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# What's at Stake in the Sovereignty Debate?: International Tax and the Nation-State

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**WHAT'S AT STAKE IN THE SOVEREIGNTY DEBATE?:  
INTERNATIONAL TAX AND THE NATION-STATE**

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# WHAT'S AT STAKE IN THE SOVEREIGNTY DEBATE?: INTERNATIONAL TAX AND THE NATION-STATE

## ABSTRACT

The international tax problems of today are typically beyond the scope of a single nation to solve. However, the prospect of multinational problem solving, often under the auspices of an international organization, unleashes objections grounded in sovereignty. Despite widespread reliance on sovereignty arguments, little attention has been directed at what precisely is meant by sovereignty and what place it has in international tax policy. This article contends that a loss of sovereignty undermines both significant functional roles played by a nation-state (revenue and fiscal policy) and important normative governance values (accountability and democratic legitimacy). Whether these limitations are severe enough to demand that a sovereign state recall its taxing powers from an international body (or not surrender them initially) depends on the nature of the powers in question and the necessity for a coordinated global response.

Part I develops the basic nexus between sovereignty and taxation. Part II examines the use of sovereignty in the debates and analyses surrounding three international tax case studies. Drawing upon the case studies, Part III considers how sovereignty claims are manipulated in tax debates, how states think about sovereignty in taxation, and what their decisions, in turn, suggest about the future of international tax and the prospects for international cooperation.

## INTRODUCTION

No significant issue in international tax can be discussed without raising the question of “sovereignty.” Does a particular outcome or position harm or infringe upon a nation’s sovereignty? Is sovereignty advanced by the proposed tax plan? Should a sovereign nation participate in multilateral tax cooperation to solve shared problems? The larger question, however, is what exactly is meant by sovereignty and what is at stake as we think about the place of sovereignty in international tax.

Why does sovereignty matter? Sovereignty takes center stage in international tax because much of the debate over both rules and policies involves and impacts other nations. As is widely recognized, nations do not act in a vacuum in conducting international tax policy.<sup>1</sup> Even purely domestic actions can have significant ramifications abroad.<sup>2</sup> Moreover, much effective tax policy implementation requires the interaction, even cooperation, of two or more nations. Almost a century of bilateral tax treaties<sup>3</sup> evidences the longstanding need for something more than unilateral action in solving international tax problems. Often efforts have proceeded on a multilateral scale. The OECD (Organisation for Economic Cooperation and Development) itself has served

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<sup>1</sup> The observation that domestic tax legislation on matters of cross border taxation does not exist in a vacuum does not imply that such legislation and policy is carefully coordinated with the rules of other countries.

<sup>2</sup> See, e.g., Abram Chayes & Antonia Handler Chayes, *THE NEW SOVEREIGNTY* 26-27 (1995) (pervasive nature of interdependence among states); Alan James, *SOVEREIGN STATEHOOD* 177-79 (1986) (impact of interdependence in understanding sovereignty).

<sup>3</sup> See, e.g., Michael J. Graetz & Michael M. O’Hear, “The Original Intent of U.S. International Taxation,” 46 *DUKE L. J.* 1021, 1066-1089 (1997) (describing the historical development of tax treaties); Michael J. Graetz, “Taxing International Income: Inadequate Principles, Outdated Concepts and Unsatisfactory Policies,” 26 *BROOKLYN J. INT’L L.* 1357, 1395-1397 (history and growth of tax treaties).

as a primary forum for coordination of international tax through its model treaty and commentary, its reports and position papers, and its discussion opportunities. The OECD, however, does not have any binding force on nations and cannot dictate tax treatment. In the context of the European Union (EU), the potential for more binding uniform tax treatment across nations is possible; however, the progress to date on that front has been rather limited.<sup>4</sup>

In the midst of all of this multilateral discussion, the constant refrain of “sovereignty” can be heard, both explicitly and implicitly. Reference to sovereignty is used widely and varyingly – often with a broad rhetorical flourish. While this usage is not unique to taxation,<sup>5</sup> there is a particular strength to the claims for tax sovereignty and the assertion of tax’s special status.<sup>6</sup> Despite widespread reliance on sovereignty arguments, little attention has been directed at what precisely is meant by sovereignty and what place it has in international tax policy. *What* is at stake as we decide what role sovereignty should play in international tax? This article contends that significant functional roles of government and certain normative values can be undermined through a loss of tax sovereignty. Although this conclusion does not provide a definitive benchmark for decisions on tax cooperation, it does provide a caution against arguments that sovereignty is not significant and does point to elements that can make cooperative efforts more legitimate.

Part I develops the basic nexus between sovereignty and taxation by: (1) outlining the central concepts of sovereignty as they have developed in international relations (“IR”) theory; (2) mapping the functional relationship between sovereignty and taxation; and (3) considering the core norms at stake in the debate over sovereignty in international tax. Part II examines the use of sovereignty in the discussions and analyses surrounding three international tax case studies. Reliance on the concept of sovereignty appears across many nations and in many contexts. Elected officials, policy makers, commentators, scholars, and tax protestors all lay claim to “sovereignty” – whether as a critique, an explanation, or an assessment. Not surprisingly, this widespread use of the term is accompanied by variation in meaning and function that must be parsed before any consideration of sovereignty’s role.

Drawing upon the three case studies, Part III considers the how sovereignty claims are manipulated in tax debates, how states think about sovereignty in taxation, and what their decisions, in turn, suggest about the future of international tax. As nations decide whether to tackle some of the more challenging problems of international tax today, such as tax competition and tax arbitrage – which demand more than a unilateral

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<sup>4</sup> See *infra* text accompanying notes \_\_\_\_.

<sup>5</sup> See, e.g., Michael Ross Fowler & Julie Marie Bunck, *LAW, POWER, AND THE SOVEREIGN STATE* 23 (1995) (“Many politicians and diplomats use the substantial rhetorical power of the term [sovereignty] to provide additional force to their country’s diplomatic position or to express outrage at some injustice their people may have suffered. Leaders claim, perhaps with increasing frequency, that their country’s sovereign rights are being trampled by an interested power, an international organization, a multinational company, a meddling neighbor, or some real or imagined aggressor.”); Alan James, *SOVEREIGN STATEHOOD* 1-2 (1986) (describing rhetorical references to sovereignty in legal and political discourse at an international and domestic level).

<sup>6</sup> See, e.g., Yariv Brauner, “An International Tax Regime in Crystallization,” 56 *TAX L. REV.* 259, 283 (2003) (“Tax rates are the most fiercely defended component of each country’s tax system.”). Rules governing tax legislation and voting requirements in the European Union are indicative of the unique status acknowledged for tax law and policy. See *infra* Part II.B.

response to achieve an impact<sup>7</sup> – sovereignty will maintain a prominent place in the discussion. At a minimum, we can see that assertions of tax sovereignty reflect the more modern conception of the sovereign state. As “sovereignty” has transformed to mean a state with responsibility for its people, the question of a state’s legitimacy now requires satisfaction of this duty. A state will need revenue to achieve these sovereign goals. Thus, protection of the revenue source (taxes) and, correspondingly, the state’s taxing powers, become crucial to the state’s duty to its people. The exercise of these taxing powers can put a state in direct conflict with other states also exercising this basic sovereign right. Alternatively, a state might find that it requires the assistance or cooperation of other states to achieve its desired tax policy – although the very act of cooperation might paradoxically jeopardize its own sovereignty. Such is the challenge of tax sovereignty for the modern state.

The three case studies illustrate the use of sovereignty in three different stages of multistate tax cooperation. The first captures the state-to-state conflict of two nations (or groups of nations) in direct conflict over the exercise of their taxing powers. The second reflects the tension and debate surrounding a decision to surrender taxing power to an international body. The third depicts the conflict between a nation and an international organization to which it already has ceded certain taxing powers. The context in which sovereignty is asserted changes but the problems remain the same because of the democratic state’s underlying obligations to its citizens and the potential risk posed by a loss of tax sovereignty.

## I. THE NORMATIVE IMPLICATIONS OF SOVEREIGNTY FOR INTERNATIONAL TAXATION

This part begins by providing a background understanding of sovereignty as it has developed in IR theory and then by detailing the primary operational links between sovereignty and taxation. With this connection between the two, we can then examine why sovereignty is central to four key normative concepts: democratic accountability, democratic legitimacy, local control/multiple sovereigns, and the competing exercises of sovereign power.

### A. THE SOVEREIGNTY CONCEPT

The topic of sovereignty -- its meaning and use over time -- has been the subject of extensive analysis in IR literature.<sup>8</sup> No single definition of sovereignty prevails. The

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<sup>7</sup> See Reuven Avi-Yonah, “Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State,” 113 HARV. L. REV. 1573 *passim* (2000); OECD, HARMFUL TAX COMPETITION: AN EMERGING GLOBAL ISSUE (1998) [hereinafter OECD TAX COMPETITION REPORT]; and Diane M. Ring, “One Nation Among Many: Policy Implication of Cross-Border Tax Arbitrage,” 44 B.C.L. REV. 79,168-69 (2002).

<sup>8</sup> The “modern” vision of sovereignty emerged in the 1500s: “The concept of exclusive control within a delineated geographic area and the untrammelled right to self-help internationally, which emerged out of late medieval Europe, have come to pervade the modern legal system.” Stephen D. Krasner, *Structural Causes and Regime Consequences*, in INTERNATIONAL REGIMES 1, 17-18 (Stephen Krasner ed., 1983) [hereinafter *Structural Causes*]; Fowler & Bunck, *supra* note \_\_ at 21 (“Popular references to the term sovereignty may be traced to . . . the late sixteenth century.”); Hendrik Spruyt, *THE SOVEREIGN STATE AND ITS COMPETITORS* 27 (1994) (explaining that his case studies of European state formation “ends about the time of the Peace of Westphalia (1648), which formally acknowledged a system of sovereign states.”). Certainly predecessors of this vision developed in the Roman Empire (and elsewhere) but then receded

meaning changes over the centuries and across contexts. Moreover, the meaning, scope and contours of “sovereignty” are extensively debated. Nonetheless, certain core elements provide a common thread to analysis of sovereignty (although their precise value, importance, and necessity remain contested). At a minimum, a sovereign state is expected to have three elements: “territory, people, and a government.”<sup>9</sup> A sovereign state must have de facto supremacy and control (at least in some measure) over its territory and people (the internal component).<sup>10</sup> That is, the state represents the supreme source of authority on internal matters.<sup>11</sup> Additionally, a sovereign state must exhibit some de facto external independence – “not the supremacy of one state over others but independence of one state from its peers.”<sup>12</sup>

Even at this preliminary stage two observations about sovereignty emerge. First, the sovereignty idea places the “state” front and center. The sovereignty focused view of the world conceives of states as the primary actors and cannot envision a world without them.<sup>13</sup> “Sovereignty designates states as the only actors with unlimited rights to act in the international system. Assertions by other agencies are subject to challenge. If the constitutive principle of sovereignty were altered, it is difficult to imagine that any other international regime would remain unchanged.”<sup>14</sup> This idea of the “state” as paramount runs through the two dominant theoretical branches in international relations theory -- neoliberalism and neorealism. Both of these schools share a common premise – that states are the central (and rational) actors in international relations. Although other forces may be at work, and merit consideration, the state remains the primary focus.<sup>15</sup>

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during the medieval period. See, e.g., James, *supra* note \_\_ at 3-4; see also Joseph R. Strayer, ON THE MEDIEVAL ORIGINS OF THE MODERN STATE 10 (1970) (“the Roman Empire was a state [b]ut we are looking for the origins of the modern state, and the modern state did not derive directly from any of these early examples.”); James E. Dougherty & Robert Pfaltzgraff, Jr., CONTENDING THEORIES OF INTERNATIONAL RELATIONS 10-11 (2001) (discussing the role of Jean Bodin (1530-1596) in formulating the modern sovereign state system).

<sup>9</sup> James, *supra* note \_\_ at 13; Fowler & Bunck, *supra* note \_\_ at 33. See also, Thomas J. Biersteker & Cynthia Weber, *The Social Construction of State Sovereignty*, in STATE SOVEREIGNTY AS SOCIAL CONSTRUCT 1, 3 (Thomas J. Biersteker & Cynthia Weber eds., 1996).

<sup>10</sup> See, e.g., Stephen D. Krasner, *Sovereignty, Regimes and Human Rights*, in REGIME THEORY AND INTERNATIONAL RELATIONS 139, 142 (Volker Rittberger ed., 1993) [hereinafter *Human Rights*] (“Sovereignty is a system of political order based on territory. The territorially grounded nature of sovereignty distinguishes it from other forms of political order such as tribes . . .”).

<sup>11</sup> See, e.g., Spruyt, *supra* note \_\_ at 38-39 (outlining the differences between a feudal organizational structure (which lacked exclusive territorial domain and lacked a final source of authority) and a sovereign territorial structure); see also, Strayer, *supra* note \_\_ at 8, 45. For example, some matters of internal governance could not be appealed to another state, or an external religious authority, as was common in the Middle Ages with the expansive power of the Christian Church. See, e.g., James, *supra* note \_\_ at 228-29 (domestic dimensions of sovereignty).

<sup>12</sup> Fowler & Bunck, *supra* note \_\_ at 37.

<sup>13</sup> See generally Fowler & Bunck, *supra* note \_\_ at 163.

<sup>14</sup> Krasner, *Structural Causes* *supra* note \_\_ at 17-18; see also Ryan Goodman & Derek Jinks, “Toward an Institutional Theory of Sovereignty,” 55 STAN. L. REV. 1749, 1760 (2003) (noting that “[o]f all the possible organization forms political activities could assume, the contemporary nation state is the ‘preferred form of sovereign responsible actor.’” (quoting John W. Meyer, John Boli, George M. Thomas & Francisco O. Ramirez, “World Society and the Nation State,” 103 AM. J. SOC. 144, 158 (1977))).

<sup>15</sup> See, e.g., Dougherty & Pfaltzgraff, *supra* note \_\_ at 68, 97-98, 166-68; Arthur Stein, WHY NATIONS COOPERATE 4, 7 (1990) (defining realism and liberalism).

Second, despite extensive debates in the literature regarding sovereignty, there is no expectation that to claim sovereignty a state must demonstrate complete satisfaction of all of the underlying elements. This is true on both a conceptual level and on a more practical one. Conceptually, all nation-states are impacted and affected by the decisions of other nation-states. Even the most powerful states must take into account the desires, needs and views of other states in pursuing their own agendas. Tax commentators have long recognized this reality, as discussed in Part II below. Sovereignty, in some sense, is never a truly absolute quality.

On the more practical level, states vary widely in the degree to which they possess and demonstrate the elements of sovereignty delineated above: “Historically, one or the other of the major principles associated with sovereignty has always been under challenge. . . . Only a few states have actually possessed all of the major attributes that are associated with sovereignty – territoriality, autonomy, recognition, and effective control – the United States being the most obvious case. Hence, in some sense, almost all of the states of the world have been semi-sovereign.”<sup>16</sup> The reality that states vary considerably in their real power does not undermine the operation of the sovereignty concept.<sup>17</sup> Nor is sovereignty synonymous with power – some nations with minimal economic or military power may face little challenge to their territorial control, whereas other presumably more powerful nations can break apart (such as the Soviet Union).<sup>18</sup> However, related to these practical observations, sovereign status seems to be a partial one way street. Problems that might cause a state difficulty in gaining sovereign status (for example, unstable domestic control) might be overlooked once sovereign status has been achieved, and will not cause the state to lose such status.<sup>19</sup>

The definition of sovereignty has been expanded by some to incorporate ideas of “legitimacy.”<sup>20</sup> Not only should a sovereign state demonstrate basic supremacy and control over its territory and people, it should accomplish this through exercise of authority that is “legitimate” in terms of the source, exercise and recognition of the

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<sup>16</sup> Stephen D. Krasner, “Pervasive Not Perverse: Semi-Sovereigns as the Global Norm,” 30 CORNELL INT’L L. J. 651, 652 (1977) [hereinafter “Semi-Sovereigns”]. See generally Chayes & Chayes, *supra* note \_\_ at 27 (“The largest and most powerful states can sometimes get their way through sheer exertion of will, but even they cannot achieve their principal purposes – security, economic well-being, and a decent level of amenity for their citizens – without the help and cooperation of many other participants in the system. . . . Smaller and poorer states are almost entirely dependent on the international economic and political system for nearly everything they need to maintain themselves as functioning societies.”).

<sup>17</sup> Obvious differences in the power and attributes possessed by different states, while not undermining the concept of sovereignty *per se*, have generated debated as whether those differences are part of sovereignty (i.e. whether what sovereignty precisely means varies by state) or comes after sovereignty (i.e. all sovereign states possess specified qualities as part of being sovereign, and remaining differences are simply those of history and dynamic state relations). See, e.g., Fowler & Bunk, *supra* note \_\_ at 63-82.

