996-2019 regressions using country dummies.

	Tax-to-GDP	PIT (% revenues)	CIT (% revenues)	SSCs & payroll (% revenues)	GCT (% revenues)
LDV	-0.2368*** (0.0355)	-0.2617*** (0.0399)	-0.2341*** (0.0551)	-0.2770*** (0.0440)	-0.2382*** (0.0350)
EU (t-1)	0.1124 (0.2514)	-0.8271*** (0.3084)	0.2260 (0.2950)	-0.2978 (0.2832)	0.0281 (0.2527)
CEE (t-1)	-8.0973*** (2.6053)	-5.1471+ (3.5367)	-3.3302*** (1.2885)	9.0466*** (1.4850)	2.1007 (2.7534)

	Tax-to-GDP	PIT (% revenues)	CIT (% revenues)	SSCs & payroll (% revenues)	GCT (% revenues)
Tax-to-GDP (t-1)		0.0768** (0.0316)	-0.0609* (0.0320)	0.0296 (0.0329)	-0.0166 (0.0299)
Δ Trade	-0.0274*** (0.0071)	0.0169** (0.0084)	-0.0128 (0.0089)	-0.0035 (0.0075)	-0.0017 (0.0071)
Trade (t-1)	0.0036 (0.0028)	0.0070* (0.0037)	0.0012 (0.0047)	-0.0006 (0.0024)	-0.0022 (0.0033)
Δ Left government	0.0024+ (0.0016)	-0.0015 (0.0023)	0.0089*** (0.0026)	-0.0028 (0.0020)	-0.0044*** (0.0015)
Left government (t-1)	0.0030*** (0.0012)	0.0055*** (0.0016)	0.0013 (0.0015)	-0.0018 (0.0014)	-0.0049*** (0.0010)
Political constraints (t-1)	0.2596 (0.6172)	1.3820 (1.0703)	1.2034+ (0.7907)	-1.9383* (1.1689)	-1.1979* (0.7057)
PR electoral system (t-1)	0.4208+ (0.2780)	-0.1398 (0.2799)	0.4989* (0.2598)	0.0834 (0.3531)	-0.2561 (0.2829)
Wage coordination (t-1)	0.1864** (0.0823)	0.0175 (0.0816)	0.0460 (0.0716)	-0.0697 (0.0664)	0.1164+ (0.0759)
Δ Unemployment	0.0495 (0.0407)	-0.0779 (0.0607)	-0.1333*** (0.0432)	0.1609*** (0.0550)	-0.1162*** (0.0422)
Unemployment (t-1)	0.0113 (0.0206)	-0.0339 (0.0273)	0.0112 (0.0214)	-0.0039 (0.0258)	0.0059 (0.0227)
Elderly (t-1)	0.1284*** (0.0390)	-0.0285 (0.0608)	0.0430 (0.0617)	0.0861+ (0.0553)	0.0150 (0.0476)
Budget surplus (t-1)	-0.0335** (0.0168)	-0.0284 (0.0210)	-0.0071 (0.0181)	0.0216 (0.0189)	0.0030 (0.0168)
Ln GDP per capita (t-1)	2.2869** (1.1251)	-0.3003 (1.6170)	-0.1574 (1.3936)	-1.2947 (1.4538)	0.7345 (1.3760)
Ln GDP (t-1)	-3.5434*** (1.2369)	0.2898 (1.5656)	0.3065 (1.5297)	3.2176** (1.3389)	-0.8327 (1.3474)
GDP growth (t-1)	0.0157 (0.0221)	-0.0035 (0.0277)	0.0651*** (0.0234)	-0.0136 (0.0231)	-0.0350* (0.0193)
Constant	28.2181*** (10.0374)	7.0804 (14.0883)	1.9688 (10.9782)	-29.2546*** (11.2958)	7.1398 (11.0243)
R <sup>2</sup>	0.2922	0.2494	0.3603	0.3471	0.2577
Observations	720	720	720	720	720
Countries	30	30	30	30	30
<i>Interactions</i>					
LDV * trade (t-1)	0.0002	0.0002	0.0001	-0.0001	-0.0001
LDV (t-1)	-0.2512***	-0.2850***	-0.2421***	-0.2642***	-0.2289***
LDV * tax-to-GDP (t-1)		0.0017	0.0070+	-0.0048**	-0.0014
LDV (t-1)		-0.3210***	-0.5026***	-0.1287+	-0.1919*

Notes: Models include country dummies, year dummies, panel-corrected standard errors and autoregressive disturbances. \*\*\*Significant at the 0.01 level; \*\*Significant at the 0.05 level; \*Significant at the 0.10 level; +Significant at the 0.15 level.



## ABSTRACT

The current international tax system is based on bilateral treaties that generally favour taxation by the resident state rather than by the source state. Low-income countries that have signed those treaties do not necessarily benefit from them. That outcome is paradoxical because tax treaties can be seen as international analogues of contracts, which, in a well-functioning market, should be mutually beneficial. The reason for this paradox is three-fold. First, a tax treaty improves conditions for bilateral investment, which puts pressure on third capital-importing nations to join the treaty network. Second, a country's need for investment worsens its bargaining position in treaty negotiations, especially against a 'cartel' of OECD countries aiming to disseminate OECD standards. Third, there may be imbalances in the treaty partners' capacity to oversee the treaty's tax-technical and economic consequences. Hence, three contracting problems may occur, namely, externalities, coercion and asymmetric information. We examine the solutions to these problems provided by contract theory and investigate whether those solutions can provide guidance in discussions of fair tax base distribution in bilateral treaties. In the two main (liberal and welfare consequentialist) approaches to contracting problems, we find no clear standards to deal with the interests of third parties or to determine whether a party's consent to an agreement is voluntary and informed. Several existing theories of justice in tax policy work analogously to either of these approaches. We show that these theories are equally unable to provide satisfactory normative criteria to guide the balancing act between national autonomy and international fairness in a context of bilateral tax treaties.

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- This chapter has been accepted for publication in IK Lindsay and B Mathew (eds), *Fairness in International Taxation* (Oxford, Hart Publishing, forthcoming): <https://www.bloomsbury.com/us/fairness-in-international-taxation-9781509968077/>. It was co-authored with Dirk Broekhuijsen and Henk Vording. To comply with the PhD regulations outlined by the Doctorate Board of the Faculty of Law at Leiden University, which require me to provide an overview of contributions to co-authored chapters, I declare the following. The idea to use insights from contract theory to analyse issues of fairness in the bilateral distribution of taxing rights was Dirk Broekhuijsen's. The design of an earlier version of the study was a common effort with equal input from all authors. Bastiaan van Ganzen designed the final version of the study. Section 5.1 was written by Bastiaan van Ganzen. Section 5.2 was drafted by all authors together but was finalised by Bastiaan van Ganzen. The first two paragraphs of section 5.3 ('The costs imposed (...) the first place.') were drafted by Dirk Broekhuijsen and Henk Vording and finalised by Bastiaan van Ganzen; the remainder of that section was written by Bastiaan van Ganzen. Sections 5.4 through 5.6 were written by Bastiaan van Ganzen, except one paragraph in section 5.5 ('Insofar those unreasonable (...) has come about.'), which was largely written by Henk Vording. Editing was done by Bastiaan van Ganzen. Bastiaan van Ganzen claims >70% authorship.

## 5.1 INTRODUCTION

Whereas most theories of international tax justice take a normative stance on the fairness of unilateral tax policy, the realm of international taxation is dominated by bilateral treaties. Those raise fairness issues of their own: to what extent do low-income countries as well as high-income countries benefit from tax treaties;<sup>1</sup> how does the relative negotiating power of those countries impact treaty content; are existing OECD treaty standards renegotiable; are countries under economic and/or political pressure to sign; do both countries oversee the treaty's consequences; and does the treaty generate spill-over effects on third countries? The answers to these questions have considerable implications for international tax justice and may possibly conflict with normative theories on unilateral tax policy.

A common element of the abovementioned issues is that they can be regarded as international analogues of three much-examined problems in the theory of contracts, namely: externalities, which are spill-over effects imposed on third parties that are not involved in the agreement; coercion, whereby voluntary consent to the agreement is negated by severely constrained choices; and information asymmetry, whereby one of the contracting parties is inadequately informed about the contents and consequences of the agreement. In this chapter, we aim to investigate whether and how those aspects of contract theory can provide guidance in discussions of fair tax base distribution. Our aim is not to draw an analogy between the law of contracts and international tax law, as they are incomparable in many respects.<sup>2</sup> Instead, we base our analysis on the *theory* of contracts, which provides the philosophical underpinning for the norms that guide the

- 1 Although the terms 'developing countries' and 'developed countries' are relatively common in the academic literature on this topic, this chapter will instead refer to 'low-income countries' and 'high-income countries', respectively. This choice avoids oversimplification of the complexities of socio-economic development into a singular definition based on Western-centric standards that might imply inferiority and that disregards global leadership in specific areas such as technology. Furthermore, an income-based categorisation is more relevant than a broad socio-economic indicator in the context of this chapter, which will emphasise that a country's need to attract foreign direct investment may force it to accept poor treaty conditions; that economically powerful nations are dominant in the tax policy community; and that there are imbalances in countries' domestic tax-technical expertise. These issues are relatively closely related to countries' economic development or power, for which gross national income per capita can be regarded as a proxy variable. The arguments in this chapter will mainly centre on countries' differences in economic development or power, rather than their absolute levels, such that 'high-income countries' and 'low-income countries' should be read as illustrative generalisations rather than given sets of nations. However, for a classification of countries by income, see World Bank, *World Bank income groups* (2024), retrieved 26 November 2024 from <https://ourworldindata.org/grapher/world-bank-income-groups>.
- 2 Y Brauner, 'The True Nature of Tax Treaties' (2020) 74 *Bulletin for International Taxation* 28; A Rasulov, 'Theorizing Treaties: The Consequences of the Contractual Analogy' in CJ Tams, A Tzanakopoulos and A Zimmermann (eds), *Research Handbook on the Law of Treaties* (Cheltenham, Edward Elgar, 2014).

conduct of two autonomous parties entering into agreements. The contract analogy seems appropriate, as several theories of international tax justice compare the sovereignty of nation states to the concept of individual freedom as used in liberal political theory.<sup>3</sup> The axiom ‘one’s freedom ends where another’s begins’ then applies analogously to national sovereignty. The regulation of those conflicting spheres of individual freedom is the basis of contract law in our liberal democratic order.

This chapter is structured as follows. In section 5.2, we highlight several issues of fairness raised by bilateral tax treaties. As shown in recent studies, low-income countries do not necessarily benefit from treaties, but they feel pressure to sign and may be forced to accept poor treaty conditions. This has to do with competition for foreign direct investment (FDI), the dominance of the OECD Model in the tax policy community, and imbalances in countries’ tax-technical expertise. We then use insights from contract theory to analyse those issues. Starting with externalities in section 5.3, we argue that tax treaties have the potential to induce a ‘race to the bottom’ in treaty conditions accepted by low-income countries. This policy spill-over is comparable to that caused by unilateral tax competition. But whereas the tax fairness literature has proposed several standards aimed at reducing the negative spill-overs of unilateral tax policy while leaving room for national autonomy, we show that such standards fail when applied to bilateral tax treaties. We illustrate this using Dietsch and Rixen’s Fiscal Policy Constraint. We argue that the only workable solution is to significantly reduce the normative weight attached to national tax policy autonomy. This negates the value of freedom of contract. With respect to coercion (section 5.4), contract theory appears equally unhelpful because the philosophical theories that underpin contract freedom are unable to provide a satisfactory criterion to determine whether a country has voluntarily consented to certain treaty conditions. We show that resultingly, existing remedies to imbalances in bargaining positions, including Christians and Van Apeldoorn’s Equal Benefit Principle, may produce adverse outcomes. Only with respect to asymmetric information, which we examine in section 5.5, can contract theory provide some guidance. As a remedy to clear imbalances in knowledge and expertise, existing treaties could be interpreted in favour of the weaker party. However, when it comes to drafting new treaties, the question arises whether a country knows which treaty conditions are ‘best’, which makes it difficult to avoid value imperialism. Section 5.6 concludes.

## 5.2 BILATERAL TAX TREATIES AND FAIRNESS

It might be assumed that tax treaties, like contracts, are entered into for mutual benefit – that is, there is a net benefit and both parties perceive to

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3 eg P Dietsch, ‘The State and Tax Competition: A Normative Perspective’ in M O’Neill and S Orr (eds), *Taxation: Philosophical Perspectives* (Oxford, OUP, 2018), 214–15.

get a share in that benefit. For instance, a contracting state's citizens may experience more tax certainty and fewer fiscal obstacles when engaging in economic activities in the other state. The government or the national community at large may benefit when enhanced cross-border economic activities increase tax revenues, GDP, welfare, employment, and/or human and financial capital inflow.

The assumption that bilateral tax treaties are beneficial for both parties was first challenged fifty years ago by Irish, who argued that treaties 'shift substantial amounts of income tax revenues to which developing countries have a strong legitimate and equitable claim from their treasuries to those of developed countries', which 'creates the anomaly of aid in reverse – from poor to rich countries'.<sup>4</sup> This is why Dagan calls the prospect that double tax relief will benefit all parties involved by facilitating free trade and generating allocative efficiencies, the 'tax treaties myth'.<sup>5</sup> Nowadays, it is broadly accepted that low- or middle-income countries do not necessarily, or even usually, obtain benefits from concluding tax treaties.<sup>6</sup>

For instance, Leduc and Michielse note that, for those countries, potential tax treaty gains break down into: (1) a positive impact on FDI inflows; (2) supporting tax administration functions; and (3) enhancing international relations. In reviewing these gains, they find little indication of success. Moreover, with respect to the first point, they argue that even if source-country tax incentives stimulate FDI and/or generate positive economic spill-overs that increase human and financial capital, 'the optimal policy would seemingly be to adopt this reduction unilaterally under domestic statutes (by legislating moderate-to-low statutory withholding tax rates, for example)'.<sup>7</sup> As Hearson notes, high-income countries' tax systems already offer relief for taxes paid in source countries routinely, such that 'the most significant effect of a [bilateral tax treaty] between a developed and a developing country is to shift the burden of doing so from the former to the latter'<sup>8</sup> – which is indeed the key finding of Dagan's 2000 article.<sup>9</sup>

With respect to the second point mentioned by Leduc and Michielse, we would underscore that technical tax assistance offered by high-income countries (or by the OECD) to lower-income countries can be, and is, supplied independent of any tax treaty context. Additionally, one wonders whether the recent tendency to add anti-avoidance rules to bilateral tax

4 CR Irish, 'International double taxation agreements and income taxation at source' (1974) 23 *International and Comparative Law Quarterly* 292.

5 T Dagan, 'The Tax Treaties Myth' (2000) 32 *JILP* 939.

6 Overview in M Hearson, *Imposing Standards: The North-South Dimension to Global Tax Politics* (Ithaka, Cornell University Press, 2021).

7 S Leduc and G Michielse, 'Are Tax Treaties Worth It for Developing Countries' in R de Mooij, A Klemm and V Perry (eds), *Corporate Income Taxes under Pressure: Why Reform Is Needed and How It Could Be Designed* (Washington DC, IMF, 2021) 143.

8 M Hearson, 'When Do Developing Countries Negotiate Away Their Corporate Tax Base?' (2018) 30 *Journal of International Development* 233, 236.

9 Dagan (n 5).

treaties (such as principle purpose tests) has much practical relevance to low- and middle-income countries.<sup>10</sup> In sum, as the IMF put it in 2014, low- or middle-income countries 'would be well-advised to sign treaties only with considerable caution'.<sup>11</sup> One is left wondering why those countries have signed so many treaties with high-income nations over the last decades.<sup>12</sup> We argue that the answer is twofold: it boils down to the external effects of third countries' tax treaties, and to existing inequality between treaty partners.

Like contracts, tax treaties have the potential to generate both internal and external (or: spill-over) effects. The internal effect of a treaty is the immediate impact on the treaty partners' tax revenues (through the channels of tax base allocation and withholding tax rate reduction) and on their investment stocks.<sup>13</sup> Following the abovementioned interpretation of tax treaties 'shifting the costs of relief to developing countries', the tax revenue effect may tend to be zero-sum – the gain to one treaty partner is a loss to the other. The internal effect on FDI must be distinguished from substitution of FDI between alternative foreign states. For instance, when a country-A/B treaty leads to +100 investment from A to B, and -60 investment from A to the rest of the world, the internal effect of the treaty from A's perspective is +40, and the external or spill-over effect is -60.<sup>14</sup> This implies that A and B have created a benefit (to be distributed between them) at the expense of the rest of the world. That this spill-over effect should occur, follows from two plausible efficiency assumptions: the worldwide allocation of investments will equalise expected after-tax returns to capital; and a new A/B tax treaty increases the expected after-tax return to capital for bilateral A/B investments. The effect becomes bigger when residents of third countries can get access to the treaty, for instance by locating a letterbox company in country A that notionally holds the interests of a third-country investor in country B.

Even though B's neighbouring (low- or middle-income) countries would be able to attract investments through unilateral tax policy, any loss in FDI from country-A investors that they experience as a result of the A/B

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10 Illustratively, few low-income countries have signed the MLI agreement which implements the 2017 BEPS Action Plan. A likely reason is a lack of administrative capacity: International Monetary Fund, 'International Corporate Tax Reform' (2023) IMF Policy Paper 2023/001, 18.

11 International Monetary Fund, 'Spillovers in International Corporate Taxation' (2014) IMF Policy Paper, 24.

12 This growth is neatly documented by Leduc and Michielse (n 7) 133–38.

13 Strictly speaking, this is an external effect. It is not the governments of both countries that adapt their investment choices, but their residents. Only the subsequent effect on both states' tax revenues is truly internal. We ignore this for simplicity.

14 Again, this is a simplification, as FDI responses do not equal welfare effects.



treaty should make them more willing to conclude a treaty with A as well.<sup>15</sup> Such external effects should be divergent in size across countries and might be small in many cases, for instance when treaty partners have limited economic ties, or because non-tax factors overshadow taxation in affecting returns to investment. However, the effects should be large in at least some cases, for instance when a treaty partner has a particularly large outward FDI stock or performs a hub function in international tax planning.

