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

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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.¹ The early modern era witnessed a gradual emergence of statehood as power centralised into independent political entities that were tied to a particular territory.² 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.³ 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'.⁴ 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.⁵ 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.⁶ 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.⁷ 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.⁸ Likewise, taxation should be based on the consent of taxpayers and can therefore only be justified in a democratic process.⁹ In other words: the community ‘taxes itself’.¹⁰

While the constitutions of many nineteenth-century parliamentary states echoed this idea,¹¹ 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.¹² 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.¹³ 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.¹⁴ 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.¹⁵ 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

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).¹⁶

This refutation of the Lockean right to property¹⁷ has neither been shared across the entire political spectrum nor been associated with expropriation,¹⁸ 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.¹⁹ 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.²⁰ 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.²¹

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

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.²² 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.²³ 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).²⁴ 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.²⁵

In democratic states, it is debatable whether or not the latter observations should be regarded as examples of repressive taxation.²⁶ Either way, they illustrate the importance of sociological questions and the weighing of political values in tax policymaking.²⁷ 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.

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)²⁸ 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.²⁹ 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'.³⁰ 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.³¹ The general consensus is that tax competition is a negative-sum game that might lead to tax revenue losses³² and will result in lower levels of redistribution than states would have had in a closed-border situation.³³

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.³⁴ 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 Clausen, '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.³⁵ 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.³⁶ Second, poor countries depend to a larger extent on tax bases that are viable to competitive pressure, such as foreign direct investment.³⁷ 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.³⁸

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.³⁹ 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;⁴⁰ 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.⁴¹ 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.⁴² 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.⁴³

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.⁴⁴ Hence, taxpayers' personal characteristics are commodified in financial

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.⁴⁵ 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.⁴⁶

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.⁴⁷ 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.⁴⁸ 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?⁴⁹

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

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.⁵⁰ 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.⁵¹ 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.⁵² 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.⁵³

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.⁵⁴ Chapter 4 contains statistical analyses of the convergence and determinants of OECD countries' tax mixes.⁵⁵

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.⁵⁶

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).⁵⁷

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

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.⁵⁸ 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.⁵⁹ 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

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.⁶⁰ 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.⁶¹ 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.⁶² 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.⁶³ 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.⁶⁴ 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.⁶⁵ 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.⁶⁶ 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

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.⁶⁷ 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.⁶⁸ Hence, if governments are forced to cut their corporate tax rate under international competitive pressure,⁶⁹ 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,⁷⁰ 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.⁷¹

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.⁷² Furthermore, labour taxation is highly politicised and strongly connected to arguments of fairness and economic efficiency.⁷³ 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

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.⁷⁴ 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.⁷⁵ 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.⁷⁶ 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.⁷⁷ 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.⁷⁸ Most studies that do focus on the top personal income tax rate do not include the corporate income tax rate as a control variable.⁷⁹ Studies that do include both rates generally find a strong correlation between them.⁸⁰ 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

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.⁸¹ 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.⁸²

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.⁸³

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-

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.⁸⁴ 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.⁸⁵ 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,⁸⁶ and corporate taxes are generally considered worse for economic growth than consumption taxes.⁸⁷ 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.⁸⁸ A large body of literature has studied this convergence process, but has mainly looked at various government expenditures, such as benefit systems.⁸⁹ Despite the importance of the tax mix for a country's

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.⁹⁰ 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.⁹¹ 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.⁹² 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.⁹³ EU countries should have more homogeneous tax systems because of the EU's harmonisation efforts;⁹⁴ whereas the CEE Member States might converge into a specific direction because of their distinct political economies.⁹⁵

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.⁹⁶ 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?*

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.⁹⁷ 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 β -convergence: a negative β -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;⁹⁸ 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.⁹⁹ 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-

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.¹⁰⁰ 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.¹⁰¹ 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.¹⁰² In an attempt to codify which unilateral policies should be allowed or disallowed, Dietsch and Rixen propose a 'Fiscal Policy Constraint'.¹⁰³ 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'.¹⁰⁴ 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.¹⁰⁵

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

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.¹⁰⁶

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.¹⁰⁷

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.¹⁰⁸ In a similar vein, Infanti proposes to make tax

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.¹⁰⁹ 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.¹¹⁰ 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

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.¹¹¹ 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.¹¹² 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.¹¹³

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.¹¹⁴ 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.¹¹⁵ 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.¹¹⁶ 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.¹¹⁷ 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.¹¹⁸ 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.

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.