<sup>18</sup> Fowler & Bunck, *supra* note \_\_ at 29

<sup>19</sup> Fowler & Bunck, *supra* note \_\_ at 42. See also Robert Jackson, QUASI STATES: SOVEREIGNTY, INTERNATIONAL RELATIONS AND THE THIRD WORLD 23-24 (1990) (observing that international society has modified its treatment of marginal states: “They are not allowed to disappear juridically – even if for all intents and purposes they have already fallen or been pulled down in fact. They cannot be deprived of sovereignty as a result of war, conquest, partition, or colonialism such as frequently happened in the past. . . . The rules of sovereign statehood have changed in the direction of far greater international toleration and accommodation of marginal governments than has been the case since the emergence of the Western-dominated universal international society in the mid nineteenth century.”).

<sup>20</sup> See, e.g., Fowler & Bunck, *supra* note \_\_ at 38 (citing the work of Raymond Aron and Alan James)



power.<sup>21</sup> We see throughout the 20<sup>th</sup> century increased attention to and links between “legitimacy, responsibility, and international recognition”<sup>22</sup> of the sovereignty state. The increased role for legitimacy and responsibility drive changes in areas such as human rights and colonial rule.<sup>23</sup> For example, “in the 1890s the international community entitled a sovereign state to treat its citizens as it pleased. A century later, human rights campaigns . . . sharply challenged this historical entitlement.”<sup>24</sup> Following World War I, the beginnings of advocacy for human rights could be witnessed in the work of the International Labour Organization.<sup>25</sup> Up until that time, questions of human rights were understood “as the exclusive preserve of the state.”<sup>26</sup> The post World War II<sup>27</sup> period ushered in an era of growing attention to human rights and a corresponding shift in the understanding of the sovereign state’s rights and responsibilities.<sup>28</sup> This shift produced two potentially competing threads into the international community of states that persist today and surface in the taxation case studies – (1) broadening what it means to be a sovereign state to include the protection and promotion of citizen welfare and (2) accepting international scrutiny, and in some cases organized effort, to evaluate and ensure that states meet these obligations to their citizens.

Similarly, changing views on sovereignty and colonial rule in the 20<sup>th</sup> century also marked a development that reverberated in the tax arena, as discussed more extensively in the tax competition case study in Part II. Through the nineteenth century and into the twentieth, more powerful sovereign nations engaged in empire building. At that time, “states . . . claimed, and the international community acknowledged, the sovereign right to acquire and govern colonies.”<sup>29</sup> Once again, with the advent of World War II, the idea

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<sup>21</sup> A state’s exercise of political power is legitimate where: “it is acquired and exercised according to established rules; -- the rules are justifiable according to socially accepted beliefs about the rightful source of authority and . . . the proper ends . . . of government,” and “authority [is] confirmed by the express consent or affirmation on the part of the appropriate subordinates and other legitimate authorities.” David Beetham & Christopher Lord, *Legitimacy and the European Union*, in *POLITICAL THEORY AND THE EUROPEAN UNION* 16, 16 (Albert Weale & Michael Nentwich, eds., 1998). See also *infra* note [65].

<sup>22</sup> Fowler & Bunck, *supra* note \_\_ at 6.

<sup>23</sup> Fowler & Bunck, *supra* note \_ at 39. Twentieth century independence movements by former colonies received broader support as the “former” imperial state’s control over the colony lost its legitimacy. Fowler & Bunck, *supra* note \_\_ at 39; see Inis L. Claude, Jr., *THE CHANGING UNITED NATIONS* 96 (1967). For example, the United Nations has striven “to delegitimize colonialism, to invalidate the claim of colonial powers to legitimate possession of overseas territories – in short, to revoke their sovereignty over colonies.” Claude, *supra*, at 96.

<sup>24</sup> Fowler & Bunck, *supra* note \_\_ at 73.

<sup>25</sup> See Jack Donnelly, “International Human Rights: A Regime Analysis,” 40 *INT’L ORG.* 599, 614 (1986).

<sup>26</sup> Donnelly, *supra* note \_\_ at 614.

<sup>27</sup> See, e.g., Kathryn Sikkink, “Human Rights, Principled Issue-Networks, and Sovereignty in Latin America,” 47 *INT’L ORG.* 411, 413 (1993) (“[U]ntil World War II, in the widest range of issues the treatment of subjects remained within the discretion of the state; no important legal doctrines challenged the supremacy of the state’s absolute authority within its borders.”). See also, Donnelly, *supra* note \_\_ at 614-15 (World War II marks a decisive break; the defeat of Germany ushered in the contemporary international human rights regime.”).

<sup>28</sup> See, e.g., Sikkink, *supra* note \_\_ at 414 (observing that “if sovereignty is a shared set of understandings and expectations about the authority of the state, and is reinforced by practices, then a change in sovereignty will come about by transforming understandings and practices.”).

<sup>29</sup> Fowler & Bunck, *supra* note \_\_ at 73. See also, Stephen D. Krasner, Review: “Sovereignty Redux,” 3 *INT’L STUD. REV.* 134, 135 (2001) (“Nineteenth-century imperialism, which required the European states to claim the right to rule over wide swaths of the earth’s territory, required a doctrine drawn from national

of colonialism “became controversial and finally unacceptable in principle.”<sup>30</sup> States no longer claimed the right to colonial rule, and “various imperial states voluntarily relinquished sovereignty over former colonies, as the British did in Belize, various Caribbean states, and Australia.”<sup>31</sup> Moreover, as former colonies moved past their colonial status, they also began to assert rights not previously recognized as part of the sovereign’s general set of powers: “[E]xpropriation and nationalization of foreign owned property – which was typically barred under international law in the past, [became] a sovereign right and a legal act.”<sup>32</sup> The impetus for change came from the newly independent states of the 1950s and 60s which “refused to consider themselves bound by a law in whose formation they had not participated . . . [t]he law of expropriation attracted their special animus since it purported to place strict limitations on how they could deal with foreign investors in control, at the time of independence, of many of the new states’ natural resources.”<sup>33</sup> The tax competition case study in Part II (and the position of the tax haven states) can be viewed as analogous to that of the former colonies regarding expropriation rules.

Not only has sovereignty been an evolving concept, some contend it is evolving straight toward extinction. At various points sovereignty has been declared dead, or dying.<sup>34</sup> Given the obvious continued existence of many traditional states, such as the United States, why is this claim made? The rise of international organizations and the recognition that states are not the only actors in the international arena<sup>35</sup> have contributed to the analytical shift. One view holds that the combination of multinational, transnational and global forces (including the growth of multinational organizations and

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sovereignty [which emphasized the state’s power and authority as unconstrained] rather than constitutional sovereignty [which viewed the power and authority of the state as constrained]. The state was the final authority – the final arbiter over its own actions, including occupying foreign lands and governing alien populations.”).

<sup>30</sup> Robert H. Jackson, “Quasi-States, Dual Regimes, and Neoclassical Theory: International Jurisprudence and the Third World,” 41 INT’L ORG. 519, 526 (1987).

<sup>31</sup> Fowler & Bunck, supra note \_\_ at 73. Another area which saw a shift in the rights of a sovereign state involved declarations of war: “A century ago sovereignty implied that a state could go to war whenever it pleased. Once again, states have renounced such a sovereign prerogative.” Id.

<sup>32</sup> Fowler & Bunck, supra note \_\_ at 75. See generally, Karol N. Gess, “Permanent Sovereignty over Natural Resources: An Analytical Review of the United Nations Declaration and Its Genesis,” 13 THE INT’L & COMP. L. Q. 398 (1964) (reviewing the history, process and debates underlying the U.N. resolution in 1962 on sovereignty over natural resources); Patrick M. Norton, “A Law of the Future or a Law of the Past? Modern Tribunals and the International Law of Expropriation,” 85 AM. J. INT’L L. 474, 478 (1991) (describing the role played by the 1962 U.N. resolution in the changing views on expropriation and nationalization).

<sup>33</sup> Norton, supra note \_\_ at 478. However, the shift toward greater acceptance of states’ rights to engage in expropriation or nationalization has not been entirely one directional. See Rudolf Dolzer, “New Foundations of the Law of Expropriation of Alien Property,” 75 AM. J. INT’L L. 553, 555-56 (1981). The decades following the independence of the former colonies may be less pertinent and less reflective of actual practice, as countries have renegotiated many contracts, and may view foreign investment as desirable. Norton, supra note \_\_ at 496-97.

<sup>34</sup> See, e.g., James, supra note \_\_ at 3 (noting assertions by some scholars that “sovereignty” was on the decline).

<sup>35</sup> See Diane M. Ring, “International Tax Relations: Theory and Implications,” 60 TAX L. REV. 83, 145-46, 152-53 (2007) (discussing the role of nonstate actors in international tax policy).

multinational corporations, “MNCs”) has weakened the authority of the state.<sup>36</sup> Under this view, states are on the decline as their power “leak[s] away, upwards, sideways, and downwards.”<sup>37</sup> Among the various mechanisms by which state power is drained away are the array of international laws and principles with which states must, to varying degrees, comply: “According to conventional wisdom, there is a structural tension between state sovereignty and a range of practices including compliance with international obligations, participation in multilateral regimes, and acceptance of international principles. Major concerns include preserving national control over domestic legal and policy choices, and . . . avoiding exogenous constraints on sovereign prerogatives, especially in the area of national security.”<sup>38</sup>

However, not all analyses of globalization adopt the view that the changing nature of international activity inherently spells the decline of the state.<sup>39</sup> Some observers believe that these concerns about internationalization “are at best mispecified and at worst misleading.”<sup>40</sup> Others offer an even more affirmative characterization of the impact of the modern global system on state sovereignty in the financial context: “[With the] tightening linkage between domestic and foreign policies . . . [i]t is tempting to exaggerate the degree to which governments may be vulnerable to buffeting financial market volatility. Nevertheless, governments still make the policies that affect interest rates, investment, taxation, the value of currency, capital flows, and so on.”<sup>41</sup> For those who see a long future for the nation-state, the concept of sovereignty has nonetheless continued to evolve. Under this new “schema,” state sovereignty has not dissipated or declined but it has transformed.<sup>42</sup> What does this new sovereignty look like? The focus has shifted “from sovereignty as control to sovereignty as responsibility in both internal functions and external duties.”<sup>43</sup> Effectively, the sovereignty concept has morphed to absorb (not be undermined by) the important 20<sup>th</sup> century changes regarding the proper role of the nation state. In this new world, international organizations can *enable* a state to perform its functions of protection and promotion of welfare in an era of truly global intersections of peoples, goods, and ideas. This reliance on the international community exists not only in those states that depend on international organizations to satisfy some

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<sup>36</sup> See, e.g., Dougherty & Pfaltzgraff, *supra* note \_\_ at 32-33 (reviewing competing views on the health of the modern state); Jessica T. Matthews, “Power Shift,” 76 *Foreign Affairs* 50, 53 (Jan./Feb. 1997) (characterizing nongovernmental organizations as increasingly powerful entities that frequently fulfill state functions and direct and shape state action: “Today’s NGOs deliver more official development assistance than the entire U.N. system (excluding the World Bank and the International Monetary Fund).”).

<sup>37</sup> Susan Strange, “The Defective State,” 124 *DAEDALUS* 56 (Spring 1995) (quoted in Dougherty & Pfaltzgraff, *supra* note \_\_ at 33).

<sup>38</sup> Goodman & Jinks, *supra* note \_\_ at 1785; see also Peter Evans, “The Eclipse of the States? Reflections on Stateness in an Era of Globalization,” 50 *WORLD POLITICS* 62, 70-71 (Oct. 1997) (most states are constrained by international norms, structures, and agreements (including GATT and WTO) in their efforts to make unilateral state decisions favoring their local economy/state).

<sup>39</sup> See, e.g., Fowler & Bunck, *supra* note \_\_ at 1-4 (discussing predictions of the decline of sovereignty and its importance).

<sup>40</sup> Goodman & Jinks, *supra* note \_\_ at 1785.

<sup>41</sup> Dougherty & Pfaltzgraff, *supra* note \_\_ at 33.

<sup>42</sup> Although there has been “no transfer or dilution of state sovereignty. . . there is necessary re-characterization involved. . .” Anne-Marie Slaughter, “Security, Solidarity, and Sovereignty: The Grand Themes of UN Reform,” 99 *AM. J. INT’L L.* 619, 628 (2005).

<sup>43</sup> Slaughter, *supra* note \_\_ at 628.

of the basic responsibilities of a state to its citizens, but also among states with more extensive resources that nonetheless face problems extending far beyond their borders.<sup>44</sup>

## B. FUNCTIONAL ROLE OF SOVEREIGNTY IN TAXATION

Sovereignty-based arguments appear regularly in tax debates, discussions, analyses and commentaries as states consider the degree to which they should cooperate, coordinate, or defer to the views of other states. Often the reference is quite explicit, with the formal language of sovereignty highlighted. In other cases, the term itself may not appear, but the characterization of why some action or non-action is a problem implicitly relies on an underlying norm and expectation of tax sovereignty. Certain topics, such as tax rates, seem particularly vulnerable to critiques based on sovereignty. Other topics, such as definitions, appear more amenable to shared decision-making although even there, if the definitions at issue have a strong unilateral impact, sovereignty objections might surface.<sup>45</sup> Why, however, are tax issues such powerful lightning rods for critics concerned about sovereignty? Several interconnected reasons may explain this phenomenon, but the two dominant functional reasons are revenue and fiscal policy control.

### 1. REVENUE

Perhaps the most fundamental function of taxation is raising revenue to pay for governmental expenses and programs. "Taxes are necessary to raise revenue for public goods and infrastructure, as well as to provide other sorts of public services conducive to general welfare and economic growth."<sup>46</sup> Tax revenues pay for the necessary goods – like national defense or a legal system – that an unregulated market cannot provide by itself.<sup>47</sup> In fact, the link between taxes and “necessary” state revenues is typically considered so obvious that tax analysts, politicians, government officials and tax reformers of all stripes presume the connection in their commentary. For example, advocates of strong government and a social safety net argue that protecting the state’s ability to levy taxes is crucial to allowing the state to continue these functions. Conversely, advocates of the market view of government services argue that guaranteeing nations the flexibility to “compete” on their tax systems (an issue considered below in more detail) “ensures” efficient government.<sup>48</sup>

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<sup>44</sup> See *supra* text accompanying note \_\_\_\_\_. This observation also resonates with the idea from the U.N. secretary-general’s High-Level Panel on Threats, Challenges and Change of “confronting states with a direct choice of accepting conditional sovereignty in return for the kind of effective collective action that has become indispensable to performing a sovereign’s basic obligations to its people.” Slaughter, *supra* note \_\_ at 620.

<sup>45</sup> See the case studies reviewed in Part II.

<sup>46</sup> Kenneth L. Sokoloff & Eric M. Zolt, “Inequality and Taxation: Evidence from the Americas on How Inequality May Influence Tax Institutions,” 59 *TAX L. REV.* 167, 167-68 (2006).

<sup>47</sup> Kyle Logue & Ronen Avraham, “Redistributing Optimally: Of Tax Rules, Legal Rules, and Insurance,” 56 *TAX L. REV.* 157, 170 (2003). Today, personal income taxes are the federal government’s most important general source of revenue. IRS Data Book for 2006, Table 1 at 3.

<sup>48</sup> This argument can extend into the classic “Leviathan” argument which views government spending as inherently undesirable, and views steps to reduce “funding” the state as appealing because the government cannot spend what it does not collect. Regardless of the desirability of government spending, the connection between taxes and spending is presumed. Collecting the money to fund that government and then setting up that government to determine its scope, size and function in society are therefore two core

At the founding of the United States, the states themselves appreciated the importance of revenue collection to the effective, if not the literal, existence of state government.<sup>49</sup> Supporters of local control claimed that “the [taxing] powers given to the federal body . . . will necessarily destroy the state sovereignties for there cannot exist two independent sovereign taxing powers in the same community.”<sup>50</sup> At the Pennsylvania ratifying convention in 1787, the outnumbered advocates for state power feared “that the national government would ‘monopolize every source of revenue [and] indirectly demolish the State governments.’”<sup>51</sup> Convention participants did not mistake the link among taxes, sovereignty, power and revenue.