If the demand for joining country A's treaty network is large enough, it may well be that countries must be prepared to pay an entrance fee in the form of unattractive treaty conditions. This is the negative side of the network effect of tax treaties as discussed by Dagan.<sup>16</sup> This spill-over might be especially burdensome for low- and middle-income countries with relatively small domestic tax bases. Corporate income tax revenues from FDI often comprise a relatively large share of their tax revenues,<sup>17</sup> which increases the need to participate in treaty networks, at least to stimulate development in the short run. Thus, external effects and existing inequality intersect here.

Those factors constrain not only the freedom of low-income countries whether or not to conclude treaties, but also those countries' ability to decide upon treaty content. To begin with, participating in the treaty network only makes sense if a country first adopts the rules underlying income taxation, in order to be able to comply with common international tax principles. Hence, as Avi-Yonah notes, 'the process of integration into the world economy forces change'.<sup>18</sup> Moreover, as stressed by Brauner, the existing treaty network is dominated by 'the OECD, its Model, its negotiators' network, and the availability advantage of its work'.<sup>19</sup> Hearson observes the role of a specialized tax community of tax professionals and civil servants

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15 Ring emphasises that investment is indeed a key reason why tax treaties appeal to low-income countries. She explains that 'the comfort that [tax treaties] provide to the new investor (...) can be both concrete and intangible. On the concrete side, treaties facilitate the intersection of two countries' tax system and provide a framework for resolving conflict. On the intangible side, treaties can signal to investors that a country is part of the "international" system and one can be comfortable pursuing business and investments there. Many emerging market countries believe that a treaty is an important indicator to potential investors about the status and reliability of the nation – i.e. you need to have a treaty to be perceived as a plausible and viable investment destination': D Ring, 'International Tax Relations: Theory and Implications' (2007) 60 *Tax Law Review* 83.

16 T Dagan, 'Tax Treaties as a Network Product' (2015) 41 *Brooklyn Journal of International Law* 1081. Generally, network effects are positive externalities. The point here is that low- and middle-income countries participate in this network without apparently obtaining much of the positive effects.

17 R de Mooij, T Matheson and R Schatan, 'International Corporate Tax Spillovers and Redistributive Policies in Developing Countries' in BJ Clements and others (eds), *Inequality and Fiscal Policy* (Washington DC, IMF, 2015).

18 RS Avi-Yonah, 'Tax Competition, Tax Arbitrage and the International Tax Regime' (2007) 61 *Bulletin for International Taxation* 130.

19 Y Brauner, 'Tax Treaty Negotiations: Myth and Reality' (2021) University of Florida Levin College of Law Legal Studies Research Paper Series No. 22-15, 59.

that regards the OECD Model Treaty as a panacea whatever the outcome for low- and middle-income countries and that aims to disseminate OECD standards. He notes that experts from lower-income countries who 'want to be part of this (...) community [have] little room (...) to challenge such a long-standing consensus, even where it exhibits a strong bias against them.'<sup>20</sup> In a recent survey of tax treaty negotiations, Brauner argues that '[t]his imbalance is completely unaccounted for by the current tax treaty interpretation canon', and he draws an analogy with the 'dilemma (...) which exists under contract law when it comes to interpretation of unbalanced contracts.'<sup>21</sup> We would add that the (partial) absence of voluntary consent and the constrained choices that low-income countries face resemble the situation that the theory of contracts calls 'coercion'.<sup>22</sup> Indeed, in an empirical investigation of treaty content using regression models, Oei finds evidence for the hypothesis 'that treaty negotiation outcomes predominantly reflect the power and preferences of the more powerful developed country signatory, resulting in treaties unfavorable to developing countries': the outcomes show that treaties signed with more populous, as well as with more 'tax attractive' OECD countries tend to be less favourable for low-income nations.<sup>23</sup>

What also plays a role is that low-income countries often have limited resources available for treaty negotiations and international tax policy. Tax treaties are formulated in tax-technical language and have complex economic consequences such as changes in FDI and strategic tax planning behaviour. When treaty partners have unequal access to the expertise required to oversee the treaty's consequences, this can be regarded as a contracting failure caused by asymmetric information. Of course, a country can hire outside expertise to partially alleviate information asymmetries, but as mentioned above, it will be dependent on experts who generally aim to disseminate OECD standards. Hence, the problem of information asymmetry intersects with the abovementioned problem of 'coerced' contracts.

A similar intersection occurs in the use of the OECD model convention as a standard-form contract. In contract theory, standard-form contracts are usually regarded as a subset of information asymmetry problems because they are drafted by a single party before negotiations start, implying a take-it-or-leave-it situation, and generally signal an imbalance in power, knowledge and expertise among the contracting parties. Brauner, while rejecting the contractual analogy in itself, compares these attributes to the current practice of tax treaty negotiations.<sup>24</sup> Arguably, the repeated use

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20 Hearson (n 6) 6.

21 Brauner (n 19) 59, although he rejects the contractual analogy in itself: Brauner (n 2).

22 We discuss the precise definition of coercion in section 4.

23 S Oei, *Disentangling Power and Preferences in Tax Treaty Negotiations: Analyzing Tax Treaties between Developing and OECD Countries Using Multilevel Modeling* (2024) Duke Law School Public Law & Legal Theory Series No. 2024-47, retrieved 27 November 2024 from [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=4904333](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4904333).

24 Brauner, (n 19) 59.

of the OECD model tax convention does make treaties easier to draft and negotiate, which actually alleviates problems of information asymmetry. However, the more parties rely on an OECD-based standard form, the less freedom they have to challenge the OECD consensus.

In sum, the fairness issues raised by bilateral tax treaties boil down to international analogues of market failures and contracting problems which relate to externalities, coercion, and asymmetric information – and intersections between them. We will examine the theory behind those respective problems in the next three sections.

### 5.3 EXTERNALITIES

The costs imposed on, and benefits enjoyed by third parties are not usually taken into account by contracting parties, and are hence neither part of their reasons to conclude a contract nor of the mutual entitlements and obligations that follow from that contract. These externalities, therefore, constitute a ‘social’ cost or benefit – they may lead to both inefficient contracting and inefficient non-contracting, such that freedom of contract may not lead to net welfare improvements, let alone Pareto optimality.<sup>25</sup> Contract law is one of the government’s instruments to reduce externalities.

Civil contract law does so by protecting good morals and public order (*boni mores*) through the doctrine of prohibited contracts.<sup>26</sup> As Smits notes, ‘underlying (...) violation of (...) *boni mores* (...) lies not only the wider interest of society in general, but often also the wish to protect people who are not a party to the contract’.<sup>27</sup> Likewise, English common law takes into account the illegality of contracting contrary to public policy, a concept that is considered not very far removed from its civil-law counterparts.<sup>28</sup> Yet, neither civil law nor common law currently observes a clear-cut concept of externalities, and both define the ‘third party’ narrowly.<sup>29</sup> One reason is that the concept of ‘public policy’ generally refers to the national realm only, such that third parties in foreign countries are rarely taken into account.<sup>30</sup> Contract theory that seeks to expand the regulation of external effects is of an exploratory and normative, rather than of a descriptive nature. Relevant theories depart from notions such as ‘ethical consumerism’ and ‘corporate

25 RH Coase, ‘The Problem of Social Cost’ (1960) 3 *Journal of Law and Economics* 1.

26 Eg article 138 BGB, Germany; article 3:40 BW, Netherlands.

27 JM Smits, ‘The Expanding Circle of Contract Law’ (2016) 27 *Stellenbosch Law Review* 227, 232.

28 V van den Brink, ‘De rechtshandeling in strijd met de goede zeden’ (PhD thesis, University of Amsterdam, 2002); C Mak, *Fundamental Rights in European Contract Law* (Alphen aan den Rijn, Wolters Kluwer, 2008) 32–33.

29 Smits (n 27) 232.

30 Smits (n 27) 233.

social responsibility'.<sup>31</sup> Most of those concepts are vague because the underlying reason for, and method of dealing with externalities depends greatly on one's philosophical justification of the freedom of contract. The liberal and welfare consequentialist perspectives that provide two common underpinnings of contract freedom<sup>32</sup> are conceptually incommensurable, and neither provides a clear standard to judge externalities in the first place.

From a liberal or libertarian perspective, one could view freedom of contract as a prerequisite for individual autonomy, which should be promoted as a good in itself. Consequently, externalities are problematic because they harm the autonomy of other individuals. As almost all human conduct affects others, the definition of justifiable versus inappropriate harms requires decisions about the right level of state intervention and the design of balancing tests for conflicting individual rights.<sup>33</sup> As illustrated elsewhere in this chapter, these decisions inevitably rely on assumptions, political choices or moral values that go beyond the sole pursuit of 'autonomy'.

From a contrasting, consequentialist perspective, freedom of contract would be instrumental to some other goal. A much-explored goal is welfare maximisation, to which freedom of contract should contribute as parties enter into contracts for mutual benefit.<sup>34</sup> A classic example is a factory polluting a river and giving fisheries downstream a compensation that outweighs their damages. All parties experience a Pareto welfare improvement, despite the fisheries losing some autonomy. When transaction costs prevent resource allocation via contracting, the initial distribution of property rights is crucial: can the factory use the river freely, or should it negotiate with the fisheries before polluting it? Negotiations with two hundred individual fisheries (or, in international taxation, countries) are perhaps too burdensome. In those cases, choices about the initial set of property rights will affect welfare. In making these choices, governments must make assumptions about transaction costs and economic outcomes. The chosen set of rights will curb at least one party's autonomy, based on no other moral standard than those assumptions.

Of course, under consequentialism, freedom of contract could be instrumental to any other goal, such as resource equality or justice – whatever their definition. But the further those goals deviate from the mutual benefit

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31 JM Smits, 'Enforcing Corporate Social Responsibility Codes Under Private Law: On the Disciplining Power of Legal Doctrine' (2017) 24 *Indiana Journal of Global Legal Studies* 99.

32 See eg Nozick's idea of contract as just acquisition, based on libertarian freedom: R Nozick, *Anarchy, State and Utopia* (New York, Basic Books, 1974); Coase's analysis of the efficiency of contracts, rooted in welfare economics: Coase (n 25).

33 MJ Trebilcock, *The Limits of Freedom of Contract*, 2nd edn (Cambridge MA, Harvard University Press, 1998) 61–64.

34 For an exploration of the distinction between welfare economics, utilitarianism and other forms of welfare consequentialism, see ER Morey, 'What are the ethics of welfare economics? And, are welfare economists utilitarians?' (2018) 65 *International Review of Economics* 201.

for the two contracting parties, the more complex the law of contracts will become. For instance, it would be infeasible to serve egalitarian purposes by judging externalities on a case-by-case basis depending on the respective resource endowments of contracting parties and third parties. Instead of burdening parties who contract with poor people, society as a whole takes on redistributive duties through the tax-and-transfer system.<sup>35</sup> We will revert to this issue later, but note here that case-by-case decisions generally will not make the rules that guide externalities any less arbitrary.

In sum, neither a deontological commitment to individual freedom, nor a consequentialist approach is able to provide a clear-cut solution to externalities without invoking external values or standards.<sup>36</sup> In the remainder of this section, we draw a parallel between these perspectives and existing theories of international tax justice. In international taxation, spill-overs stem from divergent tax rates, overlapping tax jurisdiction, dissimilar tax base definitions, special regimes to attract non-residents, and anti-abuse rules to deter residents from using attractive features of other tax systems. They may lead to cross-border relocation of taxpayers, FDI, and paper profits, which in turn induces competitive tax rate setting by governments.<sup>37</sup> Because this competition is mainly aimed at attracting mobile capital and rich individuals, countries' tax burdens shift from capital towards labour, and the progressivity of tax systems declines.<sup>38</sup> Thus, spill-overs reduce the range of policy options that states can realistically pursue, and hence undermine their fiscal self-determination or sovereignty,<sup>39</sup> which can be regarded as the international analogue of individual autonomy.<sup>40</sup> Additionally, spill-overs widen the difference in fiscal autonomy between countries, as low-income nations face a particularly salient trade-off between attracting taxpayers and FDI on the one hand, and raising domestic revenues in a way that matches democratic preferences on the other. As noted by De Mooij, Matheson and Schatan, corporate income tax revenues from FDI comprise a relatively large share of those countries' tax mixes.<sup>41</sup> Furthermore, low-income countries are particularly vulnerable to policy spill-overs caused by tax havens, because they have limited administrative capacity to tackle base erosion and profit shifting (BEPS) strategies.<sup>42</sup>

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35 Trebilcock (n 33) 98–101.

36 There are also perspectives that are neither consequentialist nor deontologically committed to the promotion of autonomy, eg virtue ethics. As those are virtually unexplored in theories of international tax justice, we do not consider them in this chapter.

37 P Genschel and P Schwarz, 'Tax competition: a literature review' (2011) 9 *Socio-economic review* 339.

38 eg S Ganghof, *The Politics of Income Taxation* (Colchester, ECPR Press, 2006); B van Ganzen, 'Determinants of top personal income tax rates in 19 OECD countries, 1981–2018' (2023) 43 *Journal of Public Policy* 401.

39 P Dietsch and T Rixen, 'Tax Competition and Global Background Justice' (2014) 22 *The Journal of Political Philosophy* 150, 156.

40 Dietsch (n 3).

41 de Mooij, Matheson and Schatan (n 17) 177.

42 Ibid.

In the existing tax fairness literature, the normative implications of those spill-overs have given rise to concepts like ‘sovereign duty’ (Christians)<sup>43</sup> and ‘fiscal policy constraint’ (Dietsch and Rixen),<sup>44</sup> centred on the idea that states should not pursue unilateral tax policies that are aimed at damaging other states’ taxing rights. Like the abovementioned perspectives on the freedom of contract, the underlying theories of international tax fairness differ in the normative weight they assign to autonomy (that is, national sovereignty) and in the extent to which they make taxation instrumental to some external goal. For instance, Risse and Meyer assert that ‘[a]ny state should design its fiscal policy to advance justice, both domestic and global’.<sup>45</sup> From their perspective, it is in principle irrelevant whether tax competition reduces countries’ range of realistic tax policy options; what matters is whether it disables countries to meet basic duties of justice towards their citizens. Governments should refrain from implementing policies with such a detrimental effect on other countries, or they should compensate those countries via international redistribution.<sup>46</sup> By contrast, Dietsch and Rixen argue that unilateral tax policy should not be made instrumental to international redistribution by biasing the normative enquiry into tax policy spill-overs.<sup>47</sup> For that normative enquiry, they propose a fiscal policy constraint (FPC) that proscribes policies which are both strategically motivated and negatively affect the aggregate fiscal autonomy of states. The ban on strategic policies would allow countries to pursue non-strategic policies that match the preferences of their electorates, even if those preferences include low taxes that incidentally attract foreign tax base. Those local preferences are key in realising justice, as national communities have different conceptions of what justice entails. Because part of today’s injustice boils down to existing inequality between countries, with some nations lacking the resources to be fiscally autonomous in the first place, Dietsch and Rixen acknowledge that redistributive duties may co-exist beside the FPC – but those duties constitute a separate normative issue.<sup>48</sup> Risse and Meyer, however, find the approach too procedural and want to ‘determine the range of permissible tax regimes first, by appealing to substantive principles of global justice’ – only within that range can countries follow their democratic preferences.<sup>49</sup>

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43 A Christians, ‘Sovereignty, Taxation and Social Contract’ (2009) 18 *Minn J Intl L* 99.

44 Dietsch and Rixen (n 39).

45 M Risse and M Meyer, ‘Tax Competition and Global Interdependence’ (2019) 27 *The Journal of Political Philosophy* 480, 492.

46 Resultingly, a competitive tax policy that attract tax base from poor countries may give rise to redistributive duties. Additionally, in extreme cases, poor countries would be allowed to become tax havens for paper profits of taxpayers from rich countries, insofar those rich countries fail to meet international redistributive duties.

47 Dietsch and Rixen (n 39) 166. See also P Dietsch and T Rixen, ‘Debate: In Defence of Fiscal Autonomy: A Reply to Risse and Meyer’ (2019) 27 *The Journal of Political Philosophy* 499.

48 See text to n 47.

49 Risse and Meyer (n 45) 495.



The arguments in this debate are conceptually incommensurable because they are based on different normative premises, namely a deontological attachment to autonomy versus a consequentialist view in which international tax law is instrumental to justice. This will turn out relevant in the remainder of this section, where we use those respective views to normatively assess the spill-overs of tax treaties (that is, increased bilateral investment at the expense of the rest of the world). We will pay particular attention to the autonomy-based position, exemplified by Dietsch and Rixen's stance on unilateral tax policy.<sup>50</sup> This position appears the most intuitively appealing and the least controversial, because the scope of its normative enquiry (asking whether a tax policy harms other countries' autonomy) is narrower than a pursuit of 'global justice'.<sup>51</sup> Relatedly, its focus on autonomy seems the most compatible to the freedom of contract, and hence to countries' existing freedom to conclude tax treaties.<sup>52</sup>

The starting question in this assessment is whether the spill-overs of bilateral tax treaties are normatively different from the situation in which two countries change their tax policies unilaterally. If not, no further analysis would be required. We see a key difference with respect to democratic decision-making. Unilaterally, the application of Dietsch and Rixen's FPC is feasible under the simplifying assumption that governments act in accordance with their citizens' preferences,<sup>53</sup> and provided that one is able to distinguish those preferences from strategic intentions. To identify those intentions, one should ask whether a country would still implement a policy if the resulting 'benefits (...) in terms of attracting tax base from abroad did not exist'.<sup>54</sup> If it would, the policy is motivated by local preferences; if it would not, the policy is strategically motivated, and thus illegitimate insofar it reduces countries' aggregate fiscal autonomy. It is difficult to answer this question in a bilateral setting, which lacks a single decision-making authority. Treaties are products of complex games of negotiation in which the respective treaty partners have strategic intentions vis-à-vis each other. Those individual intentions exist beside any unified strategic intentions vis-à-vis third countries. And as illustrated by numerous treaty interpretation disputes, it is questionable anyway whether both countries will ever speak

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50 Dietsch and Rixen themselves limit the application of the FPC to the national level. Regarding tax base distribution, they 'endorse unitary taxation with formulary apportionment': Dietsch and Rixen (n 39) 152. Thus, our application of the FPC on the international level is a theoretical exercise rather than a critique of the FPC.

