Taking Sovereignty Seriously

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David Hasen, *Tax Neutrality and Tax Amenities*, __ **Fla. Tax Rev.** __ (forthcoming 2011), available at SSRN.

As with many areas of law, a canon of sorts has grown up around the field of international taxation. Pursuant to this canon, income disappearing "through the cracks" of the international taxing regime, and the resulting loss of tax revenue, has been singled out as one of the single largest problem plaguing the international fiscal order. This has led to concerted efforts to recapture this disappearing tax base through multiple types of enforcement or punishment, most famously through a blacklist campaign led by the OECD against so-called uncooperative tax havens.

What may surprise some, however, is that this canon appears to rest primarily on a single, somewhat dated, premise arising from the public finance literature: that of tax "neutrality" – or the idea that the tax law should not change where and how capital invests around the world as compared to what would occur absent taxes. Neutrality, it was argued, was the *sine qua non* of the international tax regime in that it would prevent "distortions" to international capital flows, thus maximizing worldwide efficiency; increased worldwide efficiency would mean increased worldwide growth, making all countries better off – the supposed common goal of all. Given that neutrality would benefit the entire worldwide tax regime, the argument went, it was appropriate or even necessary to punish countries which did not adopt "neutral" policies in their tax laws as well. Even critics of this approach seemed to base their analysis in neutrality terms, effectively ceding the battleground before a shot was fired.

Notwithstanding its canonical status and intuitive appeal, a small but growing chorus has begun to question the dominance of the "neutrality" paradigm as the driving force behind international tax policy. David Hasen adds a powerful and persuasive voice to this chorus in his forthcoming article *Tax Neutrality and Tax Amenities*. In this article, Hasen takes on the idea that tax neutrality is desirable – or even feasible – in the context of cross-border capital flows among sovereign countries by taking seriously the concept of tax sovereignty, that is, the idea that each country raises revenue to provide for its own public goods. Once the impact of capital flows on tax revenue, and thus public goods, is taken into account, Hasen argues, there is no way to analyze the efficiency loss of capital flows out of one country without also taking into account, among other things, potential efficiency gains arising from increased tax revenue in the other.

Although an open economic system analysis such as this is not novel, what is new is Hasen's attempt to explicitly incorporate the efficiency benefits of public goods – which he refers to as "tax amenities" – into the international tax policy analysis. Doing so fundamentally challenges what we think of as neutral or whether neutrality even has any purchase in this context. From the introduction of the paper:

> [I]t is not clear that the concepts of tax neutrality and tax distortion in the international setting are meaningful. If it is impossible to articulate a neutral baseline, it would seem impossible to justify normative claims about the value of minimizing actual departures, that is, "distortions," from whatever is taken as the baseline. (P. 4.)

This key insight represents a direct assault on the conceptual underpinnings of neutrality as the intellectual basis of the international tax regime itself because including tax amenities into the neutrality analysis in this manner creates a fundamental and potentially fatal endogeneity problem in defining a normative tax baseline: (1) any claim to sovereignty by a state necessitates collection of revenue, to pay for the tax amenities necessary to exist as a sovereign state, such as roads, bridges, and electricity, (2) these tax amenities in turn increase the returns to capital in that

country, thereby changing the worldwide efficient allocation of capital. Put differently, without a fixed baseline, there can be no way to tell what a "distortion" from the baseline is. From the paper:

> Because levels of funding for tax amenities affect the absolute rate of return to factors of production in each jurisdiction, tax-induced adjustments to tax revenues, no less than changes in the relative supply of and demand for factors of production, will affect the productivity of those factors, and indeed in ways that diverge between the affected jurisdictions. (P. 20.)

From this perspective, the validity of prescriptive claims based solely on the rhetorical or normative strength of neutrality, from either a first best or second best standpoint, must be called into question. Instead, Hasen adopts an alternative approach, analyzing whether improvements to a given allocation of capital and tax amenities may be possible using an empirically identified starting point (in this case, 1980 United States GDP). What Hasen demonstrates rather convincingly is that, in an open system, improvements could arise either from neutrality or redistribution, or both, depending on (among other things) the marginal return to capital and the marginal return to public goods in different countries.

In addition to this extremely important and insightful point, Hasen undertakes a larger, more ambitious, goal in this paper, namely, to craft a comprehensive alternative model through which to analyze international tax law. The paper does not necessarily address all of the questions that logically follow, however. For example, if gains from tax amenities are possible, why can't countries borrow against them to provide the tax amenities, especially if capital is so mobile? Further, several of the ultimate prescriptions discussed in the paper appear to differ only slightly from many of the prescriptions arising under the neutrality regime, making the ultimate payoff somewhat less grand than the premise. Notwithstanding these points, however, the paper is an extremely thoughtful and valuable contribution to this emerging strand of the literature.

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