## 2. FISCAL SOVEREIGNTY

Taxes, however, do more than simply raise revenue: “Any tax that produces revenue will in some way alter the social and economic order.”<sup>52</sup> Taxes that only raise revenue without effecting other changes do not exist in the real world.<sup>53</sup> For example, if a very high tax rate is imposed on the highest income bracket in an effort to boost tax revenue, taxpayers in that bracket may be forced into “comparative idleness”<sup>54</sup> – they will choose leisure over earning such highly taxed income. The concept of fiscal policy captures that link between revenue collection and government spending. The hope throughout the twentieth century has been that a nation’s fiscal policy can shape overall demand in the economy, growth, stability of prices, and full employment.<sup>55</sup> When used in concert with a complete government policy, states expect that taxes can be used to control the pace and direction of the economy.<sup>56</sup> The 2008 stimulus package passed by the U.S. Congress included one-time tax rebates explicitly premised on this belief.<sup>57</sup> More specifically, taxes can be used to increase or decrease inflation and purchasing power, stimulate investment, and prevent harmful concentrations of wealth.<sup>58</sup> The

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facets of being a sovereign state. See, e.g., Marjorie E. Kornhauser, “Legitimacy and the Right of Revolution: The Role of Tax Protests and Anti-Tax Rhetoric In American,” 50 *BUFF. L. REV.* 819, 882 (2002) (“Taxes are directly tied to legitimacy of any government because governments need a cheap, steady source of revenues to survive.”); *Nicol v. Ames*, 173 U.S. 509, 515 (1898) (“The power to tax . . . is as necessary to the existence and prosperity of a nation as is the air he breathes to the natural man.”).

<sup>49</sup> Thomas Slaughter, “The Tax Man Cometh: Ideological Opposition to Internal taxes,” 41 *WILLIAM & MARY Q.* 566, 588 (1984) (noting fears that adoption of the U.S. Constitution, with its significant federal taxing powers would spell “the death of states governments”).

<sup>50</sup> *Id.* at 588 (quoting comments of Pennsylvania’s William Findley in 1787).

<sup>51</sup> *Id.* at 588.

<sup>52</sup> Randolph E. Paul, *TAXATION FOR PROSPERITY* 214 (1947).

<sup>53</sup> Paul, *supra* note \_\_ at 214.

<sup>54</sup> Paul, *supra* note \_\_ at 415.

<sup>55</sup> See, e.g., James R. Schlesinger, “Emerging Attitudes Towards Fiscal Policy,” 77 *POL. SCI. Q.* 1, 1-4, 10-13 (1962). See also John B. Taylor, “Reassessing Discretionary Fiscal Policy,” 14 *J. OF ECON. PERSPECTIVES* 21 (2000) (considering the role of fiscal policy, particularly in comparison to monetary policy at the end of the 20<sup>th</sup> century).

<sup>56</sup> George A. Nikolaieff, *Preface*, in *TAXATION AND THE ECONOMY* 3, 3-4 (George A. Nikolaieff ed., 1968).

<sup>57</sup> See *Jt. Comm. On Taxation, Technical Explanation of the Revenue Provisions of H.R. 5140 (The “Economic Stimulus Act of 2008”), JCX-16-08, Part A (Feb. 8, 2008)* (“The [tax] credit mechanism (and the issuance of checks. . . ) is intended to deliver an expedited fiscal stimulus to the economy.”)

<sup>58</sup> Paul, *supra* note \_\_ at 413-14; James R. Repetti, “Democracy and Opportunity: A New Paradigm in Tax Equity,” \_\_ *VAND. L. REV.* \_\_ (2008).

underlying theory for much of this is Keynesian economics.<sup>59</sup> To simplify—quite substantially—that theory for our purposes: when an economy is too slow, taxes can be reduced to increase the capital available to consumers to reduce unemployment and increase demand and production. During economic booms, when high inflation becomes a problem, taxes can be raised to reduce the capital available to consumers and reduce demand.<sup>60</sup> However, the link between tax and economic behavior is not entirely new. As far back as Alexander Hamilton, American officials have used taxes as a tool to influence business activity and not merely raise revenue (Hamilton believed that an inheritance tax would foster small proprietorships).<sup>61</sup> In addition to its role in managing the economy, the tax system can and is used regularly to influence arenas not generally viewed as market or economy related, through provisions such as the adoption credit (IRC section 23), the child credit (IRC section 24), the exemption from income of certain prizes and awards (IRC section 74(b)), and the exclusion from income of the rental value of a parsonage (IRC section 107).

### C. WHAT NORMS ARE AT STAKE WHEN STATES ASSERT SOVEREIGNTY?

The prior subsection noted that nations assert tax sovereignty because they want to control revenue and fiscal policy. This desire is logical, but is there anything beyond this functional use of sovereign taxing power? This subsection contends that four important norms<sup>62</sup> are at stake as nations struggle to claim or maintain tax sovereignty: (1) democratic accountability, (2) democratic legitimacy, (3) local control/multiple sovereigns, and (4) competing exercises of sovereign state power. The first two points reflect the importance of certain democratic measures and systems for states whose own legitimacy is based on democratic rule. The third point considers what would be desirable even if democracy concerns could be eliminated, and the final point considers the normative problem created when there are competing sovereignty claims.

#### 1. THE DEMOCRACY PROBLEMS

For nations relying on democratic rule for their legitimacy, the assertion of sovereignty and the concomitant resistance of efforts to surrender national decision making to any type of international body are consistent with a goal of preserving legitimacy of the state. The “sense of legitimacy that underpins [advanced industrial democracies’] political systems, and that undergirds both the actual exercise of political authority and the willing deference of those subject to it, rests on the common belief that government is responsible to a given people, accountable to that people, and obliged to

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<sup>59</sup> See George A. Nikolaieff, *Introduction to “Longest Boom In History, in TAXATION AND THE ECONOMY* 11, 11-27 (George A. Nikolaieff ed., 1968) (for a brief overview of Keynes's economic theory and impact).

<sup>60</sup> See George A. Nikolaieff, *Introduction to “The Reckoning,” in TAXATION AND THE ECONOMY* 115, 115-16 (George A. Nikolaieff ed., 1968).

<sup>61</sup> Paul, *supra* note \_\_ at 214. Beyond traditional fiscal policy goals, the tax system has been used to regulate a wide array of taxpayer behaviors. For example, some taxes are designed to promote or discourage certain types of activity in addition to producing revenue. High taxes on liquor and tobacco are one example of this; not only do such taxes produce revenue, but the resulting high prices are supposed to decrease consumption of an elastic and harmful commodity. See *id.*

<sup>62</sup> These norms, however, are not limited to expressions of tax sovereignty.

serve the best interests of that people.”<sup>63</sup> Shifting certain decisions and powers *away* from the nation-state – an act often characterized as a *loss* of sovereignty – can be expected to weaken claims by the state that it operates according to democratic principles and that the decisions and policies it pursues are the product of democratic systems. Why is that the case? As examined below, there are serious concerns about the ability of organizations or bodies above the nation state level to satisfy the elements of democratic rule. At the same time, “the historical bearers of democratic legitimacy [the nation states] cannot transfer it [their own legitimacy] to another level of governance.”<sup>64</sup> Essentially, if real power is being transferred to another level of decision-making beyond the state, that body must itself earn democratic legitimacy and cannot rely on the pre-existing legitimacy of the nation-states. Moreover, as the states surrender power in this context and ultimately implement the resulting policies, the states themselves can be charged with failing to operate according to democratic principles.

To examine the challenges to democracy posed by a state’s loss of sovereignty, it is valuable to first consider *why* states might even consider pursuing paths that would impair sovereignty. Essentially, the motivations for a state transferring some power or decision-making to a broader international body are the very set of pressures outlined in the introduction. Globalization decreases a state’s ability to implement and pursue the policies of its people<sup>65</sup>: “[t]here is a danger that political communities will be unable to reach a desired goal owing to conditions outside their jurisdiction.”<sup>66</sup> Multilateralism may provide a way for a nation to effect positive policies for its citizens that it cannot implement acting alone

Although globalization is not a new force, its meaning in the 19<sup>th</sup> century (extensive trade routes and burgeoning empires) contrasts sharply with its role today. It is characterized today by “an international order involving the conjuncture of a global

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<sup>63</sup> Louis Pauly, *Introduction*, in *DEMOCRACY BEYOND THE STATE* 1, 1 (Michael Th. Greven & Louis W. Pauly eds., 2000). See also David Beetham & Christopher Lord, *Legitimacy and the European Union*, in *POLITICAL THEORY AND THE EUROPEAN UNION* 15, 16-17 (Albert Weale & Michael Nentwich eds., 1998) (“[T]he legitimacy of a liberal democratic system depends on three criteria: an agreed definition of the people or ‘political nation’ as defining the rightful bounds of the polity; the appointment of public officials according to accepted criteria of popular authorization, representativeness and accountability; and the maintenance by government of defensible standards of rights protection, or its routine removal in the event of ‘failure.’”).

<sup>64</sup> Stephen Newman, *Globalization and Democracy*, in *DEMOCRACY BEYOND THE STATE* 15, 16 (Michael Th. Greven & Louis W. Pauly eds., 2000). In the context of the European Union the transfer of various powers from the member states to the EU bodies has created just this problem: “In transferring legal competencies from the national to the supranational level, the democratically elected parliaments in the EU’s member states have lost some of their power to shape and control policies. However, there has been no strengthening of the democratic legitimacy on the supranational level to compensate for this weakening of democracy on the national level.” Edgar Grande, *Post-National Democracy in Europe*, in *DEMOCRACY BEYOND THE STATE* 115, 117-18 (Michael Th. Greven & Louis W. Pauly eds., 2000).

<sup>65</sup> See, e.g., March Plattner, *DEMOCRACY WITHOUT BORDERS? GLOBAL CHALLENGES TO LIBERAL DEMOCRACY* 81-2 (2008) (“The rise of multilateral institutions is a natural response to a shrinking world. As cross-border contacts multiply, both in the economy and in other spheres, there is an inevitable need for institutions that can address problems that lie beyond the competence of any single state. Even for a superpower like the United States, neither isolationism nor across-the-board unilateralism is a realistic option. The serious argument is about the nature of multilateral institutions and their power vis-à-vis national governments.”);

<sup>66</sup> Michal Zurn, *Democratic Governance Beyond the Nation State*, in *DEMOCRACY BEYOND THE STATE* 91, 93 (Michael Th. Greven & Louis W. Pauly eds., 2000).

system of production and exchange which is beyond the control of any single nation-state (even the most powerful); extensive networks of transnational interaction and communication which transcend national societies and evade most forms of national regulations; the power and activities of a vast array of international regimes and organizations, many of which reduce the scope for action of even the leading states; and the internationalization of security structures which limit the scope for the independent use of military force by states.”<sup>67</sup> The European Union, for example, has been described as not just “a loss of national autonomy in social and economic regulation . . . [but also] the emergence of a system in which states can collectively regain some regulatory control over otherwise untrammelled processes of globalization.”<sup>68</sup> Given that nation-states face problems of a global scale but possess powers generally limited to the national level, it is not surprising that states turn to multilateralism as a remedy. The question remains, why is this remedy a risk to the democratic foundations of these sovereign nations? Extensive attention has been devoted to the democratic implications of international organizations and international governance mechanisms; however, for purposes of this sovereignty inquiry it is valuable to focus on two interrelated dimensions of concern – accountability and legitimacy.

a. DEMOCRACY ACCOUNTABILITY

Accountability is often seen as lacking in international organizations,<sup>69</sup> due in part to the view that accountability is grounded in an electoral process, which is not feasible on a global scale.<sup>70</sup> At the global level, there is no firm concept of "citizenship" or a "people" in the traditional sense, and without a polity, elections are not possible.<sup>71</sup> Of course there is some measure of accountability at the global level, but it exists only through multiple levels of delegation.<sup>72</sup> Although some degree of delegation may be both necessary and functional, there is a generally held belief that "long chains of delegation simply make for poor democracy."<sup>73</sup> The EU faces this critique of its multilevel governance structure: “the lack of responsiveness of the elected members of the European parliament to the preferences and interests of their constituents. . . [and the] basic

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<sup>67</sup> David Held, *Democracy and the New International Order*, in COSMOPOLITAN DEMOCRACY 96, 101 (Daniele Archibugi & David Held eds., 1995).

<sup>68</sup> Thomas Christiansen, *Legitimacy Dilemmas of Supranational Governance*, in POLITICAL THEORY AND THE EUROPEAN UNION 98, 102 (Albert Weale & Michael Nentwich eds., 1998).

<sup>69</sup> “It is generally acknowledged that all institutions lack democratic procedures and compare badly with democratic nation-states in this regard.” Thomas D. Zweifel, INTERNATIONAL ORGANIZATIONS & DEMOCRACY 13 (2006); see also Terry MacDonald & Kate MacDonald, “Non-Electoral Accountability in Global Politics: Strengthening Democratic Controls Within the Global Garment Industry,” 17 EUR. J. INT’L L. 89, 90 (2006).

<sup>70</sup> MacDonald & MacDonald, *supra* note \_\_ at 118.

<sup>71</sup> Steve Charnitz, “Opening the WTO to Nongovernmental Interests,” 24 FORDHAM INT’L L. J. 173, 198 (2000).

<sup>72</sup> Charnitz, *supra* note \_\_ at 198. This layering and delegation has been compared to the accountability of Supreme Court justices or Federal Reserve Board members in this United States. Joseph S. Nye, “Globalization’s Democratic Deficit: How To Make International Institutions More Accountable,” 80 FOREIGN AFFAIRS 2, 5 (July/Aug. 2001) (the citizens of a country elect their national officials who then elect or delegate authority to international officials just as U.S. voters elect their president and members of Congress whom ultimately select the justices and the Federal Reserve Board members).

<sup>73</sup> Kal Raustiala, “Rethinking the Sovereignty Debate in International Economic Law,” 6 J. INT’L ECON. L. 841, 853 (2003).



difficulty [in] applying the principle of representation to the multilevel system of European decision making leads to gaps of accountability and deficits of individual control.”<sup>74</sup> Similar arguments about democratic accountability have been raised against the North American Free Trade Agreement (NAFTA) and the World Trade Organization.<sup>75</sup> The United Nations also suffers from accountability problems because its agenda setting “has been far from democratic, given the low level of citizens’ representation and participation.”<sup>76</sup>

Related to the issue of accountability of the international body absorbing these formally nation-state decisions is the question of transparency.<sup>77</sup> The same layering of responsibility and the delegation of power up from the state to the international body that generates accountability problems also limits transparency. Because of their bureaucratic nature, international institutions rarely allow outside access to the details of their decision-making.<sup>78</sup> Without this access, a powerful or opportunistic group might “hijack the agenda” without the knowledge of the countries or groups affected by its actions.<sup>79</sup> Although many of these concerns regarding democratic global governance (including accountability and transparency) might be improved through institutional re-design, they nonetheless, convey a broad-based critique and wariness of the democratic quality of decision-making at a regional or global level. Moreover, such institutional redesigns would likely impact the effectiveness of the organization and its ability to reach decisions, and reach them on a timely basis.<sup>80</sup>

Yet there is reason to believe that the degree of democratic governance might closely impact the effectiveness of a tax system. One example of the importance and implications of enhanced democratic governance on taxation emerged from studies in the 1990s looking at tax compliance in 25 Swiss cantons. One analysis (Frey) argues that the type of constitution (i.e. direct democratic processes v. representative democratic processes) impacts taxpayer compliance.<sup>81</sup> In a study of 25 Swiss cantons for the years 1965, 1970, and 1978, Frey concluded that “tax morale” (measured by reference to

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<sup>74</sup> Grande, *supra* note \_\_ at 125-126.

<sup>75</sup> Giandomenico Majone, *State, Market and Regulatory Competition in the European Union*, in *CENTRALIZATION OF FRAGMENTATION? EUROPE FACING THE CHALLENGES OF DEEPENING, DIVERSITY, AND DEMOCRACY* 94, 122 (Andrew Moravcsik ed., 1998).

<sup>76</sup> Yoshikazu Sakamoto, *The Untied Nations and World Order in Democratic Transition*, in *BETWEEN SOVEREIGNTY AND GLOBAL GOVERNANCE – THE UNITED NATIONS, THE STATE AND CIVIL SOCIETY* 274, 284 (Albert J. Paolini, et al. eds. 1998).

<sup>77</sup> See, e.g., Grande, *supra* note \_\_ at 126 (“A lack of transparency and openness in the [E.U.] policy process intensifies problems of control and accountability.”); Philip Alston, “Promoting Accountability of Members of the New UN Human Rights Council,” 15 *J. TRANSNAT’L L. & POL’Y* 49, 54 (2005).

<sup>78</sup> Alston, *supra* note \_\_ at 54.

<sup>79</sup> Basu at 499.