51 According to Dietsch and Rixen, this protection of national autonomy should be acceptable even to moral cosmopolitans. It indirectly serves the interests of all individuals worldwide because nation states are more democratic and better able to match policies to local preferences than a world government: Dietsch and Rixen (n 39) 172–75.

52 As discussed above, freedom of contract can also be compatible with consequentialist views, but those tend to be welfare consequentialist and not, like Risse and Meyer's approach, 'justice' consequentialist.

53 Dietsch and Rixen (n 39) 153.

54 Dietsch and Rixen (n 39) 164.

with one voice regarding their intent behind the treaty. Thus, should one focus on the treaty partners' individual intentions; on some aggregation of their individual intentions; or only on their unified intentions vis-à-vis third countries, if observable? Another issue is that treaties are packages of multiple provisions, of which some may be strategically intended and some not: should one look at those specific provisions or only at the total package? Without spelling out all possible combinations of these options, we will highlight some difficulties.

First, focussing on the treaty partners' individual intentions behind the treaty as a whole, one would have to separate the prospect of increased inward investment from other potential benefits (such as double tax relief for domestic residents investing abroad, or tax-technical assistance). If at least one of both countries would not have signed the treaty were it not for the prospect of more FDI, the treaty would not be legitimate under the FPC – at least, if the treaty reduces aggregate fiscal autonomy. Most low-income countries sign treaties to attract FDI, so they will be under particular scrutiny of the FPC – or any normative standard that judges externalities based on a distinction between democratic preferences and strategic intentions.

Matters are different when looking at countries' individual intentions behind specific treaty provisions. A typical low-income country that expects inward investment would prefer high withholding taxes as an easy source of revenue, but will generally be forced to accept a low rate due to the 'market power' of high-income countries. Can one still argue, then, that its intentions are strategic? Furthermore, as the FPC is centred on 'attracting tax base from abroad', it focusses on this low-income country's intentions and disregards preferences of capital-exporting (high-income) countries. Those preferences probably include low withholding taxes, which exert large externalities. Thus, paradoxically, it would be relatively lenient toward 'harmful' treaties. The latter problem can be solved by expanding the FPC's notion of 'strategically attracting tax base' such that it also includes tax base attracted by the treaty partner. The underlying argument would be that capital-rich nations should reasonably know that stimulating capital export is inseparable from creating a capital import elsewhere.

However, this does not help when two capital-rich, high-income nations agree on a 0 per cent withholding tax rate, neither as a competitive policy to attract tax base, nor to stimulate capital export, but simply because they believe that withholding taxes are unnecessary distortions to the allocation of investments. Indeed, the view that corporate income taxes would suffice to tax investments at source has long been prevalent in the OECD. In this case, as highlighted in the previous section, not levying withholding taxes on bilateral investment flows might exert substantial externalities on low-income countries, but the FPC must allow it, because it clearly matches both high-income countries' democratic preferences.<sup>55</sup> Similar situations could

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55 Compare a unilateral 0% CIT rate: that would be prohibited under the FPC, because it is unlikely to be a non-strategic, democratically preferred policy.



arise with other treaty provisions, such as particular distributions of taxing rights on active and passive income.

The only solution here would be to adopt an even broader conception of the FPC, under which we consider it strategic that tax treaties discriminate between countries by giving only taxpayers in the partner country access to certain benefits (such as lower withholding tax rates). Both treaty partners should reasonably know that their investment conditions resultingly improve at the expense of the rest of the world, and that could be regarded as 'strategically attracting tax base'. This implies that all treaties are strategic and that they should be banned insofar they reduce aggregate fiscal autonomy. Under the view that treaties reduce aggregate fiscal autonomy by nature, they should indeed be banned, and only a purely multilateral tax system would suffice. Under the view that they only do so when they include provisions that generate clear externalities, such as 0 per cent withholding tax rates, we would need world-wide minimum standards regarding those provisions. The downside would be a significant reduction in fiscal autonomy for countries that genuinely believe in low withholding taxes. An additional problem is that national autonomy encompasses more than fiscal autonomy alone. Countries may well conclude tax treaties to achieve non-fiscal ends, such as strengthening their international relationships. Under the expanded application of the FPC, this form of autonomy would be subordinated to fiscal autonomy. From a liberal point of view, it is debatable whether this approach would protect countries' aggregate autonomy.<sup>56</sup>

Alternatively, when not expanding the FPC's application, one would have to accept that this standard is unable to prevent the externalities of several treaties, mostly those between rich countries. To what extent is that problematic? From the liberal perspective that underpins the FPC, the answer depends on whether those externalities violate countries' autonomy, because that is where the freedom of contract of the two treaty partners ends. Again, the key issue is whether countries genuinely believe that withholding taxes are unnecessary in the presence of adequate source-country corporate taxation. In that view, the loss of autonomy boils down to the existence of corporate tax competition, the reliance of low-income countries on corporate tax revenues from FDI, and the limited administrative capacity of those countries to tackle BEPS strategies.<sup>57</sup> The primary solution would be to curb corporate tax competition; the unilateral FPC would do that job and no further action would be required.<sup>58</sup> We consider this solution problematic for the very same reason why the FPC aims to protect national autonomy, namely the existence of value pluralism about the content of a just tax policy. This pluralism not only encompasses the issue of tax rate setting, but also the relative importance of goals like capital import neutral-

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<sup>56</sup> We thank a reviewer for the latter point.

<sup>57</sup> See de Mooij, Matheson and Schatan (n 17).

<sup>58</sup> Adhering to an affirmative conception of national autonomy, rich countries might also have to provide technical tax assistance and perhaps even financial transfers, but these things would be normatively separate from the enquiry into corporate tax spill-overs: see text to n 48.

ity, revenue-raising capacity, administrability and simplicity. Withholding taxes are comparatively easy to administer and could be a rich revenue source for low-income countries, but they conflict with the efficiency- and neutrality-based OECD vision.<sup>59</sup> The problem is that visions pro and contra withholding taxes cannot coexist because of the externalities caused by tax treaties. Even though low-income countries might be happy to receive technical tax assistance, they must involuntarily set low withholding tax rates and introduce complex anti-avoidance legislation to prop up their corporate tax systems. Thus, freedom of contract under the FPC is unable to protect national autonomy by accommodating value pluralism.

This means that we are left with 'autonomy-defying' theories of tax justice if we want to curb the externalities of tax treaties. For instance, we could eliminate the distinction between strategic and non-strategic policies from the FPC and solely aim to prohibit treaties which reduce other countries' fiscal autonomy. We are then left with a consequentialist, global standard that rules out all negative externalities without attaching any weight to local preferences. That would cause a significant and arbitrary upward bias in tax rates. Of course, consequentialism can also make tax treaties instrumental to other goals, such as 'justice'. To make this goal feasible, justice could for instance be equated with 'ensuring that all countries can meet basic duties of justice towards their citizens'; we then arrive at Risse and Meyer's standpoint. With respect to contract theory, the main lesson from this analysis is that freedom of contract offers little guidance as to the protection of non-parties' interests.

#### 5.4 COERCION

The problem thus remains that low- and middle-income countries are unfree in their choices whether or not to conclude tax treaties, and unfree in deciding upon treaty content with high-income countries. This may result in poor treaty conditions, and it negates a key assumption behind contract freedom, namely that parties enter into agreements voluntarily. Of course, even in an ideal-type free market, all contracts are based on constrained choices, because individuals' incomes are limited and most goods are scarce. To define 'coercion', the theory of contracts must identify the point at which parties' choices become so constrained that their consent to an agreement should be considered involuntary.<sup>60</sup>

59 For an examination of the goals of efficiency and neutrality, see P Hongler, *Justice in International Tax Law* (Amsterdam, IBFD, 2019).

60 Authors use different words to describe this situation. Stewart, for instance, argues that 'coercion' and 'duress' 'refer to situations where a threatens to violate  $\beta$ 's rights; situations where there is no such threat but the proposal is nonetheless improper are normally cases of exploitation or unconscionability': H Stewart, 'A Formal Approach to Contractual Duress' (1997) 47 *The University of Toronto Law Journal* 175, 185. We use 'coercion' for both situations throughout this chapter.

Section 5.3 has covered one only cause of constrained choices in the context of bilateral tax treaties: the external effects of neighbouring countries' unfavourable treaties, making the country in question relatively unattractive for FDI unless it joins this network. These externalities must be distinguished from the situation in which a capital-poor nation needs to give up taxing rights anyway in order to become attractive. That problem is not specific to tax treaties, but it may affect treaty outcomes when countries are 'coerced' to accept unfavourable treaty conditions because they lack attractive alternatives. Although it is difficult in practice to distinguish coercion from externalities as the main cause of an unfavourable treaty outcome, it is important to analyse both issues separately, because the issue of unfreedom caused by unequal bargaining positions would remain even when some multilateral effort would deal with externalities.

As with externalities, the various perspectives underpinning the theory of contracts have different approaches in defining 'coercion'. A welfare consequentialist approach would infer parties' voluntary consent from the contract increasing both parties' welfare. As Trebilcock notes, this approach begs the question, because contract theory assumes that transactions are welfare-improving for the reason that contractors close them voluntarily.<sup>61</sup> Even if one accepts the inverted line of reasoning, it seems morally problematic to look only at the welfare consequences of enforcing a contract, instead of the circumstances under which this contract was signed.<sup>62</sup> In the context of international tax law, such an approach would be unable to address the unfairness of poor treaty conditions due to countries' unequal bargaining positions, as long as low-income countries receive minor benefits from their treaties.

More generally, Stewart argues that all consequentialist theories are unsuited to evaluate voluntary consent, because they would override parties' autonomy to voluntarily enter into contracts if those contracts conflict with some external goal.<sup>63</sup> Thus, whereas a consequentialist solution seemed more appropriate for the problem of externalities, it appears more convincing to solve the problem of coercion by invoking some conception of autonomy. To this end, liberal or libertarian theories would distinguish voluntarily signed contracts from coerced contracts by asking whether a contracting party's offer expands or restricts the other party's set of meaningful options – that is, whether it increases or decreases that party's autonomy, respectively. But then we are back at the difficulty in defining a 'harm' to someone's autonomy. As explained in the previous section, liberalism must inevitably compose a list of rights and wrongs.

A negative conception of autonomy (that is, 'freedom from ...'), would only rule out explicit threats and obstacles, disregarding countries' unequal bargaining positions. By contrast, the notion of positive freedom is more

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61 Trebilcock, (n 33) 83–84.

62 Stewart, (n 60) 224, 226.

63 Stewart, (n 60) 182.

appealing in the context of coerced treaties, because it seems to capture the idea that states should be capable to freely choose between different options – or treaty content – available to them.<sup>64</sup> A nation's autonomy in this sense would mean its ability to sovereignly implement policies according to the democratic preferences of its citizens. This aggregate autonomy includes but is not limited to fiscal autonomy, which concerns the implementation of tax and redistributive policies according to national preferences.<sup>65</sup> Although a tax treaty restricts a country's set of tax policy options and may hence reduce fiscal autonomy, it is an exercise of, and ideally enhances 'aggregate' autonomy through increases in bilateral trade and tax base inflow and through the enhanced freedom of citizens to conduct cross-border activities. By contrast, if concluding a tax treaty is the only way for a capital-importing nation to attract enough FDI, and if this treaty's provisions are so unfavourable that they severely reduce fiscal autonomy, the treaty can be argued to reduce the country's set of meaningful options and thus be considered 'coerced'. Testing empirically whether a treaty increases or restricts a country's autonomy according to this definition closely resembles a welfare economic analysis. This analysis would still be unable to distinguish unfair treaties, because it remains unclear why a treaty partner would be obliged to give away more taxing rights once the treaty is marginally beneficial for the country in question.<sup>66</sup> In fact, maximising the capital-poor nation's taxing rights would harm the treaty partner's own autonomy according to the definition above.

For similar reasons, Trebilcock notes that autonomy-based approaches have no clear answer to cartelisation, whereby consumers face higher prices and a lower consumer surplus than under perfect market conditions, even though they face no explicit 'threat' from monopolistic producers. Arguably, the consumers who are priced out of the market face the largest decreases in autonomy, but theories of coercion focus on the voluntary consent of those who remain in the market. Autonomy-based approaches do not clarify why exactly it is problematic to overcharge those consumers. Introducing a right to be free of monopolistic conduct would be unhelpful. Illustratively, it seems unproblematic for a monopolistic seller of a rare stamp to extract the full consumer surplus of a collector who has an idiosyncratic preference for this particular stamp.<sup>67</sup> Incidentally, a welfare consequentialist approach would not be able to determine voluntary consent either, because overcharged consumers apparently find it beneficial to remain in the market.<sup>68</sup>

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64 See I Berlin, 'Two concepts of liberty' in I Berlin, *Four Essays On Liberty* (Oxford, OUP, 1969); A Sen, 'Equality of What?' in S McMurrin (ed), *Tanner Lectures on Human Values, Volume 1* (Cambridge, CUP, 1980).

65 See Dietsch and Rixen (n 39) 152–153.

66 Incidentally, this autonomy-based approach again requires external normative standards, namely the variables that measure 'autonomy'. Hence, this test is not truly 'empirical': see Stewart (n 60) 214.

67 Trebilcock (n 33) 92.

68 Trebilcock (n 33) 93.

These insights can be applied analogously to the world of international tax, where the OECD is the dominant ‘supplier’ of treaty provisions and the self-proclaimed ‘market leader in developing [tax] standards and guidelines’.<sup>69</sup> The OECD Model Convention is in fact so dominant that it also affects treaties between non-OECD countries, and its influence clearly trumps that of the alternative UN Model.<sup>70</sup> OECD countries together own 70% of worldwide outward FDI stocks,<sup>71</sup> such that a capital-poor nation that aims to attract investments by joining a tax treaty network needs to conclude treaties with multiple OECD countries – by definition, because one treaty is not a network. Although the OECD itself is not a cartel, each OECD country will find itself in a monopoly or oligopoly position vis-à-vis this capital-poor nation.

Morally, an unfavourable treaty outcome that would result from the OECD’s monopoly position seems more problematic than the abovementioned example of asking a high price for a rare stamp. Unfortunately, Trebilcock’s own approach is unhelpful here, because it focusses on ‘situational monopolies (...) where (...) transaction-specific market power is exploited opportunistically to extract commitments in return for quid pro quos that have a zero or negative social value, or for quid pro quos, which, while socially positive, cannot in the normal competitive environment surrounding the type of transaction in question justify anything like the commitment extracted for them’.<sup>72</sup> A semantical problem is that the OECD’s position is more accurately described as a *structural* monopoly, which Trebilcock proposes to remit to antitrust laws – and those laws do not exist in international taxation. Nevertheless, when using his criterion for situational monopolies, the question would be whether the ‘price’ paid by low-income countries in terms of treaty conditions is a competitive market price.<sup>73</sup> Barring the question how to define market prices in a tax treaty context, this seems to imply that low-income countries with less attractive investment opportunities should accept lower quid pro quos, that is, poorer treaty conditions. We find this problematic. It is questionable in the first place whether high-income countries can fully abdicate responsibility and point at international redistributive duties to alleviate unequal bargaining positions. But even when

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69 OECD, ‘The OECD’s Current Tax Agenda’ (2008) 74–75, as cited in A Christians, ‘Taxation in a Time of Crisis: Policy Leadership from the OECD to the G20’ (2010) 5 *Northwestern Journal of Law & Social Policy* 19. Illustrative is UNGA Res 77/244 (30 December 2022), [n]oting also the work of the [OECD/G20] Inclusive Framework on [BEPS]’ and ‘[recognizing] the timeliness and importance of strengthening international tax cooperation to make it fully inclusive (...)’ – a call that seems directed at the OECD.

70 P Pistone, ‘General Report’ in M Lang and others (eds), *The Impact of the OECD and UN Model Conventions on Bilateral Tax Treaties* (Cambridge, CUP, 2014).

71 OECD, ‘FDI stocks (indicator)’ (2023). DOI: 10.1787/80eca1f9-en (accessed on 27 June 2023).

72 Trebilcock (n 33) 101.

73 This follows from the latter component of his criterion. We assume that treaties are socially positive as we exclude the issue of externalities from our analysis of coercion.

accepting that argument, one would use treaty outcomes as a standard to determine low-income countries' voluntary consent.<sup>74</sup> That seems to run into the same problem that welfare consequentialist theories face, namely that prices and voluntariness are simply two different things.

We examine the issue of market prices in more detail using Gordley's approach, who aims to solve the problem of unequal bargaining positions by invoking a principle of equality in exchange.<sup>75</sup> According to Gordley, the value of performances exchanged in contracts should be equal, because self-interested parties should have no mutually redistributive intentions. Resultingly, when the value of performances exchanged is unequal, one can infer that one party is weaker than the other, and this should be a ground for contractual invalidation or revision.<sup>76</sup> We highlight this approach because it bears resemblance to Christians and Van Apeldoorn's Equal Benefit Principle for international tax law. That principle 'holds that having undertaken to cooperate with each other, states are entitled to equally share in the (net) benefits produced by such cooperation.'<sup>77</sup> These net gains discount for the gains a country would have had, had its inputs been put to use in a solely domestic situation (that is, for opportunity costs).<sup>78</sup> The argument recalls the Musgraves' proposed criterion of national neutrality of FDI.<sup>79</sup> A national community is only better off by engaging in FDI rather than domestic investment if the return to FDI exceeds the domestic return foregone, that is: the sum of (1) all private benefits and (2) the tax revenue foregone by reduced domestic investment. 'Equal benefit' then applies to the excess return.

To see the consequences of both approaches, consider the following example. High-income country A concludes treaties with low-income countries B and C, which both lack FDI. Profit margins on investments in B are high; those in C are low, for instance because C's natural resources are expensive to mine. In both countries, marginal returns to investments diminish with the aggregate amount of FDI. Barring tax revenues, each unit of investment would yield equal benefits for B and C in terms of positive domestic spill-overs from human and financial capital inflow, which both countries need. Investments in both countries would not be profitable without a tax treaty. As B and C have limited resources to tackle corporate tax BEPS strategies, both would prefer to levy withholding taxes on returns to investment income. Under the assumption that the worldwide allocation of investments equalises expected after-tax returns to capital, country-A investors will first invest in B, and once the marginal profitability of additional

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74 See Stewart, (n 60) 230.

75 J Gordley, 'Equality in Exchange' (1981) 69 *California Law Review* 1587.

76 Gordley (n 75).

77 A Christians and L van Apeldoorn, *Tax Cooperation in an Unjust World* (Oxford, OUP, 2021) 12.

78 Christians and Van Apeldoorn (n 77) 14, 29.

79 RA Musgrave and PB Musgrave, *Public Finance in Theory and Practice* (New York, McGraw Hill, 1973).



investments has declined to the level that C offers, they will invest equally in both countries. Hence, B trumps C in the amount of FDI; in the total investment income earned by A's investors; and in the tax revenues on this income raised by A's government.

Like Trebilcock's approach, Gordley's principle of equality in exchange would prescribe that the value of what B offers A (investment income and resident-country tax revenues on this income) should equal the value of what A offers B (giving up taxing rights). As B's offer is rather attractive, so should the treaty conditions offered by A. By contrast, A would be allowed to force an unfavourable treaty upon C, because C has little to offer.

Under Christians and Van Apeldoorn's Equal Benefit Principle, all countries would first have to account for the domestic opportunity costs of their inputs. As gross benefits are a function of capital and labour, and B and C are fully dependent on foreign capital, we assume for the sake of simplicity that their domestic opportunity costs equal zero, such that their treaties' gross benefits equal net benefits. By contrast, gross returns on country-C investments earned by country-A investors are only marginally higher than those investors' opportunity costs, such that net returns approach zero.<sup>80</sup> If A taxes domestic and foreign investment income equally, A's net tax-revenue benefit also approaches zero.<sup>81</sup> Because nearly all net benefits produced by cooperation between A and C accrue to C, C would have share those benefits with A, for instance by giving up taxing rights in a treaty, or even through compensatory payments. When the net gains of cooperation are shared multilaterally, some of A's relatively high net benefit earned by investing in B would be redistributed to country C. That seems fair, but the problem remains that C would need to give up a large portion of its own net gains from FDI, simply because its domestic opportunity costs equal zero.

All of those outcomes, especially the latter, seem highly unfair. Invoking a less procedural and more substantive conception of fairness, one might at least want to give B and C equal amounts of taxing rights, or even argue that C deserves more taxing rights than B. Recall that there will be fewer investors in C, such that positive spill-overs from human and financial capital will be lower. Hence, C will be unable to reap substantial benefits from its natural resources. Withholding tax revenues might compensate this to some extent, while not necessarily reducing FDI or the income earned by country-A investors. This idea resembles the proposal of Infanti, who takes up the Musgraves' point that tax treaties could be used for tailor-made redistribution of taxing rights between rich and poor countries,<sup>82</sup> arguing

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80 Net returns will not be negative, because otherwise the investors would have stayed home.

81 Incidentally, resident-country tax benefits do not affect this country's aggregate benefits anyway because they are paid by residents. Source-country taxation does make the source country better off at the expense of the resident country: Christians and Van Apeldoorn (n 77) 31.

82 RA Musgrave and PB Musgrave, 'Inter-nation equity' in RM Bird and JG Head (eds), *Modern Fiscal Issues: Essays in Honour of Carl S. Shoup* (Toronto, University of Toronto Press, 1972).

that such treaties can be made instruments for development aid.<sup>83</sup> That proposal remains at a considerable distance from current tax treaty practice; it is highly consequentialist, overriding high-income countries' voluntary consent to a treaty if that treaty runs counter to the goal of developing aid. However, this section has made clear that the procedural accounts of fairness that can be derived from contract theory also provide unsatisfactory solutions to inequalities in bargaining positions.

## 5.5 ASYMMETRIC INFORMATION

The question whether parties transact voluntarily is closely connected to the question whether they are adequately informed about the content and consequences of the agreements they enter into. Besides voluntary consent, informed consent is a key assumption in the theory of contracts.<sup>84</sup> Information imperfections may affect both parties (symmetric) or one party (asymmetric). As we have already noted, low-income countries often have limited resources for tax treaty negotiations, they might lack the expertise to deal with the tax-technical issues of treaties, and they are confronted with a model treaty and its commentary drafted by foreign, OECD-based experts. OECD countries generally do not face these problems. Therefore, this section will focus on asymmetric information imperfections.

Defining 'inadequate information' is perhaps even harder than defining 'coercion'. Unlike coercion, which can be regarded as simply befalling a contracting party, the adequacy or inadequacy of information is endogenous: it is a function of the (costly) effort that a party puts into acquiring additional information to better understand the content and consequences of the contracting options available.<sup>85</sup> Some nearly unanswerable questions arise: how much effort should a party reasonably put in acquiring additional information; how to deal with parties who have limited resources for their search; and what role should the better-informed party play?

From a liberal perspective, and invoking a positive conception of autonomy, one could argue that contracting parties should have sufficient resources for gathering information so that they are capable to make informed choices regarding the options available to them.<sup>86</sup> However, as with the issues of externalities and coercion, invoking some conception of autonomy does not answer the overarching question as to when someone is

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83 A Infanti, 'Internation Equity and Human Development' in Y Brauner and M Stewart (eds), *Tax, Law and Development* (Cheltenham, Edward Elgar, 2013).

84 eg BH Bix, 'Contracts' in F Miller and A Wertheimer (eds), *The Ethics of Consent: Theory and Practice* (Oxford, OUP, 2009).

85 KL Scheppele, *Legal Secrets: Equality and Efficiency in the Common Law* (Chicago, University of Chicago Press, 1988) 25, as cited in Trebilcock (n 33) 102.

86 See n 64.



autonomous – in this case: how much information does ‘informed consent’ require?

Welfare consequentialist approaches have no clear answer either because they run into what Trebilcock calls the ‘Paretian dilemma’.<sup>87</sup> On the one hand, if the relevant welfare-based criterion is that both parties feel better off when they sign a contract, there would be informed consent in nearly every case. On the other, if parties should experience ex-post at least the welfare improvement they expected ex-ante, every minor negative deviation from their expectations would negate informed consent, such that almost no contract would be upheld.

Recalling our previous observations on market prices, we would add that using treaty outcomes as a normative standard may be morally problematic and that even a marginal increase in either autonomy or welfare does not necessarily indicate that a contracting party had access to adequate information. For these reasons, we find Gordley’s principle of equality in exchange, examined in the previous section, equally unsuited to determine informed consent as it is to determine voluntary consent.<sup>88</sup>

In the remainder of this section, we do not aim to provide a comprehensive theory of voluntary consent, but will instead discuss two types of information asymmetries that bear particular resemblance to the world of international tax law: standard-form contracts, and inequalities in resources for acquiring information.

Standard form contracts have the reputation of expressing inequality: a large player selling the consumer a product on the basis of terms and conditions that take away all consumer rights. Consumers will not read standard form contracts and if they do, they will not understand their implications. Moreover, renegotiating standard form contracts may be very time-consuming and often even impossible: their existence implies a take-it-or-leave-it context. Tax treaty negotiations tend to produce standard form treaties, based on the OECD Model Tax Convention and the Commentaries on this model.<sup>89</sup> Standard form treaties may serve the useful purpose of reducing transaction costs – for instance, it would make little sense to renegotiate concepts like ‘permanent establishment’ and ‘principal purpose’ in every new treaty without acknowledging that such concepts have a tradition. Arguably, the repeated use of certain OECD standards makes treaty negotiations easier and can hence partially alleviate problems of information asymmetry. Nevertheless, the risk of a take-it-or-leave-it situation is evident, especially because there exist imbalances in power, knowledge and expertise between OECD and low-income countries, respectively.<sup>90</sup>

Trebilcock argues that the existence of take-it-or-leave-it contracts is not necessarily problematic, as long as there is ‘a margin of informed,

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87 Trebilcock (n 33) 103.

88 See text to n 76.

89 Brauner (n 2) 35–38; Pistone (n 70).

90 Brauner (n 19) 59.

sophisticated, and aggressive consumers', who discipline the market by either renegotiating contract terms or switching to suppliers who offer more favourable contracts.<sup>91</sup> But as explained in the previous section, the 'market' for tax treaties does not work this way. Joining a treaty network entails closing treaties with not one, but multiple countries, such that attractive, capital-rich treaty partners find themselves in a monopoly or oligopoly position vis-à-vis capital-importing nations. This position could enable them to dictate treaty content, as signalled by the dominance of the OECD Model Convention relative to the UN Model Convention.<sup>92</sup> The issue of asymmetric information thus intersects with the issue of coercion, which, as we have concluded, is difficult to solve by invoking contract theory.

In the current world of bilateral treaties, however, contract theory does offer one pragmatic solution, namely *contra proferendum* treaty interpretation – that is, interpretation of a standard form term against the party who supplied it.<sup>93</sup> This would prevent some of the adverse consequences of unclear treaty provisions for countries which are not acquainted with OECD interpretation traditions. An advantage of this approach is that it avoids the abovementioned discussions about voluntariness: one does not require the exact definition of 'informed consent' to observe that the party responsible for drafting a standard-form contract is in a relatively strong position. Still, as noted by Brauner, the OECD/non-OECD distinction does not always capture existing imbalances in power and expertise, even when a treaty is based on the OECD Model – think of a treaty between Slovenia and China.<sup>94</sup> Moreover, solutions in the phase of treaty interpretation only work when there is ex-post unclarity, and not when treaty provisions are clear but nevertheless unreasonable.

Insofar those unreasonable provisions result from information asymmetries, we should more closely look at the preceding negotiation process. As mentioned, a relevant issue is resource inequalities, manifested in countries' divergent levels of tax-technical expertise and hence their capacity to acquire relevant information for treaty negotiations. When a country lacks such expertise, it may for instance not be capable of foreseeing whether a treaty will intensify the use of BEPS strategies by taxpayers – especially when the treaty partner is a tax planning hub. A more concrete example of how a lack of expertise may lead to adverse consequences – albeit in a multilateral setting – is the concessions obtained by low-income countries in the negotiations on Pillar 2. One important gain was the recognition of a Qualifying Minimum Domestic Top-Up Tax (QMDTT). It allows source countries to tax the amount that would otherwise be due by the Ultimate Parent Entity under the Income Inclusion Rule (IIR). The QMDTT therefore reverses the precedence of the residence state as proposed in the original

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91 Trebilcock (n 33) 120.

92 Pistone (n 70).

93 eg Principles of European Contract Law article 5:103.

94 Brauner (n 19) 61.

Pillar 2 design.<sup>95</sup> This is potentially a large success for low-income countries. However, low-income countries also obtained a second concession: a Substance-Based Income Exclusion (SBIE). Called ‘carve-outs’ in previous drafts of Pillar 2, the SBIE allows source states to have low or zero tax rates on profits from real investments (in the form of an imputed return to payroll and tangible assets which need not meet the 15 per cent test). On its own merits, the SBIE allows low-income countries to attract real investment on favourable tax conditions. But in fact, it may only reduce the amount of QMDTT that they can collect (as it is easier for qualifying taxpayers to meet the 15 per cent test when a substantial part of their profits is not taken into account).<sup>96</sup> One wonders how this surprising result has come about.

Two problems arise in dealing with bilateral information asymmetries resulting from resource inequalities. Perhaps the easiest of the two is a problem of definition: what level of resources do we consider adequate to acquire information? This problem is related to the overarching question explored above: how much information does ‘informed consent’ require? The latter question is nearly unanswerable, but a pragmatic solution could be to use some index of development or economic power (for instance GDP) as a proxy for a country’s capability to acquire information. This avoids the need to draw a crude line to separate voluntary decisions from involuntary decisions; instead, the differential between the two respective treaty partners in terms of the particular proxy variable would indicate the extent to which the stronger/richer partner should take into account the interests of the weaker/poorer partner.

But then the second problem arises: how to do so? It is one thing to determine whether the poorer country knew which treaty provisions would have served its interests best, but once we conclude that it did not sufficiently know, it is quite another to determine what is in fact ‘best’. To avoid undemocratic and imperialistic solutions, we could limit ourselves to relatively uncontroversial provisions, such as the right to levy withholding taxes – it is clearly best for low-income countries to retain that right, as the UN Model Convention expresses on behalf of those countries. However, more complex solutions involve more detailed political choices, and moreover, all treaty provisions that require considerable technical skill and specialised legal knowledge may be more problematic especially for understaffed tax administrations – hence, we run into the very problem that we tried to solve.<sup>97</sup> For example, provisions against treaty shopping can in principle help low-income countries to tackle withholding tax avoidance through shell companies, but may require considerable specialised effort

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95 MP Devereux, J Vella and H Wardell-Burrows, ‘Pillar 2: Rule order, incentives, and tax competition’ (2022) Oxford University Centre for Business Taxation Policy Brief.

96 MP Devereux, J Paraknewitz and M Simmler, ‘Empirical evidence on the global minimum tax: what is a critical mass and how large is the substance-based income exclusion?’ (2023) 44 *Fiscal Studies* 9.

97 See International Monetary Fund (n 11).

– and not always with much success. Principle Purpose Tests and Limitations on Benefits are ‘rich countries’ inventions, developed for tax administrations with adequate experience in international taxation. It is doubtful whether multilateral solutions would be able to alleviate the remaining information asymmetries. At least, they might avoid value imperialism when countries have an equal voice in their design. But again, the downside would be a significant reduction in countries’ autonomy to conclude treaties which best fit their circumstances.

## 5.6 CONCLUSION

This chapter has examined discussions on fair tax base distribution in bilateral tax treaties through the lens of contract theory. Contract theory appears useful to categorise what currently makes the international tax system unfair: fairness issues boil down to contracting problems of externalities, coercion, and asymmetric information. However, contract theory does not provide a solution for these problems that can be applied in a bilateral setting.

One reason is that neither of the two main philosophical theories that underpin contract freedom – liberalism and welfare consequentialism – is able to provide clear standards to deal with the interests of third parties, and to determine whether a party’s consent to an agreement is voluntary and informed. Another reason is that in a tax treaty context, all three examined problems intersect, and in the end boil down to tax competition. For instance, one might try to solve information asymmetries by giving low-income countries tax-technical assistance to better understand the content and consequences of a treaty, but then the problem remains that this country is coerced into signing a treaty based on OECD standards, as a result of the powerful bargaining position of OECD countries. In turn, one could adjust the treaty’s provisions to make it more favourable for the low-income country in question, but then the problem arises that its neighbouring countries might have signed less favourable treaties which better facilitate taxpayers’ BEPS strategies, and hence attract more FDI.

These conclusions tentatively suggest that we should move toward a multilateral system based on global minimum standards for treaty content, or maybe even a true multilateral treaty. However, this solution would significantly reduce countries’ autonomy (that is, contract freedom) to draft treaties that fit their particular circumstances. We have shown that theories of unilateral tax justice are unable to provide satisfactory normative criteria to guide the balancing act between national autonomy and foreign interests in a context of bilateral tax treaties. We hope that our analysis can serve as a starting point for further normative work on this issue.



This thesis has examined from three perspectives the challenges posed by globalisation to national tax policy making. Chapter 2 has explored the current nature of the fiscal social contract through a Schumpeterian lens; chapters 3 and 4 have empirically shown how globalisation affects tax systems; and chapter 5 has normatively analysed how countries should deal with the effects of their tax policies on other nations, in the specific context of bilateral tax treaties. This final chapter aims to synthesise the findings of all chapters.

As all chapters have been published independently and have made specific contributions to different strands of literature, they do not answer one single research question. However, they are connected by three overarching themes: methodological diversity; dynamism; and democracy. Section 6.1 will discuss the relevance of methodological diversity in tax research. It will re-emphasise the point made in chapters 1 and 2 that taxation is essentially a cultural phenomenon. Therefore, an understanding of taxation requires an understanding of society that transcends the boundaries of law, economics, philosophy, political science and public administration. Section 6.2 will more specifically address the findings of the four chapters and connect them to the recurring themes of dynamism and democracy.

### 6.1 MULTIDISCIPLINARY TAX SCHOLARSHIP AND FISCAL SOCIOLOGY

Taxes provide the main source of funding for the modern state, which is the bedrock of our social order. The modern state shapes our lives, identities, culture and well-being through government policies, expenditures and the legal system as a whole. But rather than financing its expenditures in a socially and economically neutral way, as some theories might presume or prescribe, taxes themselves also play an important role in bringing about societal consequences. To give some examples from all four substantive chapters of this thesis: nineteenth-century fiscal innovations paved the way for innovative forms of production by making business taxation more neutral to technology; the elimination of double taxation through bilateral treaties may or may not foster international trade and economic growth; the composition of government revenues affects labour market outcomes; and top personal income tax rates play a crucial role in shaping pre-tax income distributions. Joseph Schumpeter even went so far as to assert that '[i]n some historical periods the immediate formative influence of the fiscal

needs and policy of the state on the development of the economy and with it on all forms of life and all aspects of culture explains practically all the major features of events; in most periods it explains a great deal and there are but a few periods when it explains nothing.<sup>1</sup>

But what Schumpeter found even more important than the formative role of taxation in shaping our societies was its capacity to reflect our social order – as encapsulated in his famous statement that the ‘thunder of history’ can be heard more clearly in the history of state finances than anywhere else.<sup>2</sup> A current example that illustrates his argument on a micro level is the large number of redistributive and instrumentalist tax policies. Their underlying consequentialism not only mirrors our societal view that the government is the main guardian of our material well-being, but each of these policies also individually reflects explicit or implicit societal evaluations of economic choices, cultural phenomena and personal identities. On a macro level, Schumpeter’s own example of how taxation reflects the social order is its non-existence under both feudalism (due to the absence of a state) and socialism (due to the absence of a free market).