<sup>80</sup> For example, those who advocate changing various processes within the EU to increase accountability, individual participation and transparency, acknowledge that these steps are likely to decrease the effectiveness of the EU. See, e.g., Grande, *supra* note \_\_ at 127 (“The problem is that demands for transparency and openness are incompatible with the functional requirements of consensus democracy . . . . Increasing the transparency of the European decision-making process by making Council meetings public would either necessitate an introduction of majority rule or would weaken the effectiveness of the policy process considerably. Since both of these alternatives are undesirable, we are forced to conclude that a lack of transparency and openness will remain a structural feature of the European decision-making process.”).

<sup>81</sup> Bruno S. Frey, “A Constitution For Knaves Crowds Out Civic Virtue,” 107 *THE ECON. J.* 1043, 1050 (1997) (exploring the factors beyond deterrence that contribute to law abiding behavior).

undeclared income) was *higher* in those cantons with more direct democratic processes.<sup>82</sup> That is, tax compliance was higher in the cantons whose constitutional structure was categorized as more directly democratic than in those cantons whose constitutional structure was categorized as more representative.<sup>83</sup> It seems reasonable to assume that creating this kind of taxpayer intimacy with the government and the tax system (through more direct democratic features) should be easier in a “smaller” governmental unit as opposed to a large unit, such as a single world government.

Thus, not only are accountability and representation (along with the necessary transparency) central to democratic processes, a strong democratic process with a close link between the citizen-taxpayer and the government may improve participation in the tax system. A country seeking to encourage tax compliance would have reason to worry if the political system widened the gap between taxpayers and policy makers.

#### b. DEMOCRATIC LEGITIMACY

As noted above, there are steps that can be taken in an international institution to improve the quality of the democratic process by broadening accountability, participation, and transparency – but those changes are not cost free. The institution’s effectiveness will likely be impeded. Moreover, even if such process and structural changes are implemented (and any corresponding loss in institutional effectiveness is tolerated), other democracy problems can continue to undermine the legitimacy of the institution, its process, and its outcomes: “While some observers situate the problem of democratic legitimacy in the workings of the EU and other international institutions, [other observers] question the very possibility of democratic processes beyond the nation-state. In their view, democratic legitimacy is possible only within the framework of a *demos* – that is, a political community expressed in the concept of the nation. Beyond the nation-state, there is no strong sense of public interest, and the potential for political regulation is limited.”<sup>84</sup> These limitations may be felt most strongly in situations of majority rule where the expectation is that the decision of the majority is binding and those who are outvoted should accept the outcome.<sup>85</sup> However, “the outvoted actors will accept the decision only if the decision-making process is deemed *legitimate and sanctions are applied* for noncompliance.”<sup>86</sup> But when will legitimacy and sanctions both emerge? It is expected that “legitimacy . . . and a willingness to establish a system

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<sup>82</sup> Frey, *supra* note \_\_ at 1050-1051. Werner W. Piommerehne and Hannelore Weck-Hannemann also conducted a study of these Swiss cantons for the same tax years, and among their conclusions observed that “the extent of political participation of citizens/taxpayers has a clear and stable effect, thus indicating the substantial influence of policy acceptance on taxpayers’ adherence to tax laws.” Werner W. Piommerehne & Hannelore Weck-Hannemann, “Tax Rates, Tax Administration and Income Tax Evasion in Switzerland,” 88 PUB. CHOICE 161, 168 (1996). [Note that due to a split in one of the cantons in 1979, there are now 26 cantons].

<sup>83</sup> Frey, *supra* note \_\_ at 1051 (1997). Direct democratic elements in the constitutional structure included such features as “citizens’ meetings, obligatory and optional referenda and initiatives.” *Id.* at 1050. See generally Lars P. Feld & Bruno S. Fey, “Tax Evasion in Switzerland: The Roles of Deterrence and Tax Morale,” University of Zurich, Institute for Empirical Research and Economics, Working Paper No. 284 (April 2006).

<sup>84</sup> Zurn, *supra* note \_\_ at 95.

<sup>85</sup> *Id.* at 95-96. See also Grande, *supra* note \_\_ at 119-120.

<sup>86</sup> Zurn, *supra* note \_\_ at 95-96 (emphasis added).

of sanctions [will] develop *within* the framework of a political community, and so, without a *demos*, there seems to be no basis for a democratic majority decision.”<sup>87</sup>

Assuming that a *demos* is central to democratic legitimacy, why is it not possible to create a *demos* at a level beyond the nation state? Certainly there is no a priori rule that bars recognition or creation of a *demos* beyond the state – it “is not a prepolitical quantity, the result of cultural or ethnic homogeneity.”<sup>88</sup> However, a *demos* cannot be created by “mere fiat” either.<sup>89</sup> The legitimacy of majority rule depends on “a pre-existing sense of community – of common history or common destiny, and of common identity.”<sup>90</sup> The absence of a *demos* does not mean that an international organization or body cannot accrue power, rather it limits the degree of legitimacy: “In the absence of a transnational *demos*, coercive power can in principle flow to the global level, but the legitimacy of its exercise will remain profoundly questionable. And in the absence of a shared sense of legitimate governance, even the obvious winners in the global capitalist resurgence will have cause to worry about the durability of their gains.”<sup>91</sup>

One of the more plausible candidates for a transnational *demos*, the European Union, does not currently possess this level of community sensibility, thereby increasing fears of a democratic deficit.<sup>92</sup> Accordingly, the EU might more aptly be characterized as an intergovernmental organization: “there is no real ‘European public space.’ The peoples of the EU speak many different languages. Their media, their party systems, and their politics as a whole are essentially national. A common argument holds that there is no European *demos*, and hence the EU cannot be a real democracy.”<sup>93</sup>

It should not be surprising that democracy might be more responsive and ultimately viewed as more legitimate when practiced on a smaller scale: “[i]t is much easier to design institutions that are locally democratic, than globally democratic, particularly in terms of responsiveness to the ‘cultural’ aspects of what counts as democratic decision-making; moreover, preferences and social circumstances are likely to be more homogenous within localities [than] across a set of boundaries.”<sup>94</sup> To the extent that sovereign states push power and decision making up the chain to international organizations (i.e. to the extent that they surrender sovereignty), the decisions that emerge may suffer from a lack of democratic legitimacy precisely because the decisions are applied across a population that does not constitute a *demos* with a collective sense of interconnected commitment to the enterprise. Whether these limitations are severe enough to demand that the sovereign state recall its power from the international body (or not surrender it initially) depends on the nature of the powers in question and the necessity for a coordinated global response.

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<sup>87</sup> Id. at 95-96 (emphasis added).

<sup>88</sup> Id. at 98-99.

<sup>89</sup> Grande, supra note \_\_ at 120 (quoting Fritz W. Scharpf, “Economic Integration, Democracy and the Welfare States,” 4 J. OF EUR. PUBLIC POL’Y 20 (1977) and describing the community necessary to render majority rule legitimate).

<sup>90</sup> Grande, supra note \_\_ at 119-120 (quoting Fritz W. Scharpf, “Economic Integration, Democracy and the Welfare States,” 4 J. of Eur. Public Pol’y 20 (1977)).

<sup>91</sup> Louis W. Pauly, *Democratic Foundations for a Global Economy*, in DEMOCRACY BEYOND THE STATE 165, 166 (Michael Th. Greven & Louis W. Pauly eds., 2000).

<sup>92</sup> See, e.g., Grande, supra note \_\_ at 120;

<sup>93</sup> Plattner, supra note \_\_ at 97.

<sup>94</sup> David Charny, “Regulatory Competition and the Global Coordination of Labor Standards,” 3 J. OF INT’L ECON. L. 281, 299 (2000).

## 2. LOCAL CONTROL/ MULTIPLE SOVEREIGNS

Even if we could resolve the democracy problems inherent in decision-making at a more global level, should we nonetheless prefer a world in which there are many sovereigns making decisions and exercising control at a more local level? For three reasons, the answer might be yes.

First, the sovereign state system, with localized control over the domestic sphere, can facilitate the creation and support of a unique society with a distinctive cultural and political identity<sup>95</sup> which can pursue its own vision of a desirable society. The contrast, highlighted in the second case study of Part II, between the ideals espoused by England and those espoused by Denmark for the proper role and size of government illustrate this point. The domestic control enables each state to promote and serve the goals, values and ideals of its own community. This advantage of the sovereign state system is perhaps best appreciated in comparison to a hypothetical single world government<sup>96</sup> which does not accommodate such local variation. This is not to suggest that only a system premised on sovereign states can achieve preservation of local cultural and political identity, but rather that the sovereign states can do so.<sup>97</sup>

Second, a multiplicity of sovereign states might enhance the prospects for development of creative and alternative policies across many subjects including taxation, environmental law, transportation, and securities regulation. This idea reflects the same values that support the existence of multiple courts of appeals and of regulatory competition among the states in the United States. The percolation of ideas in numerous laboratories can enhance the likelihood of developing new, successful strategies.

The third, and related, reason supporting multiple sovereigns is the general reservation that accompanies any idea of a world state: “[T]he making of a world state

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<sup>95</sup> The claim regarding local culture and political identity is not intended to imply the need for single ethnicity, single religion communities. Although more localized control can be desirable, it is anticipated that states can and will accommodate multiple groups. In part, this is a message of the modern human rights movement (which supports healthy sovereign states because liberal, non-marginalized states with strong civic structures are generally more compliant with human rights standards). Gregory Fox, *New Approaches to International Human Rights*, in STATE SOVEREIGNTY 105, 127-130 (Sohail H. Hashmi ed., 1997). Human rights law and ideology set the expectation that multi-ethnic, multi-religious communities can and should exist successfully – and it is human rights law (and ideals) that helps establish the baseline for this heterogeneous interaction. Fox, *supra* note \_\_\_ at 129-130.

<sup>96</sup> The implications of and objections to a “world state” have been considered in the literature. See, e.g., Louis Cabrera, *POLITICAL THEORY OF GLOBAL JUSTICE* 90 (2004) (“even if it does not seem possible that a global government could be created, however long the time horizon, discussion of the objections is important, because any objection against global government proposals likely will have some force against proposals for less extensive sets of supranational institutions”).

<sup>97</sup> One could readily anticipate the suggestion that if a “world government” were to be rejected on the grounds that it provides insufficient local control and variation, then perhaps a basis for grouping other than on broad territorial grounds should be preferred. For example, states could comprise only a single ethnic or religious group, thus permitting the value of local control without the conflict created by multiple groups within a state. However, serious practical, social and ethical issues arise. First, ethnic and religious groups do not overlap easily (e.g., a given ethnic group may include many different religious communities, and conversely a religious grouping may include members from many different ethnic groups). Second, ethnic and religious groups do not exist in neat territorial packages, so the question remains how to handle the geographic dimension – as varying religious and ethnic groups may share the same territory. Efforts to reconstruct, on a global scale, the location of groups to achieve local uniformity, pose significant questions on many levels.

with a monopoly on force, even if conceived and realized with the most perfect democratic constitutional engineering, would risk being transformed, as does any institution, into something at variance with the intentions of its founders.”<sup>98</sup> Thus, democratic legitimacy is not the only reason to question the desirability of something approaching a world state, even in we live in a world of global problems.

### 3. POWER AND THE SOVEREIGN STATE

Given the various functional and democracy based rationales a state could articulate in justifying its policies and actions on sovereignty grounds, clashes between states claiming sovereignty should be anticipated. What if one state justifies its tax policies as necessary to preserve its sovereign control over tax and fiscal powers but another state argues that those very policies infringe on *its* sovereign right to design tax and fiscal rules beneficial to its citizens? The case study in Part II involving the tax competition conflict between the OECD and the tax havens could be characterized as just such a sovereignty conflict. How should it be resolved? Is there a priority of certain sovereignty claims over others? Should other principles be brought into play here?

For example, if sovereignty is used to justify two states’ competing and conflicting tax policies, should the power and status of the states involved be relevant? Does it matter that one state (or group of states acting in concert) is using economic and political power to “force” the other state to abandon its desired tax policy? What is an appropriate use of power among sovereign nations? Traditionally, ideas of state sovereignty have recognized and accepted inequality among nations both in terms of resources and power. Use of these advantages in negotiating and securing desired outcomes have constituted the core of inter-state relations over the centuries. It is not inconsistent with a state’s sovereign status to participate in or accept deals that are less than favorable.<sup>99</sup>

But values other than sovereignty might be relevant in evaluating a battle of sovereignty claims. The question of inter-nation equity frequently appears in discussions of international tax policy – with the implications that some redistribution might be appropriate among the winning and losing states in the global tax system. If one of the sovereign states engaged in a sovereignty conflict is a regular “loser” under the current system, should its sovereignty claim have some measure of priority? Such a decision might be sensible on strategic or economic grounds – particularly where the “losing” state has been garnering more leverage over time (think, for example, of the tax havens “hiding” income and wealth of OECD resident taxpayers). Less clear is whether a claim for inter-nation equity that is not matched by strategic considerations would have any normative bite at this point.

#### D. WHY THE LANGUAGE OF SOVEREIGNTY?

If sovereignty claims in taxation are justified based on the functional needs and democracy concerns of the state, then why not skip the “sovereignty” label and move straight to these assertions? The answer is that although more attention should be paid to

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<sup>98</sup> Daniele Archibugi *From the United Nations to Cosmopolitan Democracy, in Cosmopolitan Democracy* 121, 133 (Daniele Archibugi & David Held eds., 1995).

<sup>99</sup> The effective surrender of certain tax powers likely impairs not the ultimate status of sovereignty but rather the adequate performance of functions constitutive of its sovereign status.

these grounds generating the sovereignty furor, there are nonetheless several reasons to accept a continuing role for the sovereignty language.

First, sovereignty arguments both pre-suppose and assert the desirability of an international system based on sovereign states. While anarchy may not be the preferred world structure for most people contemplating international relations, is sovereignty, with its implicit nationalistic focus, a feature to be encouraged and fostered?<sup>100</sup> One answer to the question is a somewhat practical observation that we have no clear alternative organizational principle of international society and international relations in the absence of sovereignty, and thus states (with their accompanying sovereignty) are a necessary element of our system.<sup>101</sup> However, one could argue that even if we lack a ready, comprehensive alternative,<sup>102</sup> and even if we do not seek to eliminate the role of the state, perhaps we should not be gravely concerned when states complain that some event or course of action impinges upon their sovereignty.<sup>103</sup> Is there any counterclaim that can be made for the affirmative value of sovereignty?<sup>104</sup> Although a complete defense of the

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<sup>100</sup> See, e.g., Stephen D. Krasner, *Regimes and the Limits of Realism*, in INTERNATIONAL REGIMES 355, 366 (Stephen D. Krasner ed., 1983) [hereinafter *Limits*] (“[C]ertainly through the 18<sup>th</sup> century, and possibly the 19<sup>th</sup>, an international system based on sovereign states was highly congruent with the basic political and economic interests both of the rules themselves and of their subjects . . . [but now] writers associated with the world order perspective emphasize the deleterious economic and political consequences of sovereignty in a nuclearized interdependent world.”)

<sup>101</sup> See, e.g., Alexander Murphy, “The Sovereign State System as Political-Territorial Ideal: Historical and Contemporary Considerations,” in STATE SOVEREIGNTY AS SOCIAL CONSTRUCT 80-82 (Thomas Biersteker & Cynthia Weber ed., 1996) (observing that despite the range of debates and questions raised, most actors and most discussions assuming the centrality of a territorial based notion of the state). Although there are many good questions about the desirability of the territorial approach to political organization, as Murphy notes, one has effectively articulated an alternative schema for organizing international relations with the state as a central player. *Id.* at 108-109. Even though we may discuss and debate the role and activities of nonstate actors in the international setting, the basic framework still presupposes an international world organized by states. See, e.g., Krasner, *Limits*, supra note \_\_\_ at 367 (“[T]hese arguments, and others that could be cited have virtually no impact on the constitutive principle of the present international system. Why should this be the case? . . . There is no consensual knowledge about what principle might replace sovereignty. For another, there are high sunk costs in the existing regimes. Changing sovereignty would also mean a change in the regimes of virtually all other issue-areas. . . .”). Moreover, it seems unlikely that the dominant players in the current system (states) will be eager to institute another structure. Sovereignty has “strongly reinforced the position of the major actor in the system it legitimates – national states functioning within specific territorial boundaries. . . . Of all of the actors in the system, states are the least likely to be swayed by appeals to transcend sovereignty.” *Id.* at 367.

<sup>102</sup> In a related observation, Alan James contends that the elimination of “sovereign states” through, for example, the creation of a single world state is no guarantee of peace. Although the existence of a single “superstate” by definition eliminates “war” (understood as conflict between states), there is no reason to believe that organized violence by groups (akin to civil conflict) would not emerge. James, supra note \_\_\_ at 264-65.

<sup>103</sup> See, e.g., James, supra note \_\_\_ at 257-261 (outlining “objections” raised by critics of sovereignty to the existence and role of sovereignty, including (1) psychological influence of the term which leads actors to an undesirable decision, and (2) legitimation by sovereignty of the right to war through the structure of nationally focused competing states). An array of other critiques of sovereignty have been articulated including: (1) a Marxist critique, (2) international organization critique (which views such organizations as having a central role in reforming the current world order), (3) supranationalist critique (urging either unified world government, or at least regional unification), and (4) human rights critique. Fowler & Bunck, supra note \_\_\_ at 128-140 (cataloging some primary criticisms of sovereignty).

<sup>104</sup> Note that the identification of favorable arguments for sovereignty implicitly depends on to what the current system of sovereign states is being compared, such as a single world government, or some non-

sovereign state is beyond the scope of this paper, several observations in the prior subsection serve as justification for supporting the sovereignty of states including: (1) democracy concerns about the legitimacy of decision-making and accumulation of power *above* the nation state level; and (2) the potential benefits arising from a multiplicity of sovereigns each exploring problems and possible solutions. If these reasons favor the continued existence of thriving nation-states, it makes sense to use sovereignty language and arguments when state powers crucial to the duties and responsibilities of the state (e.g., revenue, fiscal policy) are at risk.

Second, sovereignty is a form of rhetoric which can be useful (or harmful) depending on how it is employed.<sup>105</sup> To the extent that state actors or other observers perceive particular tax choices, options or decisions as dangerous for the state, it may be easier and more effective to attract attention to the matter by designating the issue as one of national sovereignty. The word is expected to alarm the listeners who implicitly register that problem as one that might effectively allow their state to be under the control of others. However, because rhetoric can be a tool for “any” side, this alone would be a weak argument for continuing to emphasize sovereignty.<sup>106</sup>

Third, the term sovereignty signals the nature of the complaints through an accessible (though arguably vaguer) label. As most of Part I has established, a sovereign state has functional and normative reasons to preserve its decision-making authority and power over tax matters. These reasons relate to both the state’s role within its borders (e.g., design and implementation of desired economic and social policy according to democratic principles) and as part of the international community (e.g., preserving local decision-making where accountability and legitimacy are strongest). Although the tax analysis could immediately shift to these normative and functional concerns without reference to the *loss of sovereignty*, such a leap risks (1) losing the link between these concerns and the state’s democratic mission, and (2) having the message obscured in details and less familiar language. A slightly distinct signaling use of sovereignty language can be made by non-state actors such as the OECD and the E.U. Such organizations could signal their recognition of and support for sovereignty concerns by using that same language back in discussing their visions and goals as well as the *limits* of their plans.

Fourth, a sovereignty objection can capture the effect of a constellation of decisions, and reflect the fact that although any one issue might or might not be crucial on tax sovereignty, the totality of events could be troubling. The state’s goal is to keep an eye on what tools remain available to handle fiscal and economic planning. Many tax issues are detailed and sometimes esoteric,<sup>107</sup> and their broader and longer-term impact may be less readily apparent. Challenging potential decisions on sovereignty grounds can indicate, not that the specific tax question on the table is devastating to state sovereignty, but that given the choices already made, the impact of this current decision may be underappreciated.

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global system of organization based on a connection other than geography (which the current sovereign state system implements).

<sup>105</sup> See generally Kornhauser, *supra* note \_\_ (examining the impact of tax rhetoric in the United States).

<sup>106</sup> See, e.g., Kornhauser, *supra* note \_\_ at 889 (examples of anti-tax rhetoric “meant to conceal what politicians are really doing”).

<sup>107</sup> Of course others are not, such as the decision between unanimous and QMV.

Thus, the language of tax sovereignty can contribute to domestic and international discussions on the allocation of power and policy making. However, any dialogue among political decision makers that ended with sovereignty would be fruitless; it must be followed by details and examination of the underlying tax issues.

#### SUMMARY

Emerging from a medieval past, sovereignty and the sovereign state continue to play a central role in modern international political life. Although the ongoing vitality of the sovereignty concept has not been without challenge, clearly by any definition sovereignty has not died even if its meaning has evolved during the past six hundred years.<sup>108</sup> Despite debate over the use and relevance of sovereignty today, several key observations persist: (1) the state is still a central actor on the international stage; (2) international organizations and entities have grown in scope, size and power (in many cases states are the members); (3) although the increased interactions among nations at all levels – movements of peoples, goods, money, pollution, instability – have decreased autonomy (conceived of as a country’s ability to ignore what is going on outside of its borders and still achieve its desired policies domestically), the resulting interconnectedness of nations has not eliminated their focus on national self interest;<sup>109</sup> (4) sovereignty-based dialogue is alive and well and quite common among nations, though it is now expressed as a responsibility to care for its citizens as opposed to primarily a means to prevent encroachment;<sup>110</sup> and (5) states can identify powerful functional goals and normative claims supporting an assertion of tax sovereignty.

## II. USES OF SOVEREIGNTY IN INTERNATIONAL TAX

### A. U.S. PERSPECTIVES ON INTERNATIONAL TAX COMPETITION

The United States’ colonial tax history, occupied with disputes over the imposition of taxes by distant governments, echoes in many current tax debates. U.S. responses to proposals for international tax cooperation evince a long standing desire to reserve tax decisions to the nation-state. The U.S. experience in the international tax competition debate captures this dimension of U.S. tax policy. This section will outline the tax competition issue and then examine U.S. governmental and “popular” reaction to the proposals that emerged.

International tax competition, which became a significant “problem” in the 1980s, refers to a country using its tax system to attract investment, activity, or cash flow to the country itself. Common techniques include imposing little or no taxes on certain activities or on foreign investors, and not disclosing information to other governments. Competing on the basis of tax systems is not new, however, globalization and the

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<sup>108</sup> See competing views considered by Bierstock & Weber, *supra* note \_\_ at 4-7.

<sup>109</sup> When they come to the table to discuss issues of shared importance, their primary perspective is that of their nation, and their primary goal is the promotion of national (as opposed to global) interests (whether they are analyzed in the long or short term).

<sup>110</sup> This point alone would not demonstrate that sovereignty is indeed a powerful force in actual decision making in the world – the other evidence demonstrates that– but it does reveal the continued rhetorical power of sovereignty both as an appeal (i.e. “we” are entitled to this valuable asset) and as a rallying cry (“we” should come together and demand this, take action to obtain this)



technological advances of the latter half of the 20<sup>th</sup> century (including the increased mobility in capital) resulted in countries lowering their tax rates to solicit investment within their borders. Why might this be a problem? The general concern is that although some forms of tax competition may be beneficial (i.e. forcing governments to use their tax and spending powers efficiently and wisely in the market of sovereign states), other forms are not. These “harmful” forms of competition create a race to the tax revenue bottom (particularly for taxes on capital) resulting in the erosion of countries’ tax bases.<sup>111</sup> At that point, states are typically left with consumption and payroll tax bases because investment and capital are significantly more mobile than labor.<sup>112</sup> The result is a distortion of the taxing burden (more emphasis on regressive taxes) and a decline in revenue that could otherwise support the infrastructure and social welfare programs of the state.<sup>113</sup>

In response to growing concern over tax competition, the OECD countries espoused a desire to “encourage an environment in which fair competition can take place” and to create a “level playing field.”<sup>114</sup> In May of 1996 a Ministerial Communique directed the OECD to “develop measures to counter the distorting effects of harmful tax competition on investment and financing decisions and the consequences for national tax bases, and report back in 1998.”<sup>115</sup> Ultimately the OECD produced its report on harmful tax competition in 1998, which addressed practices of OECD member countries<sup>116</sup> and nonmember countries. Although tax competition can occur in a variety of settings, the 1998 Report selected geographically mobile activities (e.g., financial services, the provision of intangibles) as its focus, reserving other areas of competition for further study.<sup>117</sup> The report provided a series of factors to identify the “harmful” tax practices, enumerated their negative effects, and offered recommendations to respond to the problem of harmful tax competition.<sup>118</sup>

Three dominant tax competition scenarios were reviewed in the report: (1) a country imposing virtually no income tax (potentially a “tax haven”); (2) a country that does impose and collect significant individual or corporate income taxes, but which has preferential features to the system that enable the income at issue to face little or no

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<sup>111</sup> See OECD, TAX COMPETITION REPORT, supra note \_\_ (using the term “harmful” tax competition to identify the type of tax competition being challenged).

<sup>112</sup> Avi-Yonah, supra note \_\_ at 1578; see also OECD, TAX COMPETITION REPORT.

<sup>113</sup> See Avi-Yonah, supra note \_\_ at 1577-78.

<sup>114</sup> OECD, THE OECD’S PROJECT ON HARMFUL TAX PRACTICES: THE 2004 PROGRESS REPORT 4 (2004) [hereinafter OECD PROGRESS REPORT ].

<sup>115</sup> OECD, TAX COMPETITION REPORT, supra note \_\_ at 7.

<sup>116</sup> The original OECD member countries are: Austria, Belgium, Canada, Denmark, France, Germany, Greece, Iceland, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States. Subsequent members, in chronological order through 1998 (i.e. the time of the report) are Japan, Finland, Australia, New Zealand, Mexico, the Czech Republic, Hungary, Poland, and Korea. After the 1998 report, The Slovak Republic joined in 2000. OECD, PROGRESS REPORT, supra note \_\_ at 2; see also The OECD Website listing current member countries, available at: [http://www.oecd.org/countrieslist/0,3351,en\\_33873108\\_33844430\\_1\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/countrieslist/0,3351,en_33873108_33844430_1_1_1_1_1,00.html)

<sup>117</sup> OECD, TAX COMPETITION REPORT, supra note \_\_ at 8.

<sup>118</sup> The report made several proposals: (1) establish Guidelines on Harmful Preferential Tax Regimes; (2) create a Forum on Harmful Tax Practices; (3) develop a list of tax havens; and (4) recommendations for national level legislation and treaty action in response to continued use by any jurisdictions of these harmful practices. Id at 9.

taxation; and (3) a country that imposes and collects significant corporate or individual income tax but at effective rates lower than those in the “other country.”<sup>119</sup> Although recognizing that the “other country” (i.e. the residence country of the taxpayer with mobile activities) may be unhappy with all three scenarios, the harmful tax competition report states that the third scenario is not within its scope. Moreover, it reiterates that there is no intention to “explicitly or implicitly suggest that there is some general minimum effective rate of tax to be imposed on income below which a country would be considered to be engaged in harmful tax competition.”<sup>120</sup> With respect to the first two categories (which are addressed), the report discusses the additional factors that cause them to constitute harmful practices, including lack of effective exchange of information, lack of transparency, lack of substantial activities in the jurisdiction, or (in the case of preferential regimes) special geographic or industry limited tax regimes.<sup>121</sup>

Having established categories of harmful tax competition and their deleterious effects on other countries, the report observed that unilateral or bilateral efforts can have only a limited effect on counteracting these harmful practices: “The need for coordinated action at the international level is also apparent from the fact that the activities which are the main focus of this report are highly mobile. In this context, and in the absence of international cooperation, there is little incentive for a country which provides a harmful preferential tax regime to eliminate it since this could merely lead the activity to move to another country which continues to offer a preferential treatment.”<sup>122</sup> Thus the report recommended certain domestic level counteracting measures (such as strong controlled foreign corporation rules),<sup>123</sup> certain treaty changes (including provisions on exchange of information and on treaty shopping), and perhaps most significantly from the sovereignty debate perspective – certain coordinated steps.<sup>124</sup> Among these coordinated steps, the report recommended that the OECD member countries approve guidelines on harmful preferential tax regimes (including self-evaluation), that the OECD establish a Forum to implement the guidelines and to produce a list of tax havens against which to apply a coordinated response, and that OECD countries with links to tax havens (political, economic, or otherwise) not allow these links to facilitate harmful tax competition.<sup>125</sup> Ultimately, and presumably in recognition of the fact that many of the relevant countries are not OECD members, the report encouraged the Forum (noted above) to “engage in a dialogue with non-member countries using, where appropriate, the fora offered by other international tax organizations, with the aim of promoting the Recommendations” of the report.<sup>126</sup> In April 1998, the OECD Council adopted the recommendations of the report and directed the Committee on Fiscal Affairs to establish a dialogue with non-member countries.<sup>127</sup>

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<sup>119</sup> Id. at 19-20.

<sup>120</sup> Id. at 20.

<sup>121</sup> Id. at 23, 27.

<sup>122</sup> Id. at 38.

<sup>123</sup> Controlled foreign corporation, or “CFC” rules proscribed circumstances in which a residence country may tax its resident corporations on income earned by their foreign subsidiaries in absence of a dividend distribution to the parent.

<sup>124</sup> Id. at 46-53.

<sup>125</sup> Id. at 56-58.

<sup>126</sup> Id. at 58.

<sup>127</sup> Id. at 3.

Not surprisingly, the OECD report generated a tremendous amount of controversy and discussion. An extensive literature developed surrounding the international tax competition question and examined: (1) the quality of the report,<sup>128</sup> (2) the substance of the tax competition fears (with some agreeing that tax competition can be a serious problem that should be addressed, and others questioning the underlying premises and suggesting tax competition arguments have been overstated and that more attention should be focused on ensuring that taxpayers cannot hide certain income);<sup>129</sup> and (3) the empirical dimension of tax competition – where and under what circumstances are taxpayers making various investment and business decisions on the basis of taxation.<sup>130</sup>

Analysis and critique of the OECD project came from another, arguably “less objective”<sup>131</sup> quarter, and in this context commentators drew upon sovereignty as a major lens through which to evaluate tax competition. In 2000, perhaps influenced by the OECD’s release of its 2000 report specifically naming havens, a campaign was mounted in the United State to challenge the OECD’s efforts in tax competition. A major force in this effort was the Center for Freedom and Prosperity which was organized in October 2000. According to its mission statement, the Center’s “top project . . . is the Coalition for Tax Competition, which is fighting to preserve jurisdictional tax competition, sovereignty, and financial privacy.”<sup>132</sup> With respect to sovereignty, the Center states that the OECD’s efforts are “ill-advised;” they constitute “an attack on sovereignty” because the OECD is trying to “bully ‘tax havens’ into raising their tax rates and eliminating financial privacy, . . . [and because the OECD is] assert[ing] the right to interfere with American tax laws. Sovereign nations should be able to determine their own tax policies.”<sup>133</sup>

The CFP pursued two major directions – lobbying congress and the administration against the OECD plan, and urging tax havens to resist the OECD efforts.<sup>134</sup> And, although the CFP and other organizations with which it has affiliated (including the Heritage Foundation and the Cato institute) have been frequently criticized for nonobjective and unsupported claims,<sup>135</sup> these efforts against the OECD Tax

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<sup>128</sup> See, e.g., Arthur Wright, “Review: OCD Harmful Tax Competition Report Falls Short,” 17 TAX NOTES INT’L 461, 462 (Aug. 17, 1998); Michael McIntyre, “McIntyre Finds Fault with Wright’s Analogy,” 17 TAX NOTES INT’L 1915, 1915-16 (Dec. 14, 1998); E. Osterweil, “In Defense of the OECD Report on Harmful Tax Competition,” 17 TAX NOTES INT’L 895, 895-96 (Sept. 21, 1998); Avi-Yonah, *supra* note \_\_ at 1597, 1601, 1658-66.

<sup>129</sup> See, e.g., Avi-Yonah, *supra* note \_\_ *passim*; Julie Roin, “Competition and Evasion: Another Perspective on International Tax Competition,” 89 GEO. L. J. 543 *passim* (2001).

<sup>130</sup> See, e.g., James R. Hines Jr., *Tax Policy and the Activities of Multinational Corporations*, in FISCAL POLICY: LESSONS FROM ECONOMIC RESEARCH 401, 414-15 (Alan J. Auerbach ed., 1997); see also James R. Hines, Jr., “Lessons from Behavioral Responses to International Taxation,” 52 NAT’L TAX J. 305, 308-19 (1999) (exploring the empirical evidence that international tax regimes affect individualized corporate behavior).

<sup>131</sup> See Alex Easson, “Harmful Tax Competition: An Evaluation of the OECD Initiative,” 34 TAX NOTES INT’L 1037 (June 7, 2004) (characterizing some of these critics at “less objective”).

<sup>132</sup> Center for Freedom and Prosperity at <http://www.freedomandprosperity.org/Glance/glance.shtml>.