His exemplary use of those two extremes mirrors the embeddedness of his thinking in nineteenth-century classical liberalism. The distinction between a free-market economy and a limited public sphere that characterised Schumpeter’s tax state was also a key component of the old liberal model, along civil liberties and an aristocratic form of democracy. That model was under threat in the early twentieth century, both economically and culturally, as suffrage was extended, government intervention in the private sector increased, and mass political movements arose. In Austria, not only the classical liberal model but also the Habsburg Empire broke down. The perception of a collapsing civilisation culminated in the devastations of WWI that ended the Belle Époque.

It is in this context that we should understand the work of Austrian economists like Schumpeter.<sup>3</sup> Their primary object of study was not economics but culture: they aimed to understand the reasons for the demise of their social order. They essentially practiced a sociology that was interpretive rather than empirical, qualitative rather than quantitative, aiming for a ‘Verstehen’ rather than an ‘Erklären’.<sup>4</sup> That required a broad view, transcending the boundaries of economics, law, history, sociology and political science. Although Rudolph Goldscheid only coined the term ‘fis-

1 JA Schumpeter, ‘The Crisis of the Tax State’ in R Swedberg (ed), *The Economics and Sociology of Capitalism* (Princeton, Princeton University Press, 1991) 100.

2 Ibid 101.

3 E Dekker, ‘Left luggage: finding the relevant context of Austrian Economics’ (2016) 29 *Review of Austrian Economics* 103. See also E Dekker, *The Viennese Students of Civilization* (Cambridge, Cambridge University Press, 2016).

4 The latter dichotomy is related to the thinking of Wilhelm Dilthey, who emphasised the importance of interpretive and context-sensitive research in the humanities, distinguishing this method from the quantitative and experimental methods of the natural sciences. The concept of Verstehen was introduced into sociology by Weber and Simmel.

cal sociology' in 1917, the application of this broad sociological method to public finances had a long tradition among the scholars of classical political economy such as Adam Smith;<sup>5</sup> and also the social theorists of the nineteenth century, such as Karl Marx, paid much attention to taxation.<sup>6</sup> But shortly after Schumpeter's *Crisis of the Tax State* was published, this broad view fell out of fashion in a trend of academic specialisation, only to fully revive again in the twenty-first century. As stated in 2009 by Martin *et al.*, '[t]he new fiscal sociology promises to shed light on all of the classic questions raised by Schumpeter – the social sources of tax systems, the determinants of taxpayer consent, and the social and cultural consequences of taxation.'<sup>7</sup>

Chapter 1 has highlighted some of those social and cultural consequences. Those illustrate that ostensibly neutral tax law involves many political choices regarding the definitions of 'public interest' and 'moral equality of persons' in our fiscal social contract. That neither implies that tax law equates politics or philosophy, nor that doctrinal legal research is unimportant. For one thing, analyses of the values and choices surrounding law are rooted in an understanding of the law itself. A normative judgement of possible legal provisions preventing income tax avoidance through corporations, for instance, requires a meticulous analysis of capital gains tax regimes. Second and more obvious: lawyers will play an important role in adapting our tax systems to the challenges of the twenty-first century.

However, chapter 1 has argued and chapter 5 has shown that positive legal research should at least be accompanied by normative research concerning the values and choices surrounding it. Moreover, any such normative evaluation of how tax law affects and reflects social and economic conditions requires empirical knowledge of those real-world effects. For instance, the question 'what is the appropriate global response to tax competition' is logically preceded by: 'what are the actual effects of tax competition'.

Therefore, this thesis has made two empirical contributions (chapters 3 and 4) and one normative contribution (chapter 5) to the analysis of fiscal responses to globalisation. Although its multidisciplinary approach is inspired by the old fiscal sociology as applied by Schumpeter (see chapter 2), and although it contains many examples of the connection between taxation and culture or politics, it has not aimed for a full 'Verstehen' in the way the Austrian economists did. One difference is that chapters 3 and 4 have embraced rather than rejected the empirical method of economic research. Furthermore, the research questions of all chapters were aimed at painting a broad picture of challenges to the fiscal social contract, and not

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5 See B Moran, 'Adam Smith and the Search for an Ideal Tax System' in IW Martin, AK Mehrotra and M Prasad (eds), *The New Fiscal Sociology: Taxation in Comparative and Historical Perspective* (Cambridge, Cambridge University Press, 2009) 5.

6 IW Martin, AK Mehrotra and M Prasad, 'The Thunder of History: The Origins and Development of the New Fiscal Sociology' in Martin, Mehrotra and Prasad (n 5).

7 Ibid 14.



at studying the cultural and social aspects of taxation on a micro level. An example is how chapter 3 controlled for the redistributive preferences of electorates in its estimation of the determinants of top personal income tax rates. As explained in the theoretical section of chapter 3, taxpayers' preferences depend on both self-interest and altruistic values, and both in turn are shaped by cultural factors (see also chapter 2). These are complex sociological processes that could fill an entire thesis,<sup>8</sup> but the regression models in chapter 3 could only include a limited number of variables in order to prevent overspecification. Together with the fact that regression variables can never fully capture all relevant details of politics and culture in the first place, this renders the analyses of both chapters 3 and 4 too coarse to speak of a detailed *Verstehen* of the politics of taxation.<sup>9</sup>

However, both chapters did elucidate the relative importance of many determinants of tax policy that are often studied separately. Budget deficits, unemployment and corporatist decision making are regarded as important factors in tax policy making, but chapter 3 shows that their influence is overshadowed by tax competition when it comes to top rate setting. And whereas qualitative studies have demonstrated a clear link between corporate and personal income tax rates with a mediating effect of domestic politics, chapter 3 finds no quantitative evidence of this mediating effect. By contrast, chapter 4 shows that the influence of government ideology on tax mix composition has increased over the years. Information regarding the relative influence of these and other factors not only contributes to a fiscal-sociological understanding of the relation between taxes, the state and society; it is also directly relevant to real-world tax reforms. For instance, the government memoranda referred to in chapter 3 use similar empirical evidence to propose adaptations of dividend tax regimes and capital gains tax regimes. In addition, the findings of chapters 3 and 4 speak to various non-legal strands of literature, such as the literature on European welfare state convergence (chapter 4).

The multidisciplinary contribution of chapter 5 is that it connects several philosophical, and law and economics perspectives on contract theory and applies them in a context of bilateral tax treaties. It shows that many of these perspectives base their normative conclusions on a pursuit of either autonomy or welfare – values that are not only invoked frequently in discussions on international tax justice, but also in national tax policy debates.

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8 For an overview, see S Berens and M Gelepithis, 'What do People Want? Explaining Voter Tax Preferences' in L Hakelberg and L Seelkopf (eds), *Handbook on the Politics of Taxation* (Cheltenham, Edward Elgar Publishing, 2021).

9 The choice for an empirical analysis of selected variables was made deliberately for the reasons outlined in chapter 1. Thus, this paragraph should not be read as an apology for insufficiently following Schumpeter's methodological approach (which, incidentally, might not meet today's standards of scientific rigour). Rather, it might be read as an observation underlining that this dissertation does not claim to offer an all-encompassing investigation of the relation between tax law, society and democracy – which no single fiscal sociological work can provide.

After showing that these theories are incommensurable and that neither provides a coherent standard of fairness in the first place, chapter 5 ends with a call for more normative work on fair tax base distribution in treaties. Arguably, that normative work would remain relevant to some extent when a system of formulary apportionment would be introduced.

## 6.2 DYNAMISM AND DEMOCRACY

Schumpeter's call for an investigation into society and politics through the lens of the public finances, from a broad, multidisciplinary perspective that was characteristic of the Austrian economists, is only one part of his heritage. As argued in chapter 2, another part of his heritage is his view of society, the economy and the tax system as dynamic and ever-evolving phenomena.

### 6.2.1 Empirical conclusions

#### *Chapter 4: convergence of tax mixes*

The two empirical chapters in this thesis have quantified some of those dynamics. The chapter that has most literally done so is chapter 4, which studied the development and convergence of tax mixes. It has asked: *what are the determinants of tax mix composition in OECD countries; do the tax mixes of OECD countries converge; and if they do so, which factors shape the direction of convergence?*

Tax mixes in OECD countries outside the CEE region have been converging since the 1980s, and chapter 4 has shown that they have continued to do so through the 2010s, roughly at the same tempo. There is a continuous shift in countries' tax mixes towards general consumption tax revenues. However, a downward trend in personal income tax revenues has halted, and the revenue share of social security contributions is also relatively stable. This contrasts with the predictions of the early studies on tax competition, namely that competitive pressure would force countries to rely increasingly on regressive revenue sources.

Chapter 4 contributes to the existing literature by not only estimating the potential determinants of the revenue shares of different taxes, but also testing the conditionality of the convergence process. Its regression results show that while economic openness has a long-run negative effect on total taxation, it is unable to explain cross-country differences in both tax mix composition and tax mix convergence. The same applies for several other proxies of tax competition (capital openness, FDI, and the corporate income tax rate). Again, this is a finding that contrasts with the hypothesis that competitive pressure reduces governments' leeway in tax policy making. What also negates that hypothesis is the surprising increase over time in

the influence of government ideology on the composition of government revenues.

Chapter 4 has found that the main conditional factor behind tax mix convergence is EU Membership. That finding is not surprising given the many different channels through which the EU may affect domestic tax policy. But the insignificant effects of variables related to tax competition indicates that the supposed increase of competitive pressure within the Single Market is not one of those channels. Whether emulation of tax reforms by like-minded governments is instead responsible for the continuing convergence of tax mixes in (mainly Western) Europe could be a topic of a further study applying a spatial approach.

Within the EU, CEE countries constitute a separate convergence club with lower tax burdens and more regressive tax mixes. Some of these countries have implemented low and flat statutory tax rates that apply to both corporate and personal income. It has been highlighted in earlier studies that low and flat income taxes not only reduce the redistributive capacity of the tax system, but also leave little budgetary room for tax cuts on low incomes.<sup>10</sup> This may have adverse effects on employment.<sup>11</sup> This is an illustration of how the tax mix can be a relevant variable in the literature on European economic and welfare state convergence, which has mainly focussed on government expenditures instead. Chapter 4 was partially intended as a contribution to that literature.

Elucidating the underlying reasons for the distinct tax policies of CEE countries fell outside the scope of chapter 4. Arguably, the 'neoliberal' reforms in many of those countries are good examples of how taxation reflects and shapes societal developments (see chapter 2). Besides political, cultural and institutional factors, the need to attract capital to their post-communist economies could have played a role, although that need should have waned as they caught up economically with the rest of Europe. Those reforms remain a fruitful area for further research.

### *Chapter 3: determinants of top personal income tax rates*

Although having a sizable share of personal income tax revenues in the tax mix may be a necessary condition for a redistributive tax system, it is obviously not a sufficient condition. The redistributive capacity of the personal income tax is determined by its specific structure and can be measured in various ways. An important indicator is the top statutory rate. Chapter 3 has asked: *what are the political economic determinants of OECD countries' top*

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10 S Ganghof and P Genschel, 'Taxation and democracy in the EU' (2008) 15 *Journal of European Public Policy* 58, 69; FT Zoutman, B Jacobs and ELW Jongen, 'Optimal Redistributive Taxes and Redistributive Preferences in the Netherlands (2013) <https://jacobs73.home.xs4all.nl/OTP.pdf>.

11 A Kemmerling, 'Tax mixes, welfare states and employment: tracking diverging vulnerabilities' (2005) 12 *Journal of European Public Policy* 1.

*statutory personal income tax rate setting; to what extent should corporate tax competition be identified as the cause of the declined top personal income tax rates of OECD countries; and insofar low corporate tax rates exert downward pressure on personal income tax rates, can governments mitigate that pressure through shareholder taxation?*

The findings of chapter 3 contrast with those of chapter 4 in the sense that government ideology seems surprisingly irrelevant in governments' top rate setting, whereas the main driving factor appears to be tax competition. Chapter 3 has confirmed the so-called backstop hypothesis, according to which the corporate tax preserves the integrity of the tax system by preventing personal income tax avoidance through corporations. It has done so by showing that declining corporate tax rates pull down top personal tax rates. Granger causality tests indicate that the relation between both rates is unidirectional: prior personal tax rate setting does not affect corporate tax policy. It is also unlikely that both rates are driven down simultaneously by a third factor, such as emulation of a US neoliberal reform model, no evidence of which was found.

The implication of these results is that top personal income tax rates remain under pressure as corporate tax rates decline towards the recently introduced minimum level of 15%. This pressure is not directly visible in the trend of OECD countries' top rates: those are declining very slowly since the late 2010s, after a remarkable increase following the 2008 financial crisis. Irrespective of their ideologies, governments apparently find the leeway to uphold progressive income taxation in the presence of income shifting toward the corporate form. What drives them is probably a cultural factor: in the regression models of chapter 3, the long-term redistributive preferences of electorates stand out as one of the few variables with a significantly positive effect on the top rate. When corporate tax rates decline further, however, the result is a further erosion of tax system integrity. Furthermore, the 70% top rates witnessed in the 1970s and 1980s, even if desired by parts of the electorate, seem out of the question.

One of the research questions of chapter 3 was whether governments can mitigate the downward pull of the corporate tax rate on the personal tax rate by increasing shareholder taxation. Indeed, political debates concerning equal taxation of labour and capital appear to centre on the alignment of effective tax burdens on wage and shareholder incomes.<sup>12</sup> The average dividend tax burden has recently increased in the OECD, presumably facilitated by the successful combat of illegal capital flight.<sup>13</sup> However, chapter 3 has shown that a dividend tax increase does not improve the integrity of the income tax system. Its regression results indicate that the combined

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12 For shareholders, that means the combined burden of the corporate tax and shareholder-level dividend or capital gains tax.

13 L Ahrens, F Bothner, L Hakelberg and T Rixen, 'New Room to Maneuver? National Tax Policy under Increasing Financial Transparency' (2020) *Socio-Economic Review*, <https://doi.org/10.1093/ser/mwaa007>.

corporate-level and shareholder-level tax burden on dividend income is irrelevant in governments' top personal income tax rate setting. Whether or not dividend and wage tax burdens are aligned, the only driving factor of income tax cuts remains the corporate tax rate. A likely reason is the possibility for owner-managers to retain income inside their corporations and finance private consumption through loans.

No internationally comparable data are available that describe legal provisions preventing such loans; and the same applies for capital gains tax regimes, which owner-managers can exploit instead of distributing dividends. Compiling such data sets is an opportunity for further research in both economics and comparative tax law. Another fruitful area of future research is the political economy of special income tax regimes aimed at expatriates. Those play an important role in the international competition for highly-skilled and successful individuals, and they are increasing in number. On the one hand, those regimes further decrease income redistribution; on the other, they reduce any competitive pressure on the general rate of the income tax. Indeed, the insignificant relation between country size and top rate setting found in chapter 3 is a tentative indication that there is no direct competition via top rates. But the importance of general and targeted personal income tax competition for successful individuals, relative to competition via wealth, capital gains and inheritance tax regimes, remains unclear.

### 6.2.2 Normative and explorative conclusions

#### *Chapter 2: Schumpeter's Crisis of the Tax State*

The findings of chapter 3 fit into chapter 2's framing of the income tax as a twentieth-century phenomenon. Its grounding in a single accounting system that is applied across an entire jurisdiction rendered the income tax a logical and efficient replacement of several nineteenth-century business and consumption taxes. One underlying reason was the rapid pace of technological developments, which made some existing business tax rules obsolete because they were based on outdated methods of production. Another reason was the emergence of new transportation and communication technologies, which enabled national exchange of taxpayer information and which geographically connected all parts of the national economy – hence putting pressure on local excises. Today, our national income tax systems have become part of the problem themselves, as mobile taxpayers in our globalised economy exploit the differences between them. The OECD's Pillar 2 is rightly celebrated as a successful cooperative effort to reduce the resulting international spill-overs. However, it has required a large amount of consensus building and relies on a meticulous construction of new flows of information exchange between states, in order to achieve a relatively meagre result from the perspective of chapter 3: a 15% corporate income tax rate that is not enough to backstop a steeply progressive per-

sonal income tax. A decline of corporate tax rates towards this minimum may have serious consequences for income redistribution and for pre-tax income inequality.

Chapter 2 has regarded this issue as a symptom of a bigger problem: a world where a subset of mobile taxpayers is losing its connection to national communities. Many of those taxpayers are multinational entities. The international competition for these entities, their activities and their paper profits constitutes the primary challenge to today's tax systems. The declining progressivity of the personal income tax is only an indirect result of this. But jurisdictions also bid for mobile, successful individuals. Special income tax regimes for expatriates are just one channel, and evidence about their effects and magnitude is scarce. The political economies of wealth tax competition, capital gains tax competition and inheritance tax competition are also unknown. The result of the increasing mobility of cosmopolitan elites is that communities are becoming more tangible and that place-based identities are eroding. This coincides with the increasing urbanisation of the world and the clustering of people and firms with complementary specialisms. That development creates new dynamics in the distribution of agglomeration rents, and those rents remain largely untaxed. And on top of these issues confined to the physical world, digitalisation gives rise to new types of interactions, transactions and business models that tax systems are still incapable of addressing.