<sup>133</sup> *Id.*

<sup>134</sup> See, e.g., Robert Goulder, “New Coalition Strikes Back at OECD Tax Havens Campaign,” 21 TAX NOTES INT’L 2650, 2653-54 (Dec. 2, 2000) [hereinafter “Coalition”] (reporting interviews with CFP founders Mitchell and Quinlan who describe their plans to attack the OECD tax competition project).

<sup>135</sup> See, e.g., Easson, *supra* note \_\_ at 1052, 1057 (characterizing some of these critics at “less objective” and using hyperbole).

Competition project were largely successful.<sup>136</sup> Through the CFP's efforts, members of Congress,<sup>137</sup> including members of the Black Caucus,<sup>138</sup> challenged the U.S. participation in the OECD plan and sent letters (often quite similar) to Secretary O'Neill outlining their objections to the tax competition project. The CFP actively courted tax havens<sup>139</sup> which began to strongly resist the OECD's plan. By February of 2001, a senior Treasury official commenting on Secretary of Treasury O'Neill's plans for U.S. participation in the OECD project explicitly raised the sovereignty objection: "He [Paul O'Neill] will respect the sovereignty of the various tax systems – that's very important."<sup>140</sup>

The "final" success of the campaign against the OECD tax competition project, however, came in May 2001 when U.S. Treasury Secretary Paul O'Neill published a statement that: "The United States does not support efforts to dictate to any country what its own tax rates or tax systems should be, and will not participate in any initiative to harmonize world tax systems. The United States simply has no interest in stifling the competition that forces governments --- like businesses to create efficiencies." This strong criticism of the OECD project and the effective withdrawal of substantial U.S. backing dealt a major blow to the tax competition work. Although O'Neill's statement was considered by most tax experts to represent a misreading of the tax competition project<sup>141</sup> (which did not propose rate harmonization and did not reject competition of all

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<sup>136</sup> See, e.g., Thomas Field, "Tax Competition in Europe and America," 29 TAX NOTES INT'L 1235, 1242-43 (March 31, 2003) (describing how the CFP plan worked); Easson, *supra* note \_\_ at 1052 (same). See also, David S. Cloud, *Virginian Fights for International Tax Havens: Lobbying Finds Bush Receptive to Ideas Clinton Rejected*, WALL ST. J., July 30, 2001, at A20 (reviewing the lobbying efforts of the CFP and quoting its co-founder Andrew Quinlan: "We're going to end up generating probably 100,000 pieces of mail.").

<sup>137</sup> Many of these congressional letters were reprinted in Tax Notes International including letters by [ ]. Lists of congress members sending letters, along with copies, are also posted on the CFP website. See also Goulder, "Coalition," *supra* note \_\_ at 2653 (quoting CFP co-founder Quinlan, "What our coalition has, which no one else can claim, is that we are now set to successfully deal with Congress. We have already met with the key players."). The CFP's success on the Congressional front could be seen in the comments of Majority House Leader Dick Armey, "By fighting against an international tax cartel and working to preserve financial privacy, the Center for Freedom and Prosperity is protecting taxpayers, both in America and around the world." *Id.* at 2653 (noting also that Armey was the first major member of Congress to speak out against the OECD tax competition work and to urge the then Secretary of the Treasury Lawrence Summers to "withdraw U.S. support for the initiative.").

<sup>138</sup> The members of the Black Caucus focused their critique on the harm caused to poorer nations, especially those in the neighboring Caribbean. See, e.g., Field, *supra* note \_\_ at 1242 ("even the Black Caucus was induced to speak out against the OECD plan, on the basis of solidarity with people of color living in Caribbean tax havens."); Cordia Scott, "Congressional Black Caucus Says OECD Tax Move Unfairly Blasts Developing Nations," 22 TAX NOTES INT'L 1600, 1600-01 (April 2, 2001) [hereinafter "Black Caucus"].

<sup>139</sup> For example, the two founders of the CFP persuaded Antigua to "designate them as its official delegates to a January OECD summit with other Caribbean tax-haven countries in Barbados." Cloud, *supra* note \_\_ at A20.

<sup>140</sup> Michael M. Phillips, *U.S. Weighs Backing Away From Effort to Crack Down on Tax-Haven Countries*, WALL ST. J., Feb. 22, 2001, at A2) (quoting a senior Treasury official).

<sup>141</sup> After O'Neill's statement, a "bipartisan group of tax commissioners suggest that Mr. O'Neill was misinformed about the purpose of the [tax competition] campaign," that "the project explicitly rejects harmonizing tax codes," and that any effort to "unify tax rates would not work" given the variety of tax systems. David Cay Johnston, "Former I.R.S. Chiefs Back Tax Haven Crackdown," N.Y.T., June 9, 2001, at C1.

types) and although the United States “backpedaled” on its attack on the project (and continued to support the project in what became a modified form), then end result was a tax competition effort mostly focused on information exchange and a “major retreat from the OECD’s original tax competition goals.”<sup>142</sup>

The story of the CFP’s lobbying and political efforts make a fascinating journey through politics, rhetoric, and interest groups.<sup>143</sup> However, for purposes of this article the key element is how the CFP, and those they brought on board, used sovereignty arguments to challenge the OECD project. To consider this question, we can look at three basic categories of writings: comments by the CFP and its affiliates; letters and comments by members of Congress; and statements and comments by other writers. A review of these comments reveals three recurring themes to the sovereignty objections -- (1) fiscal policy, (2) exclusion of some countries from decision making, and (3) colonial rule and redistribution. The following analysis organizes the comments broadly along these lines.<sup>144</sup>

### *Fiscal Policy Objections*

In addition to their website mission statement, other CFP writings identify sovereignty as a major problem with the OECD project. For example, in a 2000 piece in the Washington Times, Daniel Mitchell (co-founder of the CFP) critiqued the tax competition project, asking “by what right can a bunch of Paris-based bureaucrats dictate tax policy to sovereign nations that are not even members of the OECD. . . . The time has come for the United States to reassess its funding of the OECD. . . .[which is] undermining the sovereign right of nations to determine their own tax policies.”<sup>145</sup> In a paper published two months later, Mitchell began by contending that the OECD “effort contradicts international norms and threatens the ability of sovereign countries to determine their own fiscal affairs.”<sup>146</sup> Moreover, the OECD proposed “cartel would have adverse consequences for U.S. taxpayers and threaten national sovereignty, financial privacy, technological development and rule of law.”<sup>147</sup> After discussing tax competition more broadly, and the OECD plans in more detail, the paper outlines a series of arguments as to why the OECD plan is undesirable. Under the heading “Why the OECD Proposal is Misguided,” Mitchell again references sovereignty as well as other concerns.<sup>148</sup> In the section entitled “An Attack on Sovereignty” Mitchell again states:

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<sup>142</sup> See, e.g., Field, *supra* note \_\_ at 1243-1244.

<sup>143</sup> For broader discussion of the role of the CFP in the tax competition debate see, e.g., Easson, *supra* note

<sup>144</sup> It is valuable to bear in mind for all three case studies that the substantive significance of any particular asserted objection to sovereignty does not depend on the speaker’s motivation. As Part I articulated, there are both functional and normative reasons to question the surrender of taxing powers by a sovereign state. A given speaker may tap, without conviction, those arguments and the intuitions that lay behind them to persuade others to adopt a policy desired by the speaker. The speaker’s “self-interest” and lack of true commitment to underlying principles captured by the arguments do not diminish the actual arguments. In fact, part of the reason these arguments might be selected is that they reflect a shared understanding and resonate with the audience.

<sup>145</sup> Daniel J. Mitchell, *OECD War on Low-Tax Countries*, WASHINGTON TIMES, Aug. 20, 2000, at B1.

<sup>146</sup> Daniel J. Mitchell, “An OECD Proposal to Eliminate Tax Competition Would Mean Higher Taxes and Less Privacy.” 21TAX NOTES INT’L 1799, 1799 (Oct. 16, 2000) [hereinafter “Proposal”].

<sup>147</sup> *Id.* at 1800.

<sup>148</sup> *Id.* at 1811-12.

[t]he OECD’s proposal would substantially interfere with the right of sovereign nations to determine their own tax policies. . . . In effect, the OECD seeks to overturn 200 years of established international practice so that high tax nations can impose taxes on assets and activities outside their own territory. Traditionally, governments have used a ‘territorial’ or ‘source-based’ rule for taxation, allowing them to tax all incomes and activities within their borders.<sup>149</sup>

The final paragraph of the paper concludes, “U.S. policymakers should reject the OECD initiative. It is a threat to America’s national interests. More important, it will be bad for U.S. taxpayers; it will undermine national sovereignty; it will destroy financial privacy; it will hinder technological innovation; it will lead to protectionism; and it will sabotage the rule of law.”<sup>150</sup>

Spurred on by lobbying efforts from the CFP, various members of Congress expressed their disapproval of the OECD tax competition project and subsequent international efforts to limit tax competition, and their letters typically referenced the rights of “sovereign nations” and the importance of sovereignty, particularly to fiscal policy.<sup>151</sup> Examples include the following:

(1) Letter from Dick Armey, Majority Leader in the House of Representatives: “[Instead of pursuing the OECD approach] the U.S. should shift entirely to a territorial system – the common sense notion that countries only tax income that is earned within their borders – and also eliminate the double taxation of income that is saved and invested. This approach is consistent with sound tax policy, protects financial privacy, and preserves fiscal sovereignty.” The letter concludes: “I look forward to working with you to stop the OECD’s initiative and to adopt instead, common-sense proposals that will maintain tax competition and the sovereignty of all nations.”<sup>152</sup>

(2) Letter from Wayne Allard, U.S. Senator: “This assault [the OECD initiative] on tax competition, financial privacy, and fiscal sovereignty is deeply flawed. Tax competition is a liberalizing force in the world economy. It restrains the growth of government and leads to lower tax rates. Moreover, if nations (including the U.S.) shifted to territorial taxation, the entire justification for creating a global network of tax police would disappear, as would the justification for interfering with the right of sovereign nations to determine their own tax and privacy laws.”<sup>153</sup>

(3) Letter from Sam Brownback, U.S. Senator: “It [the issue of tax competition and the OECD project] has important implications for individual

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<sup>149</sup> Id. at 1811.

<sup>150</sup> Id. at 1821.

<sup>151</sup> The CFP web site has a page devoted to listing and linking to these letters sent by Senators and Members of Congress to the Treasury Secretary objecting to the U.S. participation in the OECD tax competition project. <http://www.freedomandprosperity.org/congress/congress.shtml>.

<sup>152</sup> Letter of Majority Leader Dick Armey to Secretary of the Treasury Paul O’Neill (March 16, 2001).

<sup>153</sup> Letter of Wayne Allard, U.S. Senator to U.S. Treasury Secretary Paul O’Neill, (April 5, 2001).

freedom and national sovereignty. If implemented, the OECD initiative would require the wholesale elimination of financial privacy. The OECD also assumes that it has the right to dictate tax and privacy laws in non-member nations – and is threatening sovereign jurisdictions with sweeping financial protectionism if they do not change their laws to make it easier for high-tax nations to collect more tax revenue.”<sup>154</sup>

(4) Letter from Don Nickles, U.S. Senator: “Our relatively low-tax status has fueled economic growth and enabled our economy to draw investors and savings from many of our high-tax European competitors. Those competitors will eventually use the OECD initiative as a weapon to undermine our sovereign right to enact pro-growth tax policies.”<sup>155</sup>

(5) Letter from John Doolittle, U.S. Representative: “the Paris-based bureaucracy is demanding that low-tax nations change their tax and privacy laws so high-tax nations can tax income and assets on a worldwide basis. Low-tax countries that refuse to surrender their fiscal sovereignty and acquiesce to the OECD's demands are being threatened with financial protectionism. Not surprisingly, the previous administration supported this egregious assault on the right of sovereign nations to determine their own fiscal policies. . . . We should pull the plug on the OECD initiative, not only because it is appropriate to defend the sovereign right of all nations to adopt free market policies, but also because we do not want to create a precedent that our high-tax competitors could use against America.”<sup>156</sup>

#### *Exclusive Decision-making Objections*

The CFP and members of Congress certainly did not constitute the complete set of voices on tax competition and the OECD. A range of other advocates addressed tax competition and the importance of sovereignty, and their comments reflected a general discomfort with the fact that the OECD (a predominantly developed country membership) met alone and determined the “rules” by which non-member countries should play. Some of these writers were informally affiliated with the CFP, such as Bruce Zagaris, who has written frequently on the OECD and tax competition, and been a speaker at CFP events.<sup>157</sup> In an April 2001 paper, Zagaris directly attacked the OECD plan on the grounds of U.S. sovereignty. The paper, entitled “Application of OECD Harmful Tax Practices Criteria to the OECD Countries Shows Potential Dangers to U.S.

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<sup>154</sup> Letter of Sam Brownback, U.S. Senator to U.S. Treasury Secretary Paul O’Neill, (May 9, 2001).

<sup>155</sup> Letter of Don Nickles, U.S. Senator to U.S. Treasury Secretary Paul O’Neill, (Feb. 6, 2001).

<sup>156</sup> Letter from John Doolittle, U.S. Representative, to U.S. Treasury Secretary Paul O’Neill (March 29, 2001).

<sup>157</sup> For example, Mr. Zagaris, a tax lawyer with Berliner, Corcoran & Rowe, spoke at the CFP briefings in Barbados in January 2001. See CFP website <http://www.freedomandprosperity.org/press/Barbados/bardos.shtml>. See also, Goulder, “Opposition,” supra note \_\_ at 236-37. Mr. Zagaris’ profile on the law firm website notes that “[h]is private practice has also included monitoring international tax enforcement developments in the U.S. and the Caribbean for foreign governments and corporate clients” and extensively details his work in that area. See <http://www.bcr-dc.com/atty/bz.html>.

Sovereignty,” reviews the OECD’s “Framework for a Collective Memorandum of Understanding on Eliminating Harmful Tax Practices.” Zagaris analyzes the various requirements that would be imposed under the Memorandum and identifies sovereignty conflicts. For example, regarding the proposed “stand still” provision in the Memorandum (which would require countries to refrain from enacting any new regime that constitutes a harmful tax practice), he comments:

[T]he constitutional provisions of most countries preclude their surrender of sovereign power to tax to an international organization, especially one of limited membership and authority such as the OECD. As a general matter the stand-still provisions raise problems of potential violations of a signatory’s sovereignty and constitutional obligations.<sup>158</sup>

In other articles, Zagaris has also highlighted sovereignty concerns with the tax competition project: “The targeted countries have appropriately questioned the legitimacy, as a matter of public international law, of the efforts by the OECD and its members, which used propaganda and threatened sanctions to violate the absolute sovereignty of states over their fiscal affairs.”<sup>159</sup> In the concluding paragraph, Zagaris presents the question as “whether [the Bush administration] wants to yield its own fiscal sovereignty to an international organization, such as the OECD, at a time when another international organization has already undercut the country’s ability to determine and employ its fiscal policy.”<sup>160</sup> Academic writers also repeated objections grounded in the *process* by which the OECD reached its policies. For example, Kimberly Carlson notes that globalization inherently brings some loss of sovereignty but contends that “[a]ny sovereignty that is lost by signing worldwide trade agreements . . . is tolerable because it is only forfeited after an opportunity to negotiate. By excluding non-OECD members in the analysis and by recommending coordinated defense measures, the OECD violates the sovereignty of those nations that it unilaterally deems tax havens. . . .”<sup>161</sup>

#### *Colonial Rule and Redistribution Objections*

The CFP’s written critique of the OECD project intertwines the sovereignty argument with poverty/race claims: “Today poorer nations are being told they cannot adopt similar policies in order to have an attractive investment climate – a demand that has been called an ‘infringement on their sovereignty by a group of rich white

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<sup>158</sup> Bruce Zagaris, “Application of OECD Harmful Tax Practices Criteria to the OECD Countries Shows Potential Dangers to U.S. Sovereignty,” at 16 available at <http://www.freedomandprosperity.org/Papers/bz04-25-01/bz04-25-01.PDF>.

<sup>159</sup> Bruce Zagaris, “Issues Low-Tax Regimes Should Raise When Negotiating With the OECD,” 22 TAX NOTES INT’L 523, 524 (Jan. 29, 2001) [hereinafter “Negotiating”]. Zagaris also comments that “[i]f the executive, legislative, and judicial branches of OECD member countries are willing to undertake the same obligations, and to compromise their own sovereignty and revenue raising policy, at least the targeted countries will be able to approach the enjoyment of a level playing field.” *Id.* at 530.

<sup>160</sup> Zagaris, “Negotiating,” *supra* note \_\_ at 532 (presumably alluding to the United States’ dispute in the WTO over the foreign sales corporations rules). The foreign sales corporation rules form the basis of the third case study, see *infra* Part II.C.

<sup>161</sup> Kimberly Carlson, “When Cows Have Wings: An Analysis of the OECD’s Tax Haven Work As It Relates to Globalization, Sovereignty and Privacy,” 35 MARSHALL L. REV. 163, 177-78 (2002).



nations.”<sup>162</sup> The letters sent to these tax havens by the OECD are described as “a stark example of the organization’s disregard for sovereignty.”<sup>163</sup>

In addition to providing public commentary through newspapers and tax publications, the CFP maintained an active dialogue on its website, presented at seminars, issued press releases and statements on the OECD tax competition project, and “organized” many of the Caribbean havens.<sup>164</sup> For example, CFP founders attended the 24<sup>th</sup> Annual Conference on Caribbean and Latin American Economies, Dec. 5-7 (2000).<sup>165</sup> Mitchell spoke on behalf of the CFP at the Bahamas Bar Association in December 2000 (a trip which “followed a period during which several key Bahamian officials held consultative discussions with the OECD representatives.”).<sup>166</sup> A few weeks later, the CFP held a symposium in Barbados on the OECD tax competition project; followed by a meeting in London in January.<sup>167</sup> Then in late February 2001, the CFP had a meeting in Paris (just days before an OECD meeting).<sup>168</sup> Although the OECD tax competition project was notably revised, as described earlier, the CFP has continued to actively advocate on the subject of tax competition.<sup>169</sup>

The CRP’s lobbying efforts in Congress also garnered the support of the Congressional Black caucus, which sent a letter (signed by twenty six of the thirty eight members of the caucus) to Secretary of Treasury O’Neill objecting to the OECD project. The letter notes in part: (1) This issue “will undermine the ability of developing nations and one of our own territories to strengthen and diversify their economies and reduce poverty;” (2) “This initiative threatens to undermine the fragile economies of some of our closest neighbors and allies;” (3) “[T]he initiative will impose serious economic harm on developing nations;” and (4) “We ask you to reject the OECD’s misguided initiative. In doing so, we will be protecting our own interests and also protecting the interests of less fortunate nations around the world.”<sup>170</sup>

Other writers, including those from legal academia, have questioned the sovereignty implications for tax havens of the OECD project. For example, Vaughn E. James in an article entitled “Twenty-First Century Pirates of the Caribbean: How the Organization for Economic Cooperation and Development Robbed Fourteen CARICOM

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<sup>162</sup> Mitchell, “The Proposal,” supra note [145] at 1812. (citations omitted).

<sup>163</sup> Id. at 1812.

<sup>164</sup> See supra note [139].

<sup>165</sup> See, e.g., Goulder, supra note \_\_ at 2653 (describing CFP planned action at the 24<sup>th</sup> Annual Conference on Caribbean and Latin American Economies, Dec. 5-7 (2000)).

<sup>166</sup> “CFP’s Mitchell Warns Bahamas Against OECD Cooperation,” 22 TAX NOTES INT’L 157, 157 (Jan. 8, 2001).

<sup>167</sup> Robert Goulder, “U.S. Congressional Staffer: Opposition to OECD Tax Haven Campaign May Be Growing in Washington,” 22 TAX NOTES INT’L 236, 236-37 (Jan. 15, 2001) [hereinafter “Opposition”]; Trevor Drury, “Center for Freedom and Prosperity Meets in Paris,” 22 TAX NOTES INT’L 1201, 1201 (Mar. 12, 2001) [hereinafter “Paris”]; Robert Goulder, “OECD Tax Haven Working Group Meets in London,” 22 TAX NOTES INT’L 587, 587 (Feb. 5, 2001).

<sup>168</sup> Drury, “Paris,” supra note \_\_ at 587.

<sup>169</sup> For example, in 2007, the CFP website lists tax competition as the first topic on its “IssueWatch” page: <http://www.freedomandprosperity.org/issues/issues.shtml>. It also has a “tax competition” dedicated web page: <http://www.freedomandprosperity.org/publications/publications.shtml>.

<sup>170</sup> “Congressional Black Caucus Letter to Treasury Secretary O’Neill Against OECD Tax Initiative,” 2001-TNT 59-23 (Mar. 14, 2001). See also supra note [138].

Countries of their Tax and Economic Policy Sovereignty,”<sup>171</sup> contends “that notwithstanding the revised U.S. position [on the OECD Tax Competition project], CARICOM nations have had to effectively surrender their sovereignty on tax and economic policy to the OECD.”<sup>172</sup> This characterization of the tax competition debate mimics the objections raised by developing countries to expropriation rules which they felt had been imposed upon them by more powerful nations. Similarly, in a 2004 article, Michael Littlewood implicitly accepts the allegation that the OECD efforts constitute an infringement of tax havens’ sovereignty and focuses initially on whether the problems caused by the tax havens’ behavior warrant that type of response.<sup>173</sup> Later in the article Littlewood flips the sovereignty argument to make it both a pro and a con, suggesting that the question is one of “semantics” because:

For a country, or group of countries, to dictate another country’s tax policy is, in a sense, a violation of sovereignty. On the other hand, if the tax havens are free to structure their tax systems however they wish, why not the OECD Member States? That is, if the tax havens are free to structure their tax systems so as to facilitate the avoidance of other countries’ taxes, it seems to follow that other countries should be free to structure their tax system so as to discourage the use of havens [e.g., by disallowing deductions to haven entities, levying withholding taxes on payments to haven residents, and withholding “nonessential” aid]. Conversely, if there are limits on the OECD States’ freedom to structure their tax systems however they wish, such restrictions presumably apply to havens also.

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<sup>171</sup> Vaughn E. James, “Twenty-First Century Pirates of the Caribbean: How the Organization for Economic Cooperation and Development Robbed Fourteen CARICOM Countries of their Tax and Economic Policy Sovereignty,” 34 U. OF MIAMI INTER-AM. L. REV. 1, 28, 32, 39 (2002).

<sup>172</sup> Id. at 5. James also quotes arguments made by A. Townsend, in 25 FORDHAM INT’L L. J. 215, 252 (2001) that the OECD’s “efforts to curb tax competition marks a substantial deviation from the treaty network established to address international fiscal problems and usurps a basic tenet of fiscal legislation: national sovereignty.” James, supra note \_\_ at 28. Still other authors characterize the OECD effort as one that strips havens of their sovereignty: “The OECD scheme would encourage the world’s major economies to penalize 41 low-tax countries and territories for maintaining attractively low rates unless they essentially relinquish their fiscal sovereignty. It also would institutionalize the exchange of financial information across international borders to help tax authorities chase their citizens’ assets around the globe. This common criticism touches upon the concepts of globalization, sovereignty and privacy.” Carlson, supra note \_\_ at 172. Carlson also urges that “[e]very nation has a right to operate its own tax regimes and should not need to put its economy, which is primarily based on the offshore investment market, at risk to ensure that taxing giants maintain their imprisoned tax base.” Id. at 177-178. Ultimately, Carlson argues that the United Nations is a better forum in which to handle tax haven issues precisely because of its view of sovereignty: “The United Nations emphasizes the sovereignty of its members . . . . This global presence would encourage the cooperation necessary to effectively address international tax related issues while maintaining the sovereignty rights of all who would be affected.” Id. at 186.

<sup>173</sup> Michael Littlewood, “Tax Competition: Harmful to Whom?,” 26 MICH. J. INT’L L. 411, 441 (2004) (“Another charge routinely made against tax havens is that they facilitate the money-laundering activities of drug dealers, gun runners, terrorists, and so on. A number of havens appear, indeed to be guilty. Conduct of this kind seems a more compelling reason for countries affected to violate the sovereignty of the haven facilitating. It does not follow, though, that the havens should reform their tax systems. [Other changes may be more appropriate.]”).

Similarly, it seems difficult to categorize the withholding of aid as a violation of sovereignty.<sup>174</sup>

*Summary:* Sovereignty was used as a frequent refrain in critiques by a variety of commentators on the U.S. participation in tax competition. As a general matter, the connection between sovereignty and taxation was presumed and required no explanation, simply a “reminder.” To that degree, the usage indicates the existence of a fairly universal link between the two that can be tapped, simply as a rhetorical matter. Even the Secretary of the Treasury, when de facto expressing a change in U.S. support for the OECD plan, enunciated sovereignty concerns.<sup>175</sup> One of the authors, though, did devote some attention to specifying the connection between sovereignty and taxation. The core observation was that taxation has traditionally been a central power of the sovereign: “Taxation and the sovereign’s absolute right to tax its subjects have their origins ‘in antiquity.’ The right to tax forms one of the most intimate relationships between the sovereign and its subjects.”<sup>176</sup> Correspondingly, outside efforts to constrain a state’s taxing powers attack this sovereignty: “The decision to tax or not to tax and the manner in which to tax within domestic borders is one that has always been within the absolute discretion of each sovereign. . . . By using a state’s method of taxation as a determinative factor, The [OECD] Report impinges upon territorial sovereignty, an act otherwise violative of international law and long-standing international doctrines.”<sup>177</sup>

To the extent that critics of the OECD expounded upon their sovereignty arguments, a number of themes emerged. First, the functional role of taxation (in particular, the fiscal policy dimensions of sovereignty) regularly surfaced in these analyses and statements. The CFP repeatedly objected to the states’ loss of ability to “determine their own tax policies,”<sup>178</sup> members of Congress noted the values of fiscal sovereignty,<sup>179</sup> and academic writers described a loss of “sovereignty on tax and economic policy to the OECD.”<sup>180</sup> It is interesting that the functional role of tax sovereignty advocated in the tax competition debate does not focus on *revenue*. Presumably that decision reflects the reality that the states’ strongly pressing the sovereignty argument (the havens) are not using their policies to collect substantial tax

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<sup>174</sup> Littlewood, *supra* note \_\_ at 480.

<sup>175</sup> See, e.g., text accompanying note \_\_ [Treasury Official stating that the Secretary of the Treasury, in evaluating the OECD plan would “respect the sovereignty” of tax systems]; and text accompanying note [in announcing the U.S. pull-back, the Secretary of the Treasury objected to “efforts to dictate to any country what its own tax rates or tax system should be.”]

<sup>176</sup> George M. Melo, “Taxation in the Global Arena: Preventing The Erosion of National Tax Bases or Impinging on Territorial Sovereignty? A Critique of the OECD’s Report,” 12 PACE INT’L L. REV. 183, 186 (2000).

<sup>177</sup> *Id.* at 200.

<sup>178</sup> Mitchell, “Proposal,” *supra* note \_\_ at 1811.

<sup>179</sup> See, e.g., Letter of Majority Leader Dick Armey to Secretary of Treasury Paul O’Neill (March 16, 2001); Letter from John Doolittle, U.S. Representative, to U.S. Treasury Secretary Paul O’Neill (March 29, 2001).

<sup>180</sup> Vaughn E. James, *supra* note \_\_ at 5. See also, *id.* at 28 (quoting arguments made by A. Townsend),

revenues and that some of the other vociferous advocates of haven sovereignty support a world with little or no tax.<sup>181</sup>

A second argument raised on behalf of havens hints loosely at some of the democracy arguments by contending that “the OECD violate[d] the sovereignty of those nations that it unilaterally deems tax havens” both “[b]y excluding non-OECD members in the analysis and by recommending coordinated defense measures.”<sup>182</sup> To the extent that the havens viewed their tax policy as de facto set by the OECD, the resulting outcomes would not reflect a democratic process in which they participated. Thus, the “democracy problems” would extend beyond the quality of accountability and transparency in the OECD— these elements would be entirely absent with respect to the havens. One commentator specifically asserts that “the United Nations is a better forum in which to handle tax haven issues,” noting its commitment to granting all members regardless of size, wealth, and political system both a voice and a vote.<sup>183</sup> I would not, though, overstate the centrality of theoretical democracy concerns to the tax competition debate. To be sure, the havens perceived the OECD action, taken without their consultation, as a complete loss of voice. However, unlike the case of the EU, taken up below, where a significant literature has developed on the problems of a democratic deficit and its implications for supra-state entities and for structure and procedure in the EU, the tax competition debate constituted a head-to-head clash between two groups of states striving to exercise their tax sovereignty.

A third set of themes appearing across the comments of the CFP, the Congressional Black Caucus, and some academics challenged the impact of the OECD plan on tax havens that are developing countries. Their arguments, perhaps made with varying degrees of commitment,<sup>184</sup> question both the power and the racial disparities involved. The references to “white nations”<sup>185</sup> and the concern for and solidarity with “people of color living in Caribbean tax havens,”<sup>186</sup> especially when combined with claims that the havens are only trying to do now (compete with taxes) what these other states have done for years,<sup>187</sup> harkens back to the stance on sovereignty made by former colonies when defending expropriation as a righteous response to their economic position following colonial rule.

The related emphasis on the havens’ status as “poorer nations”<sup>188</sup> implicitly suggests a special duty for the rich nations to the poor, akin to the ideas of inter-nation equity. The critics do not elaborate upon the implications of the rich/poor imagery (it is intended to enhance the unseemly quality of the OECD nations’ trespass upon the poorer

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<sup>181</sup> The actual value added to a state by virtue of its “haven-like” tax policies is debated and likely depends on the nature of the haven and its economy, the type of tax policies, and how the benefits is measured and distributed.

<sup>182</sup> Carlson, supra note \_\_ at 172. See also, Karen Brown, “Harmful Tax Competition: The OECD View,” 32 GEO. WASH. U. J. INT’L L. & ECON. 311, 312-315, 323 (1999) (considering the havens lack of participation in the process and their financial straits).

<sup>183</sup> Carlson, supra note \_\_ at 186.

<sup>184</sup> Mitchell’s (and the CFP’s ) expression of concern for “the poorer nations” *concluded* by characterizing the OECD project as “a threat to *America’s* national interests” and as “*bad for U.S. taxpayers.*” Mitchell, “Proposal,” supra note \_\_ at 1812, 1821 (emphasis added).

<sup>185</sup> Mitchell, “Proposal,” supra note \_\_ at 1812.

<sup>186</sup> Field, supra note \_\_ at 1242 (discussing the stance of the Black caucus on the OECD plan).

<sup>187</sup> Mitchell, “Proposal,” supra note \_\_ at 1812.

<sup>188</sup> Id; see also Scott, “Black Caucus,” supra note \_\_ at 1600-01.

nations' sovereignty). However, when combined with Littlewood's recognition that tax competition arguably involves *competing* sovereignty claims<sup>189</sup> (a point not acknowledged by most of the commentators), the identification of some nations as distinctly poorer could serve as a starting point for balancing the competing claims.<sup>190</sup>

Finally, it is useful to observe that in the tax competition debate, the sovereignty claim typically was joined by an underlying objection to the substance of the tax competition project and the perceived impact on effective tax rates. Many comments demonstrated a strong preference for low tax rates, and a corresponding belief that the OECD project would lead to high tax rates. (Whether that was likely or desirable is a separate question).<sup>191</sup> This attention in the critiques to the undesirability of the possible tax effects should be no surprise. The primary sovereignty justification asserted in most of the comments involved "fiscal sovereignty" and the right to dictate your own tax policy. If the actions of other states could force your state to shift tax policy you may be outraged on general principles of sovereignty, but you will be especially outraged if their actions will lead to policies you reject.

Although all of the quoted passages on the OECD plan directly employed the language of sovereignty and expected it to carry significant weight on its own, the passages also revealed some underlying objection based on fiscal control, the nature of the decision-making process, and the perceived desirability of the resulting substantive tax policy. Perhaps because authors of the quoted passages almost uniformly objected to the *actual* effects of the plans, they made no acknowledgement of the "counter" sovereignty argument (other than Littlewood, an academic writer). But *why not* characterize the OECD plan as a manifestation of the sovereignty of the participating states? If the haven states have a sovereign right to use their tax systems as they are (including potentially the United States), then cannot the same be said for the OECD countries?<sup>192</sup> Without

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<sup>189</sup> Littlewood, *supra* note \_\_ at 480.

<sup>190</sup> One *could* argue that the tax policy actions of the OECD and the havens are not comparable by: (1) describing the haven tax policy as one which takes the other nations' tax rules and policies as a given and then designs its own, and (2) describing the OECD policy as one which seeks to change the practices of the other (haven) states. According to this line of argument the havens are respecting the OECD nations' sovereignty (and not trying to force changes), whereas the OECD states are coercing change to haven policy and thus disregarding their sovereignty. This entire line of argument, however, relies on whether the "undermining" of a nation's tax policy occurs through intentional, "forced" change in policy. This focus misses the more significant point – both the tax havens and the OECD states want to prevent the "other" from achieving its desired tax policy goals [OECD wants to collect tax; the havens want to facilitate the payment of no tax] -- and both act accordingly.