Chapter 2 has asked: *what can we learn from Joseph Schumpeter's The Crisis of the Tax State regarding today's developed tax states and their underlying social order?* Its lesson is that traditional, static evaluations of the current tax system may not be fully sensitive to the changing context described above. The doctrinal legal focus on the ability of taxes to raise revenues in a rational and internally consistent way can be very useful, but as argued by de Cogan, it does not capture the inextricable link between taxation and public law issues.<sup>14</sup> One such public law issue has been discussed in the introduction of this thesis and is relevant from Schumpeter's fiscal sociological perspective: the way in which taxes construct our societies, culture and identities. Through a fiscal-sociological lens, the changes to our social order described above become examples of how taxation is central to the entire physical and digital world around us. For instance, the issue of agglomeration rents connects tax law with the sociology of city planning: how do we want urbanised regions to look and function? And the taxation of digital transactions is essentially a cultural issue: will we ever levy VAT on transactions in a virtual world because we attach the same cultural value to physical and virtual interactions; or do we merely observe a taxable sum of income once virtual coins are exchanged for traditional currency? As concluded in chapter 2, a lesson that we can draw from Schumpeter's work is that a 'crisis of the tax state' does not materialise as a macrolevel

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14 D de Cogan, *Tax Law, State-building and the Constitution* (Oxford, Hart Publishing, 2020) ch 1.



shock that threatens revenue streams, but instead emerges when tax policy makers have no answer to the changing societal context. Therefore, the Schumpeterian approach to taxation implies that we should not assume some permanent 'system' of tax, evaluated with context-independent benchmarks.

Besides looking at their revenue-raising capacity, another common criterion to assess taxes is the maximisation of a social welfare function, usually through the trichotomy of efficiency, equity and administrability. Whether this criterion is sensitive or insensitive to the societal context of taxation depends on the way it is defined. The standard welfare-economic analysis of taxation aims to raise a predetermined amount of revenues and achieve a politically desired amount of redistribution (this embodies 'equity'), in a way that minimises the sum of efficiency costs caused by economic distortions, and administrative costs caused by, e.g., tax system complexity. An estimation of the revenue-maximising top personal income tax rate by Kotakorpi and Matikka, cited in chapter 3, exemplifies this way of thinking. The authors conclude that the revenue-maximising rate increases once taxpayers with high elasticities of taxable income drop out of the tax base by transforming labour income into corporate income.<sup>15</sup> The authors acknowledge that 'the objective of the government should be to maximize the welfare of citizens, not tax revenue' but argue that 'the revenue-maximizing tax rate provides an upper bound for the welfare-maximizing tax rate: increasing tax rates above the Laffer rate would make no sense, because it would make taxpayers worse off (because of lower disposable income) and also would reduce tax revenue (as we would be on the downward sloping part of the Laffer curve).'<sup>16</sup> In a similar vein, Selin and Simula argue that allowing high-income earners with high labour supply elasticities to shift their labour incomes towards a more lenient corporate tax regime may increase productivity. Therefore, 'giving them a lower tax rate is a good thing, and the government should not necessarily combat income shifting'.<sup>17</sup> In these frameworks, the end-goal of 'welfare' may very well depend on individuals' social preferences regarding the income distribution. But all authors assume that total income must be maximised as long as this preferred distribution can still be realised. That line of reasoning is insensitive to the societal context of taxation in the sense that it leaves no room for the questions whether individuals deserve their lower tax bill in the light of their actions or contributions to society, and whether it is morally acceptable that the tax burdens of those who can incorporate, and those who cannot, will deviate.

The view described above parallels with our changing conception of the

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15 K Kotakorpi and T Matikka, 'Revenue-maximizing Top Earned Income Tax Rate in the Presence of Income-shifting' (2017) 1 *Nordic Tax Journal* 100.

16 Ibid 106.

17 H Selin and L Simula, 'Income Shifting as Income Creation?' (2020) 182 *Journal of Public Economics* 1. <https://doi.org/10.1016/j.jpubeco.2019.104081>.

fiscal social contract under tax competition, as observed by Dagan: 'If our social contract is about the joint promotion of the combined self-interests of all of the state's constituents, and assuming we focus on material resources, the fact that some taxpayers (the mobile and fragmented, in our case) pay less taxes, should not bother us, as long as the state's welfare pie grows, and the slice each of us gets is no smaller than under the alternative (ie if we tried to impose higher taxes on the mobile).'<sup>18</sup>

Of course, 'welfare' and 'equity' can be defined much more broadly; they can harbour more societal goals and more dimensions of fairness than the realisation of some aggregate income distribution. A semantical discussion for further philosophical research is whether the welfare economic method ceases to be welfare economic once it incorporates non-consequentialist reasoning, including desert-based or egalitarian arguments that do not rest solely on individuals' utility.<sup>19</sup> Without exploring that discussion, the point made here is that the definition of 'equity' requires moral reasoning that incorporates the sociological context of tax law. That context goes beyond raising revenues or redistributing an aggregate amount of income. As stated in the introduction of this thesis, tax law depends on the weighing of political values, and those values boil down to our conceptions of the public interest, defined not only economically but also culturally, and to our understanding of moral equality of persons. The moral equality of persons in our current fiscal social contract is strongly connected to democracy. Democracy not only requires that democratic preferences are effectuated, but also that all constituents can participate on an equal footing. The democratic overrepresentation of mobile individuals, therefore, is the real 'crisis of the tax state'.

A fiscal social contract that is based on the moral equality of persons and that adapts itself to its changing societal context should therefore address those who benefit from the globalised social order. Given the inadequacy of the income tax, this may require new forms of taxation based on observable signals of wealth or income-earning capacity, including luxury consumption, land, agglomeration rents or data. However, no future tax will fully solve the problem of international policy spill-overs when it remains grounded in a national social contract. The question what constitutes an acceptable or unacceptable spill-over on other nations will therefore remain relevant.

#### *Chapter 5: international tax fairness in a bilateral setting*

Chapter 5 has approached that question not from the standard perspective

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18 T Dagan, 'Re-imagining Tax Justice in a Globalised World' in D de Cogan and P Harris (eds), *Tax Justice and Tax Law: Understanding Unfairness in Tax Systems* (Oxford, Hart Publishing, 2020).

19 See generally ER Morey, 'What are the ethics of welfare economics? And, are welfare economists utilitarians?' (2018) 65 *International Review of Economics* 201.



of unilateral tax policy, but has specifically looked at fair tax base distribution in bilateral treaties. In a review of the existing literature, it has concluded that tax treaties are not always mutually beneficial for both treaty partners in terms of investment inflows and administrative capacity building. The reason why poorer and capital-importing countries have nevertheless concluded treaties with richer nations on relatively unfavourable terms is the competitive disadvantage of falling outside the treaty network. The dominance of OECD ideas and OECD tax professionals in the international tax policy community, and the imbalance in tax-technical expertise between high-income and low-income nations may also have played a role. These issues can be seen as analogues of three contracting problems, namely: externalities, that is, effects on third parties who are not involved in the treaty itself; coercion, defined as the absence of voluntary consent as a result of constrained choices; and information asymmetry, whereby inadequate information about the contents and consequences of the treaty leads to the absence of informed consent by one of the contracting parties. Chapter 5 has therefore asked: *how can contract theory provide guidance in discussions of fair tax base distribution in bilateral tax treaties?*

It has examined solutions to the abovementioned contracting problems provided by two main approaches in contract theory. One is a liberal approach that defends contract freedom because freedom is a goal in itself. The other is a consequentialist approach that sees contract freedom as a means to serve a particular end, such as welfare. In these approaches, the acceptability of externalities, coercion or asymmetric information depends on the promotion of either of these goals. Several approaches to fairness in international tax law can be categorised along the same lines.

Most attention has been paid to an analysis of externalities from the liberal perspective. That perspective accords with Dietsch and Rixen's Fiscal Policy Constraint.<sup>20</sup> Whereas their principle provides a relatively feasible way of regulating the externalities of unilateral tax policy while leaving countries' tax policy autonomy intact, chapter 5 has shown that its application fails in a bilateral setting.

More generally, chapter 5 has demonstrated that neither autonomy-based nor consequentialist approaches to contracting problems are able to provide coherent guidelines to determine what constitutes an acceptable or unacceptable externality on third nations; under which conditions parties' consent is voluntary or involuntary; and whether both countries have sufficient knowledge of the contents and consequences of the treaty in order to speak of informed consent. The reason is that the goals of national autonomy, welfare or justice remain undefined, or are merely defined from the subjective perspectives of the nation states involved. Resultingly, those goals remain ungrounded in an overarching moral theory and say little about what is right and what is wrong from a societal perspective – which

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20 But see ch 1, n 113.

is arguably what the fiscal social contract is about.<sup>21</sup> This conclusion leaves many questions in fiscal ethics open for further exploration.

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21 This point echoes the message of A MacIntyre, *After Virtue* (Notre Dame, University of Notre Dame Press, 1981).



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## Samenvatting (summary in Dutch)

### Dynamiek en Democratie: Essays over het Fiscaal Sociaal Contract in een Geglobaliseerde Wereld

Belastingen vormen de basis en een belichaming van de relatie tussen het individu en de samenleving. Ze zijn de voornaamste financieringsbron van de moderne staat, die de fundering van onze maatschappelijke orde vormt: de staat beïnvloedt onze identiteit, cultuur en ons welzijn via onder meer wet- en regelgeving, publieke werken en sociale uitgaven. Belastingen zijn niet slechts een manier om de kosten daarvan te dekken. Zelf hebben ze ook een grote invloed op de inkomens- en vermogensverdeling in de maatschappij. Daarnaast zijn ze verbonden met culturele fenomenen in zowel de economische als persoonlijke sfeer: denk aan de fiscale gevolgen van het huwelijk, huizenbezit, woningdelen, betaald werk tegenover onbetaald werk, het krijgen van kinderen, het geven aan goede doelen en het ontvangen van een erfenis. Bedoeld of onbedoeld dragen belastingen hierdoor bij aan het vormen van onze identiteiten, zelfpercepties en sociale interacties. Belastingen zijn dus onlosmakelijk verbonden met de politiek-theoretische vraag wie wij als samenleving zijn en wat de rol van het individu daarin is.

Een bekende Westerse manier om die vraag te beantwoorden is via het concept van het 'sociaal contract', dat sterk verbonden is met de opkomst van natiestaten en nationale belastingen in de vroegmoderne tijd. In die tijd vond in Europa een geleidelijke transitie plaats van het feodale systeem – waarin macht verdeeld was tussen koningen, adel, lokale heren en de kerk, en waarin de persoonlijke en financiële loyaliteit van individuen vooral gericht was op lokale leiders en gemeenschappen – naar het principe van soevereine staten. Daarin had een gecentraliseerde macht de controle over een bepaald grondgebied waar gestreefd werd naar een zekere culturele eenheid. Pas vanaf een dergelijke ontwikkeling kunnen we naar huidige definities spreken van 'belastingen', zijnde verplichte betalingen van de private sfeer naar de publieke sfeer die niet aan een individuele tegenprestatie zijn verbonden, maar waarvan de opbrengsten worden uitgegeven aan publieke doelen, zoals een nationaal leger en overheidsinstituties. Het concept van het sociaal contract is een manier om te verklaren waarom mensen de autoriteit van de soevereine machthebber in een dergelijke samenleving accepteren.

Volgens de Britse filosoof Thomas Hobbes doen individuen dat uit lijfsbehoud: in een denkbeeldige natuurtoestand zonder overheid leven individuen in een 'oorlog van allen tegen allen', en dus achten ze het beter om hun macht over te dragen aan de soeverein, die orde houdt. Het 'sociaal contract' waarin ze dat doen, gaat uit van de morele gelijkwaardigheid van personen. De idee dat de soeverein zijn macht niet aan God dankt

maar aan een hypothetische overeenkomst met het volk was in Hobbes' tijd een radicale innovatie in politiek denken. Een voor het belastingrecht relevante ontwikkeling in dit contractdenken komt van John Locke. Zijn denkbeeldige natuurtoestand is minder chaotisch dan die van Hobbes, omdat mensen volgens hem in staat zijn tot redelijke interactie. Zij sluiten een contract omdat ze geloven dat een overheid het beste in staat is hun natuurlijke rechten te beschermen, namelijk het recht op leven, vrijheid en eigendom. Omdat die rechten volgens Locke onvervreemdbaar zijn, blijft zijn sociaal contract altijd gebaseerd op wederzijdse instemming: wanneer de overheid bijvoorbeeld het eigendomsrecht schendt, mogen de geregeerden het contract opzeggen. Hieruit volgt het principe dat belastingheffing alleen democratisch tot stand mag komen. Dit denken heeft aan de basis gelegen van de grondwetten van veel parlementaire democratieën.

Het spreekt voor zich dat de invulling van het sociale contract in de loop der tijd aan verandering onderhevig is geweest. Zo is het absolute Lockeaanse eigendomsrecht geleidelijk minder vanzelfsprekend geworden. Tegenwoordig betalen 'de sterkte schouders de zwaarste lasten' op basis van het multi-interpretabele 'draagkrachtbeginsel'. Het belastingstelsel heeft daarnaast een toegenomen invloed op de economie en zelfs op de persoonlijke levenssfeer van belastingplichtigen, via fiscale instrumenten die bijvoorbeeld pensioenbesparingen, fietsenbezit of een gezond voedingspatroon moeten stimuleren. Dat ons belastingstelsel daardoor onherkenbaar zou zijn voor iemand uit de achttiende of negentiende eeuw neemt niet weg dat de theoretische basis van het onderliggende sociale contract altijd gelijk is gebleven: het op democratische wijze dienen van de belangen van moreel gelijkwaardige individuen binnen een gemeenschap.

Die gemeenschap is altijd gedefinieerd geweest door de grenzen van de natiestaat: sinds de introductie van het algemeen kiesrecht is er een vrijwel volledige overlap geweest tussen het democratische electoraat, de groep die de lasten van de overheidsbegroting droeg en de groep die baat had van de uitgaven op die begroting. Die overlap verwatert in onze globaliserende wereld waarin individuen en bedrijven zich steeds gemakkelijker in het buitenland kunnen vestigen en grensoverschrijdende economische activiteiten kunnen verrichten. Belastingbeleid speelt daarbij een belangrijke rol, omdat belastingdruk een grote factor is bij de beslissing waar die activiteiten plaatsvinden. Nationale overheden worden daardoor geprikkeld om rijke individuen en bedrijven met waardevolle economische activiteiten aan te trekken via concurrerend fiscaal beleid, zoals algemene belastingverlagingen, specifieke fiscale regelingen of het impliciet toestaan dat belastingplichtigen misbruik maken van mismatches tussen nationale stelsels.

Deze concurrentie is in de eerste plaats problematisch voor de natie-staat zelf. Hoewel gericht op het vergroten van de nationale economie en belastingopbrengst, zorgt voortdurende verlaging van belastingtarieven uiteindelijk voor een lagere opbrengst in alle landen tezamen. Met name arme landen zijn hier de dupe van, omdat zij het meest afhankelijk zijn van

het aantrekken van buitenlandse investeringen maar tegelijkertijd hun binnenlandse belastingopbrengsten hard nodig hebben. De ongelijkheid tussen landen kan hierdoor toenemen.

Daarnaast komt de democratische invulling van het sociaal contract binnen die natiestaten onder druk te staan. Een nationale gemeenschap heeft politieke voorkeuren over bijvoorbeeld inkomens- en vermogensverdeling, over de mate waarin ongelijkheid het gevolg mag zijn van geluk of verdienste, en over het belastingbeleid dat hieraan recht moet doen. Het wordt voor overheden moeilijker om die voorkeuren te verwezenlijken wanneer zij zich uit concurrentieoverwegingen gedwongen voelen de belastingdruk op internationaal mobiele grondslagen (zoals kapitaalinkomen) beperkt te houden en te verschuiven naar minder mobiele grondslagen (zoals arbeid en consumptie). Terwijl bij het vaststellen van democratische voorkeuren in beginsel iedere stem een gelijk gewicht heeft – in lijn met de morele gelijkwaardigheid van de individuen die een sociaal contract sluiten – verdriedubbelt globalisering de democratische representatie van mobiele belastingplichtigen: niet alleen hebben zij formeel kiesrecht in hun thuisland, zij beïnvloeden ook indirect het belastingbeleid van hun thuisland met de dreiging van hun vertrek, en daarnaast het belastingbeleid van andere landen die proberen hen binnen te halen.

De nadruk van concurrerend belastingbeleid ligt op de internationale mobiliteit en het economisch nut van belastingplichtigen, in plaats van op hun bijdrage aan de sociaal-culturele gemeenschap. De erosie van het gevoel van culturele verbondenheid in maatschappijen die deels uit tijdelijk woonachtige individuen bestaan, heeft een bewezen endogeen effect op herverdelingsvoorkeuren: die nemen af wanneer een significant deel van de maatschappij zijn identiteit niet meer ontleent aan plaatsgebonden cultuur maar aan eigen financieel succes. Vanuit democratisch oogpunt zouden we geen negatief moreel oordeel moeten toekennen aan het afnemen van de wens tot herverdeling, ware het niet dat deze afname het uiteindelijke gevolg is van de democratische oververtegenwoordiging van de stem van mobiele belastingplichtigen.

De hieruit volgende vraag is hoe een fiscaal sociaal contract eruit zou moeten zien in een globaliserende wereld. Het beantwoorden van die vraag vereist weliswaar een grondig begrip van nationaal en internationaal belastingrecht, maar kan niet enkel worden gedaan met behulp van een traditionele, juridisch-doctrinaire analyse. Een reden hiervoor is de centrale rol van politieke waarden in belastingbeleid. Belastingbeleid brengt onvermijdelijk normatieve keuzes mee over de definitie van het algemeen belang, de economische en culturele aspecten die relevant worden geacht voor die definitie, de afweging van het algemeen belang tegen het individueel belang, en onze interpretatie van de morele gelijkwaardigheid van personen. Die normatieve keuzes vallen grotendeels buiten de reikwijdte van juridisch-doctrinair onderzoek, dat zich richt op het interpreteren en ordenen van geldend recht. Daarbij wordt vooral gelet op de interne consistentie van rechtsregels en -beginselen en minder op de waarden waarin die



gegrond zijn. De vraag hoe een fiscaal sociaal contract eruit zou moeten zien in een globaliserende wereld, en dus de vraag in hoeverre belastingbeleid rekening moet houden met leden en niet-leden van nationale gemeenschappen, gaat niet over interne consistentie van het recht maar is filosofisch van aard. Filosofisch onderzoek naar deze vraag heeft echter geen zin zonder dat duidelijk is wat de eigenlijke effecten zijn van die globaliserende wereld op nationaal belastingrecht. Om dat duidelijk te maken is in de eerste plaats empirisch onderzoek vereist.

Kortom, het onderzoek naar de spanning tussen nationaal fiscaal beleid, globalisering en democratie is per definitie multidisciplinair. Dit proefschrift levert een bijdrage aan de omvangrijke onderzoeksagenda rondom dit thema, in vier inhoudelijke hoofdstukken (2 t/m 5) die elk als een artikel of boekhoofdstuk verschenen zijn. Elk hoofdstuk levert een bijdrage aan een apart onderzoeksveld en vult een specifieke lacune in de betreffende literatuur. De respectieve onderzoeksgebieden en -methoden zijn fiscaal-historisch en exploratief (hoofdstuk 2); sociaalwetenschappelijk-empirisch (hoofdstuk 3 en 4); en internationaal fiscaal-juridisch en filosofisch (hoofdstuk 5).

#### *De Crisis van de Belastingstaat*

Hoofdstuk 2 beziet de status en toekomst van het Westerse fiscale sociale contract met behulp van het denkkader van het essay *The Crisis of the Tax State*, geschreven in 1918 door de Oostenrijkse econoom Joseph Schumpeter.

De aanleiding voor dat essay is de vraag of Oostenrijk zijn enorme schuldenlast te boven kan komen in de nasleep van de Eerste Wereldoorlog. In tegenstelling tot sommige van zijn tijdgenoten antwoordt Schumpeter daarop volmondig 'ja' – en dat herstel lukt volgens hem het beste met een eenmalige kapitaalheffing. Om dit te beargumenteren moet hij aantonen dat Oostenrijk overeind zal blijven ondanks het ineensinken van het eeuwenoude keizerrijk. Dat doet hij via het concept van de 'belastingstaat', gedefinieerd als een overheid die gefinancierd wordt door belastingen op de private sector. Naar huidige maatstaven is dat een weinig opmerkelijke definitie, maar Schumpeter onderstreept dat deze belastingstaat slechts een van de vele manieren is om een samenleving in te richten. Zo bestonden er geen belastingen in het middeleeuwse feodale systeem, omdat een publieke sfeer ontbrak waarin geld werd geïnd en uitgegeven. In een socialistisch systeem ontbreekt daarentegen de private sector, en is er dus eveneens geen onderscheid tussen publiek en privaat. Zolang dat onderscheid er wel is, bestaat er een belastingstelsel als schakel daartussen. Die schakel is volgens Schumpeter de belangrijkste windvaan waaraan de toestand van de maatschappij kan worden afgelezen: men zou de donder van de wereldgeschiedenis beter kunnen horen roffelen in de overheidsfinanciën dan waar ook elders. Het belastingstelsel reflecteert bijvoorbeeld de hoeveelheid ondernemingsactiviteit in de maatschappij, de arbeidsparticipatie, de staatsschuld, de capaciteiten van de uitvoerende instanties en de medewerking van burgers, zo zegt Schumpeter. Tegenwoordig zouden we daar bijvoorbeeld



aan kunnen toevoegen: electorale herverdelingswensen, het percentage huizenbezitters, vergrijzing, de wens tot handhaving op toeslagenfraude, onvrede over een toeslagenschandaal... Omdat belastingen een voortvloeisel zijn van de structuur van sociale verbanden binnen een gemeenschap, concludeert Schumpeter dat een belastingstaat prima in staat is om grote macro-economische schokken op te vangen, zolang de onderliggende sociale verbanden intact blijven. Een werkelijke 'Crisis of the Tax State' ontstaat pas bij het afbrokkelen van de sociale orde.

Hoofdstuk 2 beantwoordt de onderzoeksvraag: *Welke lessen kunnen worden getrokken uit Joseph Schumpeters essay aangaande hedendaagse belastingstaten en hun onderliggende sociale orde?* Het hoofdstuk begint met een literatuurstudie naar de relatie tussen crises en belastingen in de moderne tijd, bedoeld als een aansluiting op Schumpeters primaire vraag hoe een belastingstaat een crisis doorstaat. Historisch bewijs bevestigt zijn voorspelling: oorlogen en financiële crises vormden doorgaans geen bedreiging voor het voortbestaan van belastingstaten, en leidden op langere termijn zelfs tot hogere overheidsuitgaven en meer herverdeling. De grootte van dat effect is echter afhankelijk van de sociaal-maatschappelijke context. Een specifiek voorbeeld is de ongeëvenaarde stijging van belastingtarieven tijdens beide Wereldoorlogen, die voortkwam uit het principe van gelijke maatschappelijke offers en uit de wens om excessieve oorlogswinsten weg te nemen. Dergelijke argumenten kunnen alleen bestaan in een context van een nationale identiteit en gemeenschappelijke cultuur, iets waar tijdens eerdere oorlogen veel minder sprake van was.

Aan de hoogtijdagen van nationaal gemeenschapsgevoel en economische solidariteit gedurende de naoorlogse decennia is mede een eind gekomen door de toegenomen globalisering sinds de jaren '80. Het probleem daarbij is niet dat individuen of bedrijven de belasting die zij aan hun nationale gemeenschap zijn verschuldigd, ontwijken via kunstmatige constructies – dat gebeurde immers ook in de jaren '50 en '60. Het probleem is dat een deel van de belastingplichtigen zich door toegenomen mobiliteit überhaupt niet meer verbonden voelt met een nationale gemeenschap. Hoofdstuk 2 poogt deze ontwikkeling te duiden vanuit Schumpeters blik.

De recent geïntroduceerde multinationale anti-belastingontwikkelingsregels laten zien dat beleidsmakers hun bestaande, twintigste-eeuwse inkomsten- en winstbelastingen proberen te beschermen tegen een veranderende, eenentwintigste-eeuwse context. Dat strookt niet met Schumpeters visie dat het belastingstelsel een reflectie zou moeten zijn van onze sociale orde: wanneer die verandert, moet het belastingstelsel meebewegen of het gaat ten onder. Het hoofdstuk trekt een parallel met de invoering van inkomstenbelastingen eind negentiende eeuw, die ook grotendeels een reactie was op een veranderende maatschappij: de slechte economische positie van de onderklasse vroeg om een belasting die beter recht deed aan draagkracht dan bestaande heffingen; technologische ontwikkelingen noopten tot een neutrale vorm van belastingen die niet meer gebaseerd was op specifieke verouderde productiemethoden; toegenomen mobiliteit via spoorwegen

maakte dat lokale accijnzen makkelijker ontweken konden worden en aan belang inboetten; en nieuwe communicatietechnieken zoals de telegraaf en telefoon maakten het mogelijk belastingen nationaal te administreren. Tegenwoordig zijn het juist de inkomstenbelasting en haar rechtspersoonlijke equivalent, de vennootschapsbelasting, die niet meer passen bij de maatschappelijke context: ze hebben geen antwoord op toegenomen mobiliteit van belastingplichtigen, op de concentratie en dynastieke overerving van extreme vermogens bij enkele families, op winsten en inkomens die voortvloeien uit urbanisatie- en agglomeratie-effecten, en op nieuwe soorten transacties in de digitale economie. De uitdaging voor beleidsmakers is dus om ons belastingstelsel via het Schumpeteriaanse principe van 'creatieve vernietiging' aan de passen aan die nieuwe wereld.

#### *Determinanten van IB-toptarieven in OESO-landen*

De observatie in hoofdstuk 2 dat niveaus van belastingheffing en herverdeling gedurende de twintigste eeuw aanzienlijk zijn gestegen in een context van sociale cohesie en solidariteit sluit aan bij het thema van hoofdstuk 3. Herverdeling tussen rijkere en armere leden van de nationale gemeenschap is sinds de twintigste eeuw een hoofddoel van veel verzorgingsstaten. Aan de inkomstenkant van de overheidsbegroting gebeurt dat nog steeds voornamelijk via de inkomstenbelasting (IB). Hoofdstuk 3 bevat een empirische analyse van de determinanten van IB-toptarieven in OESO-landen.

Het toptarief is om meerdere redenen een belangrijke indicator van de hoeveelheid herverdeling die de IB kan bewerkstelligen. Logischerwijs heeft het toptarief invloed op de hoeveelheid belasting die individuen in de hoogste tariefschijf betalen. Het beïnvloedt ook indirect de tariefschijven daaronder, omdat die per definitie niet hoger kunnen zijn dan het toptarief. Belasting die wordt opgehaald bij hogere inkomens biedt bovendien financiële ruimte voor gerichte belastingverlagingen voor lage inkomens, wat een gunstig effect kan hebben op de arbeidsparticipatie. Tot slot vervult het toptarief een belangrijke indirecte herverdelingsfunctie: het verhoogt de kosten voor werkgevers om buitensporige nettolonen uit te betalen en matigt daardoor zelfs de inkomensongelijkheid nog voordat er belasting geheven wordt. Dit effect speelt tevens een rol bij vermogensherverdeling, aangezien een aanzienlijk deel van de vermogensongelijkheid niet het resultaat is van erfenissen of van rendementen op kapitaal, maar van topinkomens uit arbeid. Vooral dit laatste argument illustreert dat het uitsluitend organiseren van herverdeling via overheidsuitgaven, zoals uitkeringen, onvoldoende is om ongelijkheid substantieel te verminderen: een progressieve IB is daarbij ook van belang.

In dit licht is het opmerkelijk dat IB-toptarieven in OESO-landen de afgelopen decennia aanzienlijk zijn gedaald: hun gemiddelde is afgenomen van circa 70% in de jaren '70, tot 43% vandaag de dag. Uit bestaande onderzoeken volgen verschillende oorzaken. Een daarvan is de aanhoudende daling van de tarieven van de vennootschapsbelasting (VPB) sinds globalisering een vlucht nam in de jaren tachtig. De VPB vormt een 'stok achter

de deur' van de IB: zonder VPB kunnen goedverdienende ondernemers en zelfstandigen hun activiteiten onbelast via een rechtspersoon laten plaatsvinden, waarin ze hun verdiensten gratis kunnen opsparen. Hoewel het VPB-tarief in werkelijkheid niet 0% is, heeft de daling in OESO-landen van gemiddeld 48% in 1981 naar 25% nu, de deur naar deze ontwijkingsconstructie opengezet. Inderdaad is aangetoond dat tussen een tiende en een vijfde deel van de VPB-opbrengsten in rijke landen niet uit bedrijfswinsten voortkomt, maar uit ontweken IB. Gelet op deze afwijking is het voor overheden moeilijk houdbaar om de hoge toptarieven van de jaren '70 aan te houden: als indirect gevolg van concurrentie in de VPB moeten ook IB-tarieven omlaag.

De politieke economie van de IB is echter complexer. Omdat de belasting effecten kan hebben op de arbeidsparticipatie, werkloosheid en economische groei, wordt de tariefstelling wellicht ook beïnvloed door economische omstandigheden. Bekend is in elk geval dat OESO-landen hun toptarieven in de jaren '80 en '90 verlaagden als onderdeel van 'neoliberale' hervormingspakketten die, in combinatie met verbredingen van de belastinggrondslag, de economische efficiëntie van belastingstelsels moesten verbeteren. Boegbeeld van het neoliberale wereldbeeld waren Ronald Reagan en Margaret Thatcher, en hun belastinghervormingen in de Verenigde Staten en het Verenigd Koninkrijk hebben een significante invloed gehad op de fiscale beleidsideeën in andere landen. Dit betekent dat gelijktijdig dalende IB- en VPB-tarieven niet noodzakelijkerwijs met bovengenoemde ontwijkingsconstructie te maken hebben, maar dat ze ook het gevolg kunnen zijn van wereldbeelden en ideologische gedrevenheid van regeringen.

Daaraan gerelateerd is het sterk gepolitiseerde karakter van de IB en met name het toptarief als zichtbaarste element ervan. Wereldwijd stegen toptarieven met gemiddeld 4 procentpunt in de nasleep van de financiële crisis van 2008, en dit was waarschijnlijk het gevolg van toegenomen herverdelingswensen van electoraten. Dit suggereert dat overheden nog wel degelijk politieke speelruimte hebben wat betreft tariefstelling, ondanks het bestaan van ontwijkingsconstructies via vennootschappen.

Ondanks het belang van de IB als herverdelingsinstrument is er nog weinig kwantitatief onderzoek gedaan naar de politiek-economische determinanten van het toptarief. Enkele determinanten, zoals de politieke kleur van regeringen en de structuur van de arbeidsmarkt, zijn enkel onderzocht in relatie tot de totale belastingdruk op arbeid en/of kapitaal, maar die zegt weinig over de herverdelende capaciteit van het belastingstelsel. Studies die wel kijken naar het toptarief nemen vaak het VPB-tarief niet mee als verklarende variabele. Wordt dit wel gedaan, dan wordt vaak een sterke correlatie tussen de twee tarieven gevonden. Die correlatie toont echter nog niet de onderliggende causale relatie aan: die zou bidirectioneel kunnen zijn (beide tarieven beïnvloeden elkaar) of zou zelfs afwezig kunnen zijn wanneer beide tarieven gelijktijdig dalen door externe factoren – denk aan bovengenoemd liberaal beleid.

Het meest overtuigende bestaande onderzoek naar de oorzaak van de

dalingen van IB-tarieven in de 20<sup>e</sup> eeuw bestaat uit case studies van hervormingen in zeven OESO landen. De gevonden oorzaak is voornamelijk de ontwijking van IB via vennootschappen, en dus dalende VPB-tarieven. Het lastige van case studies is echter dat ze overlappende oorzaken moeilijk kunnen onderscheiden. Illustratief is de verklaring voor de Nederlandse IB-verlaging in 2018: de Memorie van Toelichting wees op het gelijktrekken van marginale belastingtarieven op arbeidsinkomen en inkomen van directeur-groootaandeelhouders (in het licht van het gedaalde VPB-tarief). De hervorming werd echter publiekelijk verkocht met economische en rechtvaardigheidsargumenten onder de leuze ‘werken moet lonen’. Wil de echte oorzaak nu ontstaan?

De onderzoeksvraag van hoofdstuk 3 is dan ook: *Wat zijn de politiek-economische determinanten van toptariefstelling van de inkomstenbelasting in OESO-landen?* Het hoofdstuk bevat een kwantitatief onderzoek op basis van regressieanalyse. De beschikbaarheid van internationaal vergelijkbare data over belastingtarieven en politiek-economische factoren maakt het mogelijk om dit onderzoek uit te voeren voor een groter aantal landen (negentien) en voor een grotere tijdspanne (1981 tot 2018) dan in eerdere studies. Er wordt gebruik gemaakt van paneldata met als tijdseenheid de regeerperiode van kabinetten. Dit is een innovatie ten opzichte van conventionele, jaarlijkse data, en sluit beter aan bij de politieke werkelijkheid van belastinghervormingen, die meestal niet jaarlijks plaatsvinden maar slechts eens per regeerperiode.

De regressieresultaten tonen een sterke correlatie tussen de verandering in IB- en VPB-tarieven tijdens regeerperiodes. Bovendien is een grotere discrepantie tussen het IB-tarief en het VPB-tarief bij aanvang van een regeerperiode gerelateerd aan een grotere verlaging van het IB-tarief door het betreffende kabinet. Veel bekende politiek-economische determinanten van fiscaal beleid, zoals economische groei en de ideologische kleur van een regering, hebben daarentegen geen significant effect. De belangrijkste oorzaak van gedaalde IB-toptarieven in OESO-landen lijkt dus de daling van VPB-tarieven als gevolg van internationale belastingconcurrentie. Granger-causaliteitstesten suggereren dat dit effect exogeen is: IB-tariefstelling bij aantreden van een kabinet heeft nauwelijks invloed op veranderingen in het VPB-tarief tijdens de regeerperiode.

Een deelvraag van hoofdstuk 3 is in hoeverre landen de neerwaartse druk op hun IB-toptarieven kunnen mitigeren door belastingen op aandeelhoudersniveau te verhogen, teneinde IB-ontwijking via rechtspersonen te bestrijden. Inderdaad proberen veel landen aandeelhoudersinkomen en arbeidsinkomen gelijk te belasten, om de rechtsvormkeuze van ondernemingen niet te laten afhangen van de fiscale gevolgen daarvan – iets wat in Nederland bekend staat als de leer van het ‘globale evenwicht’. Schattingen van modellen waarin de gecombineerde VPB- en dividendbelastingdruk voor aandeelhouders is meegenomen als verklarende variabele laten zien dat dividendbelastingtarieven geen invloed hebben op IB-tarieven. Dat is in lijn met de realiteit waarin IB-ontwijking vooral gericht is op het opsparen

van inkomen in vennootschappen; dividendbelasting is dan minder relevant, en kan bovendien ontweken worden door de opgespaarde winsten niet als dividenden uit te keren maar ze als lening te verstrekken. Een les uit hoofdstuk 3 is dus dat onze perceptie van de IB als gepolitiseerd herverdelingsinstrument niet meer strookt met de realiteit: IB-tarieven zullen waarschijnlijk verder dalen dan de huidige 43%, totdat VPB-tarieven het internationaal afgesproken minimum van 15% hebben bereikt.

#### *Convergentie van belastingmixen in OESO-landen*

Het onderzoeksobject van hoofdstuk 4 is een minder zichtbare maar evenzeer relevante factor voor de mate waarin belastingstelsels in staat zijn tot inkomensherverdeling: de samenstelling van overheidsinkomsten in termen van verschillende soorten belastingen, oftewel belastingmix.

Een deel van de herverdelingscapaciteit van het belastingstelsel wordt bepaald door de mate waarin belastingen worden opgehaald bij kapitaal, via bijvoorbeeld de VPB of vermogensbelastingen. De reden hiervoor is dat hoge inkomens vaak grotendeels kapitaalinkomens zijn, bestaande uit bijvoorbeeld dividenden of vervreemdingsvoordelen uit aandelen. Van de belastingen die daarentegen op arbeid vallen is met name de IB in staat tot herverdeling. Sociale premies zijn dat minder, omdat ze doorgaans geen progressief tarief hebben en meestal slechts geheven worden tot een bepaald inkomensniveau. Consumptiebelastingen zoals de btw zijn zelfs degressief, omdat mensen met lage inkomens een groter deel van hun inkomen kwijt zijn aan consumptie. De belastingmix heeft echter niet alleen effecten op herverdeling, maar ook op de nationale economie. Zo is het percentage sociale premies in de belastingmix negatief gecorreleerd met de arbeidsparticipatie, en lijkt de VPB slechter voor economische groei dan de btw. Deze effecten maken de belastingmix een relevant onderzoeksobject in twee onderzoeksvelden waaraan hoofdstuk 4 bijdraagt.

Ten eerste is de belastingmix een weinig onderzochte factor in de literatuur over Europese economische en verzorgingsstaatconvergentie. Het is een expliciet doel van de Europese Unie dat de sociale stelsels van lidstaten convergeren (dat wil zeggen: meer op elkaar gaan lijken) als gevolg van de economische integratie van de Unie. Bestaande studies naar dit convergentieproces hebben zich bijna volledig gericht op de uitgavenkant van overheidsbegroting, kijkend naar bijvoorbeeld pensioenstelsels of werkloosheidsuitkeringen. De samenstelling van de inkomstenkant van de overheidsbegroting is echter een even zo relevant onderdeel van de verzorgingsstaat, gelet op bovengenoemde effecten van de belastingmix op inkomensherverdeling en de arbeidsmarkt. Het kleine aantal bestaande studies naar belastingmixconvergentie richt zich voornamelijk op West-Europese landen aan het einde van de twintigste eeuw en is dus weinig actueel: tegenwoordig bestaat de EU voor een derde uit Centraal- en Oost-Europese landen. Bovendien hanteren bijna al deze studies een grove statistische maatstaf van convergentie over de gehele steekproef van landen. Die maatstaf is inconsistent wanneer convergentie slechts plaatsvindt binnen

een selecte groep landen uit de steekproef. Op basis van de literatuur over de politieke economie van belastingbeleid kan dat laatste met enige zekerheid worden aangenomen. Zo is het plausibel dat open economieën die veel belastingconcurrentie ervaren minder inkomstenbelastingen en meer consumptiebelastingen zullen heffen. Europese harmonisatie van belastingregels, met name in de btw, zorgt daarnaast dat belastingmixen van EU- en niet-EU-landen zich waarschijnlijk verschillend ontwikkelen.

Ten tweede zijn deze laatstgenoemde determinanten van de belastingmix relevant in de bredere literatuur over de politieke economie van belastingen, die relateert aan het overkoepelende thema van dit proefschrift. Naast belastingconcurrentie en Europese harmonisatie heeft een groot aantal nationale factoren invloed op de belastingmix, waaronder partijpolitiek, belangengroeperingen, het kiesstelsel en de structuur van de arbeidsmarkt. Een actuele kwestie in de politiek-economische literatuur over belastingbeleid is de relatieve invloed van die factoren. Met andere woorden: zijn nationale regeringen nog in staat nationaal belastingbeleid te baseren op nationale omstandigheden en democratische voorkeuren in een context van toenemende Europeanisering van beleid en globalisering van de economie?

De centrale vraag in hoofdstuk 4 is daarom: *wat zijn de determinanten van de samenstelling van belastingmixen in OESO-landen?* Twee deelvragen zijn: *convergeren belastingmixen in OESO-landen; en zo ja, welke factoren beïnvloeden de richting van die convergentie?*

De focus van hoofdstuk 4 ligt op vier categorieën belastingen: inkomstenbelastingen, vennootschapsbelastingen, sociale premies en algemene consumptiebelastingen. Hun relatieve aandeel in de totale belastingopbrengsten, gemeten als percentage, wordt geanalyseerd met behulp van foutencorrectiemodellen (error correction models). De afhankelijke variabele in die modellen is de verandering in dat percentage, en een onafhankelijke variabele is de vertraagde waarde ervan (dat wil zeggen: het percentage zoals het één tijdseenheid eerder was). Een negatieve  $\beta$ -coëfficiënt voor de relatie tussen die variabelen toont zogeheten  $\beta$ -convergentie aan, omdat lage waarden dan geassocieerd zijn met een hogere groei en hoge waarden met een lagere groei, wat impliceert dat de waarden naar elkaar toe bewegen. De modellen bevatten diverse controlevariabelen en interactietermen om de determinanten van zowel de samenstelling van de belastingmix als van het convergentieproces te schatten. Gegevens zijn beschikbaar voor 30 OESO-landen, waarvan 23 EU-lidstaten, inclusief 8 landen in Centraal- en Oost-Europa. Belastingmixen in het gehele panel worden bestudeerd over de periode 1996 tot 2019, en een aanvullende analyse zonder de Centraal- en Oost-Europese landen wordt uitgevoerd voor de periode 1980 tot 2019.

De resultaten laten zien dat de belastingmixen in OESO-landen convergeren. De richting van die convergentie is een begroting met minder IB-opbrengsten en meer btw-opbrengsten. Hoewel dat in een wereld met toenemende belastingconcurrentie in de lijn der verwachting ligt – mede gelet op de bevindingen in hoofdstuk 3 – worden de niveaus van deze belastingopbrengsten niet verklaard door variabelen die belastingconcur-



rentie meten. Ook veel andere onafhankelijke variabelen hebben geen significant effect. Een opvallende uitzondering is de variabele voor regeringsideologie, welke laat zien dat linkse regeringen IB-opbrengsten verhogen en btw-opbrengsten verlagen. De hierboven besproken conclusies van hoofdstuk 3 suggereren overigens dat deze regeringen de toegenomen IB niet weten op te halen bij de hoogste inkomens, aangezien toptarieven in OESO-landen blijven dalen, onafhankelijk van regeringsideologie.

Convergentie van belastingmixen wordt eveneens niet verklaard door belastingconcurrentie, maar vooral door EU-lidmaatschap. Hoewel de belastingmixen van EU-landen dus homogener zijn dan die in het gehele panel, bewegen binnen de EU de belastingmixen van Centraal- en Oost-Europese landen in een afwijkende richting. Hun btw-opbrengsten en sociale premies waren al hoger dan in West-Europa, en stijgen bovendien sneller. Aangezien beide typen heffingen weinig herverdelende capaciteit hebben, is dat een bedenkelijke ontwikkeling in het licht van het Europese doel van convergerende verzorgingsstaten.

*Contracttheorie als leidraad bij de verdeling van heffingsrechten in belastingverdragen*  
Hoofdstuk 5 richt zich niet op de empirische vraag hoe globalisering en belastingconcurrentie nationale belastingstelsels beïnvloeden, maar op de filosofische vraag hoe landen daarmee om moeten gaan in het licht van hun fiscale sociale contract. Aan het begin van deze samenvatting is beschreven dat globalisering de nationale fiscale beleidsruimte beperkt en de totstandkoming van fiscaal beleid minder democratisch maakt. Meer specifiek is in hoofdstuk 3 aangetoond dat belastingconcurrentie de tariefstelling van de inkomstenbelasting, het belangrijkste herverdelende instrument aan de inkomstenkant van de overheidsbegroting, negatief beïnvloedt. Dat betekent dat het concurrerende fiscale beleid van één land het fiscale sociale contract van een ander land kan ondermijnen. De consensus onder overheden en belastingwetenschappers is dan ook dat onvoorwaardelijke fiscale soevereiniteit tot het verleden behoort: landen worden geacht op een of andere manier rekening te houden met de invloed van hun belastingbeleid op de belangen van andere landen en hun burgers. Hoewel het fiscale sociale contract binnen een nationale gemeenschap is gebaseerd op de aanname van moreel gelijkwaardige individuen, rijst de vraag welk normatief gewicht moet worden toegekend aan deze 'insiders' van de nationale gemeenschap ten opzichte van 'outsiders', namelijk burgers van andere landen. Hoofdstuk 5 draagt bij aan de omvangrijke literatuur die met deze vraag worstelt.

De meeste studies in die literatuur richten zich op nationale soevereiniteit over unilateraal fiscaal beleid: de grondslagen en tarieven die in het eigen land gelden. Auteurs hebben verschillende beginselen voorgesteld om de verantwoordelijkheden die overheden daarbij richting andere landen hebben, te codificeren. Een voorbeeld is het verbieden van strategisch fiscaal beleid dat enkel wordt geïmplementeerd om buitenlandse belastinggrondslagen aan te trekken.

Veel minder studies richten zich op rechtvaardigheidsbeginselen die



iets zeggen over de inhoud van bilaterale belastingverdragen. Dit terwijl belastingverdragen de hoeksteen van het internationaal belastingrecht vormen en dus misschien nog wel relevanter zijn voor internationale fiscale rechtvaardigheid dan unilateraal beleid. De meeste belastingplichtigen die grensoverschrijdende economische activiteiten verrichten, vallen onder een verdrag dat de heffingsrechten verdeelt tussen de staat waar zij wonen en de staat waar hun economische activiteiten plaatsvinden. Deze verdeling kan aanzienlijke herverdelende gevolgen hebben tussen de twee verdragspartners, vooral wanneer het gaat om het mogen belasten van dividend-, rente- en royaltybetalingen door het land van waaruit die betalingen gedaan worden. Landen die afhankelijk zijn van buitenlandse investeringen (bronlanden) zijn doorgaans armer en hebben relatief veel baat van zulke bronbelastingen, maar veel belastingverdragen beperken het recht om die te mogen heffen. Belastingverdragen kunnen ook externe effecten hebben op derde landen door investeringen in de twee verdragspartners te stimuleren ten koste van de rest van de wereld – vergelijkbaar met de externe effecten van unilaterale belastingverlagingen. Bovendien kunnen specifieke verdelingen van heffingsrechten bijdragen aan mogelijkheden voor belastingontwijking door grote bedrijven, hetgeen meestal nadelig is voor arme landen die afhankelijk zijn van belastinginkomsten uit buitenlandse investeringen.

Voor het beantwoorden van de vraag welke verdeling van heffingsrechten in belastingverdragen eerlijk is voor zowel de beide verdragspartners als voor derde landen, nemen veel bestaande studies een relatief kosmopolitische positie in: hun doel is wereldwijde rechtvaardigheid en/of herverdeling. Hierbij past het vervangen van het systeem van belastingverdragen door een wereldwijde formule die heffingsrechten verdeelt op een manier die relatief gunstig uitpakt voor arme landen. In een minder utopische wereld waarin belastingverdragen nog wel bestaan, stelt een aantal auteurs voor om de hoeveelheid heffingsrechten die aan bronlanden wordt toegewezen afhankelijk te maken van het verschil in economische ontwikkeling tussen de verdragspartners. Een minder kosmopolitische variant op het laatste voorstel is het alleen laten gelden van dit principe voor verdragspartners met een sterke economische band, vanuit het idee dat economische samenwerking wederkerige relationele plichten schept.

Hoewel het laatste idee het minst beperkend is voor de vrijheid van staten om de inhoud van hun bilaterale verdragen te bepalen, laat het economisch geïsoleerde landen aan hun lot over en zegt het niets over de externe effecten van verdragen op derde landen. De eerdergenoemde, meer kosmopolitische ideeën beperken daarentegen sterk de nationale fiscale beleidsautonomie. Het debat tussen deze twee posities verzandt dan ook in de gebruikelijke tegenstelling tussen nationalistische en kosmopolitische denkbeelden over internationale rechtvaardigheid.

Het doel van hoofdstuk 5 is het vinden van normen voor een eerlijke verdeling van heffingsrechten in bilaterale belastingverdragen, die definiëren hoe landen bij het sluiten van die verdragen rekening moeten houden met de belangen van hun verdragspartners en van derde landen. Die nor-

men zouden universeel moeten gelden, maar wel moeten vertrekken vanuit het principe van nationale fiscale beleidsautonomie. De reden voor dat uitgangspunt is zowel pragmatisch als normatief. In de huidige wereld ligt de macht om belasting te heffen en belastingverdragen te sluiten nu eenmaal in de handen van natiestaten, en daar zijn goede redenen voor: natiestaten zijn bijvoorbeeld democratischer en receptiever voor lokale ideeën over wat 'rechtvaardig' is dan een hypothetische wereldregering. Bovendien lijkt het begrenzen van de verdragsbepalingen die landen mogen afspreken, een minder grote politieke uitdaging dan het vervangen van belastingverdragen door een wereldwijde formule om heffingsrechten te verdelen.

In theorieën van internationale fiscale rechtvaardigheid wordt het begrip 'nationale fiscale beleidsautonomie' vaak expliciet of impliciet geïnterpreteerd als analoog aan het liberale vrijheidsbegrip. De plichten van staten om in hun belastingbeleid rekening te houden met buitenlandse belangen worden dan bepaald door het principe dat hun vrijheid, oftewel fiscale beleidsautonomie, eindigt waar die van een andere staat begint. De theorie die de handvatten levert om de grenzen van die vrijheid te definiëren in de situatie dat twee partijen een overeenkomst sluiten is de contracttheorie. Het uitgangspunt in de contracttheorie is dat partijen vrij zijn om een overeenkomst te sluiten, tenzij morele normen zich daartegen verzetten. Dit komt overeen met het bovengenoemde doel om normen te vinden voor een eerlijke inhoud van belastingverdragen, vertrekkend vanuit het uitgangspunt dat landen vrij zijn om de verdragen te sluiten die ze willen. De onderzoeksvraag van hoofdstuk 5 is dan ook: *Hoe kan contracttheorie richting geven aan de discussie over eerlijke verdeling van heffingsrechten in bilaterale belastingverdragen?*

Hiertoe categoriseert hoofdstuk 5 eerst de gevolgen van belastingverdragen voor internationale herverdelende rechtvaardigheid in het contract-theoretisch denkkader. Bestaand onderzoek laat zien dat de voordelen van belastingverdragen, zoals rechtszekerheid voor belastingbetalers en een toename in bilaterale investeringen, voor arme landen vaak niet opwegen tegen de nadelen van beperking van heffingsrechten. Dat arme landen toch veel verdragen sluiten, komt deels doordat zij bang zijn buitenlandse investeringen mis te lopen als hun buurlanden wel verdragen sluiten en zij niet. Contracttheoretisch kan dit worden gezien als een probleem van 'negatieve externe effecten', namelijk effecten op derden die geen partij zijn bij een overeenkomst. Los van deze externe effecten leidt de afhankelijkheid van belastingverdragen om buitenlandse investeringen aan te trekken tot een zwakke positie in verdragsonderhandelingen. De sterkere, dominante verdragspartner kan hierdoor zijn wil opleggen. Een analoge situatie in de contracttheorie is die van 'dwang', waarbij de wil om een overeenkomst te sluiten op gebrekkige wijze tot stand komt door het ontbreken van een redelijk alternatief. Ten slotte is er soms een aanzienlijk verschil in belasting-technische expertise tussen verdragspartners, waardoor de zwakkere partij onvoldoende kennis heeft van de consequenties van de overeenkomst. In de contracttheorie heet deze situatie 'asymmetrische informatie'.

Hoofdstuk 5 analyseert de filosofische en rechtseconomische literatuur over deze contractproblemen en past de inzichten uit die literatuur toe op belastingverdragen. De literatuur valt grofweg uiteen in twee benaderingen. De eerste is een liberale benadering die contractvrijheid verdedigt omdat vrijheid een doel op zichzelf is. De tweede is een consequentialistische benadering die contractvrijheid beschouwt als een middel om een specifiek ander doel te dienen, zoals welvaart. De aanvaardbaarheid van externe effecten, dwang of asymmetrische informatie hangt dan af van de mate waarin het respectieve doel geschonden of bevorderd wordt.

De conclusie van hoofdstuk 5 is dat geen van de benaderingen in staat is om coherente richtlijnen te bieden voor de vraag of de externe effecten van verdragen op derde landen aanvaardbaar zijn; of de instemming van een verdragspartij voldoende vrijwillig was; en of beide verdragspartners voldoende kennis hadden van de gevolgen van het verdrag. De reden hiervoor is dat de onderliggende doelen van beide benaderingen – autonomie en welvaart – vaak ongedefinieerd blijven, of slechts worden gedefinieerd vanuit de subjectieve perspectieven van de betrokken natiestaten. Daardoor blijven ze ongegrond in een overkoepelende morele theorie en zeggen ze weinig over wat juist of onjuist is vanuit een maatschappelijk perspectief. Deze conclusie laat veel fiscaal-ethische vragen over de inhoud van belastingverdragen open voor verdere verkenning.

# Curriculum Vitae

Bastiaan Niels van Ganzen (Amsterdam, 1994) graduated in Tax Law at Leiden University (LLM, 2018, *summa cum laude*) and in Economic Policy at Utrecht University (MSc, 2018, *cum laude*). In 2019, he started as a PhD Candidate and Lecturer at the Leiden University Institute of Tax Law and Economics. As of 2024, he has been appointed Assistant Professor. He teaches several courses at the bachelor's and master's levels, supervises master's theses, and has recently designed a new master's-level course on fiscal sociology. In his research, he aims for an interdisciplinary understanding of the relation between tax law, society and distributive justice.



In the range of books published by the Meijers Research Institute and Graduate School of Leiden Law School, Leiden University, the following titles were published in 2023 and 2024

- MI-395 A.H.A. Mohammad, *De normering van academisch ondernemerschap. Perspectieven vanuit het onderwijs(bekostigings)recht, het Europees staatssteunrecht en de academische vrijheid & wetenschappelijke integriteit*, (diss. Leiden), Amsterdam: Ipskamp Printing 2023
- MI-396 T.L. Masson-Zwaan, *Widening the Horizons of Outer Space Law*, (diss. Leiden), Amsterdam: Ipskamp Printing 2023, ISBN 978 94 6421 977 7
- MI-397 W. Zhang, *Achieving decent work in China. A case study of decent working time*, (diss. Leiden), Amsterdam: Ipskamp Printing 2023
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