<sup>191</sup> This rate fear seems linked in part to "anti-big government" views: if you desire small government, you should provide it little revenue. See, e.g., text accompanying note [letter from 22 US representatives]. Also characterizing the OECD by the phrase "Paris-based bureaucrats" seems to provide fuel for both the basic sovereignty rhetoric and for the low tax-small government message. See, e.g., text accompanying note [U.S. rep. Doolittle; Mitchell in CFP comments].

<sup>192</sup> Even if one acknowledged that the OECD plan could be viewed as an exercise of its members own sovereignty, there could nonetheless be challenges to the plan on other grounds. For example, see the arguments raised by Karen Brown regarding the lack of participation of developing countries in the OECD

recognition of the OECD states' sovereignty arguments, the problem of balancing competing sovereignty claims has yet to surface in the tax competition debate.

#### B. SOVEREIGNTY CONCERNS OVER TAXATION IN THE EUROPEAN UNION

Whatever might be the sensitivity of states in general to potential incursions into their "tax sovereignty," one could imagine the members of the EU might be different. They are states that have come together voluntarily to create a rather unique<sup>193</sup> level of interdependence, while maintaining their individual "sovereign" state status.<sup>194</sup> However, an inquiry into EU tax policy and procedure, and into the sentiments expressed on issues of taxation reveals that taxation remains hotly contested and sovereignty a frequent concern.<sup>195</sup> After providing a brief overview of the structure of the EU and its provisions on taxation, this section then looks at sovereignty concerns expressed by member states and others on tax voting rules and on the specific issue of corporation taxation.<sup>196</sup>

#### EUROPEAN UNION BACKGROUND

Although some concept of "Europe" and a greater European organization has existed for over 600 years, the push for an effective European union did not take shape until the end of WWII.<sup>197</sup> With two catastrophic wars in the first half of the 20th century, the post-war climate was critical of the Westphalia system of independence and sovereignty.<sup>198</sup> Westphalia's objectives of peace and prosperity were clearly not achieved, and the opposite, war and hardship, seemed to result.<sup>199</sup> By 1944, some groups in Europe believed that an "irrevocable surrender" of sovereign rights in the areas of defense and foreign relations was essential to lasting peace.<sup>200</sup>

Proposals for a new European system ranged from the radical (e.g., Altiero Spinelli's idea of the complete abolition of independent states) to the more moderate (e.g.,

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plan, the distinct financial situation and needs of developing countries, and the limited options of developing countries. Brown, *supra* note \_\_ at 312-315, 323.

<sup>193</sup> Efforts to describe the type of "federalism" in the EU quickly result in a determination that its structure is not like that of other forms of federalism (e.g., U.S., Canada).

<sup>194</sup> See, e.g., Marcel Gerard, "The Challenge of Taxing Multijurisdictional Companies in Europe," 40 TAX NOTES INT'L 1169, 1169 (Dec. 26, 2005) (noting that "the European Union is not quite a collection of sovereign states, nor is it yet a federal state").

<sup>195</sup> Perhaps, a counter-intuition could be offered: having relinquished so many "traditional" sovereign powers, the EU member states cling tenaciously to taxation as one of their core remaining powers.

<sup>196</sup> Debates in the EU over taxation and sovereignty are certainly not limited to these topics. See, e.g., Clemens Fuest, Thomas Hemmelgarn, & Fred Ramb, "The Tax Revenue Implications of Marks & Spencer for Germany," 38 TAX NOTES INT'L 763, 763 (May 30, 2005) ("In principle, the EC Treaty grants full sovereignty to member states in direct tax matters. But recently, national tax systems have increasingly been challenged by rulings of the ECJ.").

<sup>197</sup> Sir William Nicoll & Trevor C. Salmon, UNDERSTANDING THE EUROPEAN UNION 4, 7-9 (2001).

<sup>198</sup> Nicoll & Salmon, note \_\_ at 7 ("The system created after the Treaty of Westphalia system in 1648, which had ended the Thirty Years' War but which also laid the basis for the sovereign state system in Europe, had now demonstrably failed to maintain international order, peace and security. . . .").

<sup>199</sup> Nicoll & Salmon, note \_\_ at 7.

<sup>200</sup> Nicoll & Salmon, note \_\_ at 8 (quoting Some Members of the Resistance Groups in Europe, 'Draft Declaration II on European Federation,' in W. Eichler, *Europe Speaks*, Militant Socialist International, 1944).

Jean Monnet's concepts of "collective action" and "coordinated war efforts").<sup>201</sup> Monnet's ideas became the basis for the European Coal and Steel Community (ECSC),<sup>202</sup> a system of pooled production which laid the basic structure for all future European integration.<sup>203</sup> By the end of the decade (1957), a number of countries signed the Treaty of Rome, establishing the European Economic Community (EEC), frequently known as the common market, which sought to provide a broader economic union that could both prevent war and promote prosperity.<sup>204</sup> In addition, the second Treaty of Rome (1957) established the European Atomic Energy Community (known as Euroatom) which focused on pooling resources in Europe for the development of a nuclear energy industry (with exclusively civil functions) that could potentially provide energy independence.<sup>205</sup> Ultimately, by 1990s the EU system expanded to include social rights and other not strictly economic goals.<sup>206</sup> The Treaty on the European Union (the Maastricht Treaty) of 1992 not only unified the three former communities of Euroatom, the EEC and the ECSC; but it also established cooperation on important non-economic issues including foreign policy, defense, and justice.<sup>207</sup>

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<sup>201</sup> Nicoll & Salmon, note \_\_ at 8-9.

<sup>202</sup> The stated purpose of the ECSC was to "contribute, in harmony with the general economy of the Member States and through the establishment of a common market, to economic expansion, growth of employment and a rising standard of living in the Member States." Treaty Establishing the European Coal and Steel Community, April 18, 1951, Art. 2.

<sup>203</sup> Nicoll & Salmon, note \_\_ at 9, 14-15; European Union Website at [http://europa.eu/abc/history/1945-1959/index\\_en.htm](http://europa.eu/abc/history/1945-1959/index_en.htm). The website also characterizes the ECSC as "the first step towards a supranational Europe." Shortly after the ECSC's formation under the Treaty of Paris of 1951, commentators considered the longer term implications of the changes to sovereign status under the states' new relationship. Raymond, Vernon, "The Schuman Plan: Sovereign Powers of the European Coal and Steel Community," 47 AM. J. OF INT'L L. 183 *passim* (1953)

<sup>204</sup> See, e.g., Nicoll & Salmon, note \_\_ at 17-20; European Union website at [http://europa.eu/scadplus/treaties/eec\\_en.htm](http://europa.eu/scadplus/treaties/eec_en.htm).

<sup>205</sup> See, e.g., European Union website, available at [http://europa.eu/scadplus/treaties/euratom\\_en.htm](http://europa.eu/scadplus/treaties/euratom_en.htm); Nicoll & Salmon, note \_ at 18-21.

<sup>206</sup> Nicoll & Salmon, note \_\_ at 52.

<sup>207</sup> Nicoll & Salmon, note \_\_, at 352-354, 359. The new structure was built on the concept of "three pillars": (1) the European Communities (the economic dimension formally labeled the EEC and changed to the EC); (2) the Common Foreign Policy and Security policy pillar, under the acronym CFSP; and (3) the police and justice pillar, Justice and Home Affairs (JHA). The treaty also set in motion the EMU (economic and monetary union). Subsequent treaties continued this process (Treaty of Amsterdam in 1997 and the Treaty of Nice in 2001). In 2004, the EU took a significant step in signing the Treaty Establishing a Constitution for Europe, replacing with a single document all prior treaties (except the Euroatom Treaty). See Protocol 36, of the Treaty Establishing a Constitution, available at [http://eur-lex.europa.eu/LexUriServ/site/en/oj/2004/c\\_310/c\\_31020041216en03910394.pdf](http://eur-lex.europa.eu/LexUriServ/site/en/oj/2004/c_310/c_31020041216en03910394.pdf). See also [http://europe.ue/scadplus/treaties/eec\\_en.html](http://europe.ue/scadplus/treaties/eec_en.html). However, ratification by the member states was required for this to take effect. Although many states did ratify the Treaty, France and the Netherlands rejected the Treaty in their national referenda, thereby derailing the process and hopes for implementation. See, e.g., Christopher Caldwell, *Why Did the French and Dutch Vote No? Because They Were Asked, For A Change*, THE WEEKLY STANDARD, June 13, 2005, Features, Vol. 10, no. 37; Ralph Atkins, Ian Bickerton, and George Parker, *Dutch Deal a Further Blow to EU Treaty* FINANCIAL TIMES, June 2, 2005, Sec. 1 at 1. In June 2007, the EU members began pursuing a Reform Treaty, to replace the failed Constitutional Treaty. See, e.g., George Parker, *EU Rushes to Get New Treaty Set in Stone*, FINANCIAL TIMES, June 27, 2007, London Edition 1, World News at. 8; Ian Bickerton, James Blitz & Tobias Buck, *EU 'Emerges From Paralysis' With Breakthrough Constitution Treaty*, FINANCIAL TIMES (June 25, 2007) U.S. Edition 2, Sec. 1 at 1.

In the words of the European Union's website, the EU today is "a family of democratic European countries, committed to working together for peace and prosperity."<sup>208</sup> More specifically it is a set of "common institutions to which [member countries] delegate some of their sovereignty so that decisions on specific matters of joint interest can be made democratically at [the] European level."<sup>209</sup>

#### EU DECISION-MAKING

Decision-making procedures in the EU vary widely depending on the issue and the governing body. Due to their complexity and dynamic nature, these procedures cannot be reduced to a simple summary.<sup>210</sup> However, for purposes of this article, key features include the difference between the two primary voting methods, (qualified majority voting (QMV) and unanimous voting) and the explanations for when each is used.

The main decision-making body in the EU is the Council of the European Union (the Council) which represents the member states.<sup>211</sup> All member states are represented, and their number of votes is based on population although the allocation of votes is weighted in favor of countries with smaller populations.<sup>212</sup> Currently the total number of votes on the Council stands at 345. For most decisions, the Council uses QMV, under which the requisite majority in the Council is reached if: (1) 255 out of the 345 possible votes are cast favorably, and (2) a majority (sometimes a 2/3 majority) of member states approve. In addition, member states can request confirmation that the majority represents at least 62% of the total EU population.<sup>213</sup> Over the years, QMV has been extended to a broader number of topics.<sup>214</sup>

Areas not subject to QMV require unanimous votes. Although the trend is for more areas to use QMV, many issues still require unanimous votes including foreign

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<sup>208</sup> European Union Website available at [http://europa.eu/abc/panorama/index\\_en.htm](http://europa.eu/abc/panorama/index_en.htm).

<sup>209</sup> Id. The site also asserts that "[i]t is not a State intending to replace existing states, but is bigger than any other international organization." Id.

<sup>210</sup> See generally John Peterson & Elizabeth Bomberg, DECISION-MAKING IN THE EUROPEAN UNION (1999); Nicoll & Salmon, note \_\_ at 79-173.

<sup>211</sup> See, e.g., European Union website at [http://europa.eu/institutions/inst/council/index\\_en.htm](http://europa.eu/institutions/inst/council/index_en.htm). See also, Peterson & Bromberg, note \_\_ at 33-34. In contrast to the Council, where each State has a minister to represent that state's interests; the European Parliament is elected by the citizens of the EU to represent them. See, e.g., European Union website at [http://europa.eu/institutions/inst/parliament/index\\_en.htm](http://europa.eu/institutions/inst/parliament/index_en.htm); Peterson & Bromberg, note \_\_ at 33, 43-44. Parliament's role varies depending on the topic involved. For matters of taxation, Parliament acts in a consulting role. See [http://ec.europa.eu/taxation\\_customs/taxation/gen\\_info/tax\\_policy/index\\_en.htm](http://ec.europa.eu/taxation_customs/taxation/gen_info/tax_policy/index_en.htm). ("The EC Treaty, under Article 93, specifically provides for the Council, acting unanimously on a proposal from the Commission and after consulting the European Parliament and the Economic and Social Committee, to adopt provisions for the harmonization of Member States' rules in the area of indirect taxation (principally Value Added Tax and Excise Duties) . . . . As far as other taxes are concerned, Article 94 provides for the Council, acting unanimously on a proposal from the Commission and after consulting the European Parliament and the Economic and Social Committee, to adopt provisions for the approximation of such laws, regulations or administrative provisions of the Member States as directly affect the establishment or functioning of the common market.")

<sup>212</sup> See EU website, available at [http://europa.eu/institutions/inst/council/index\\_en.htm](http://europa.eu/institutions/inst/council/index_en.htm).

<sup>213</sup> Id.

<sup>214</sup> See, e.g., Peterson & Bomberg, note \_\_ at 48 (discussing the impact of the Single European Act of 1987 which greatly expanded the role for QMV); Nicoll & Salmon, note \_\_ at 36 (same).



policy and defense, EU membership applications, election rules, and taxation.<sup>215</sup> The topics needing a unanimous vote have been characterized as “particularly sensitive areas.”<sup>216</sup> The need for unanimous decision-making in certain areas can be traced back to the infancy of what has become the EU, and can be seen as a national veto on matters that an individual state deems important.<sup>217</sup> Even the failed EU Constitutional Treaty, which sought to increase EU “unification” in a variety of ways,<sup>218</sup> intended to reserve certain matters for unanimous voting, including taxation, harmonization of social security, foreign policy and defense, membership, and citizenship.<sup>219</sup>

#### EU TAX POLICY: BASIC TAXING AUTHORITY AND THE EFFORTS TO HARMONIZE THE CORPORATE TAX BASE

The sovereignty debate simmering in the EU, over taxation voting rules and over efforts to harmonize the corporate tax base, represents a case study of the tensions states face in deciding *whether* to surrender sovereignty to a multilateral body. These tensions reflect several different sovereignty based concerns. Some concerns mirror those found in the first case study (e.g., fiscal control and revenue), and some arise at this stage of multilateral interaction where there is not immediate conflict but rather the contemplation of the risks of shifting decision-making power up to the chain (democracy and local culture concerns). The following analysis of comments and positions on the prospect of increased EU power in taxation tracks these basic categories.

##### *Fiscal Control and Revenue*

As noted above, tax matters continue to be subject to unanimous voting requirements in the EU. But what tax issues are taken up by the EU, as opposed to the member states themselves? Direct taxation in the EU has been, and continues to be, a national affair not subject to *formal* EU rules,<sup>220</sup> although if “the single market, free movement of capital or individuals’ rights are being undermined by tax rules, the

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<sup>215</sup> See, e.g., Nicoll & Salmon, note \_\_\_ at 555-556;

<sup>216</sup> EU website, available at [http://europa.eu/institutions/inst/council/index\\_en.htm](http://europa.eu/institutions/inst/council/index_en.htm).

<sup>217</sup> Nicolls & Salmon, note \_\_\_ at 25.

<sup>218</sup> The Constitutional Treaty would have switched some issues to QMV and added some new articles that would be subject to QMV. For three special articles (on free movement/social security; judicial cooperation, and definition of crimes), QMV was specified, but with an “emergency brake” that would allow a member state to pursue an appeal of the issue with the European Council. See E.U. website available at [http://europa.eu/scadplus/constitution/majority\\_en.htm](http://europa.eu/scadplus/constitution/majority_en.htm).

<sup>219</sup> See EU website, available at: [http://europa.eu/scadplus/constitution/majority\\_en.htm](http://europa.eu/scadplus/constitution/majority_en.htm).

<sup>220</sup> “More obstacles arise from the lack of a strong legal basis to harmonize direct taxes. Unlike with indirect taxes expressly covered by article 93, the EC Treaty has no provision that would directly allow the European Commission and the EU Council to harmonize corporate tax rates. Instead, an indirect and general legal basis is used under article 94.” Michal Niznik, “EU Corporate Tax Harmonization: Road to Nowhere?” 44 TAX NOTES INT’L 975, 976 (Dec. 18, 2006). See also Nicolls & Salmon, note \_\_\_ at 244. Although [e]ach member state of the European Union retains its sovereignty on matters concerning direct taxation . . . . In many decisions, the ECJ has held that any exercise of that sovereignty by a member state must take account of the fundamental freedoms conferred by the founding treaties of the European Union, which have direct effect in each member state and in Iceland and Norway, the two European Economic Area states that are not member’s states.” Michael McGowan, “U.K. Restrictions on the Use of Dual Consolidated Losses,” 33 TAX NOTES INT’L 903, 907 (Mar. 8, 2004)

European Court of Justice” will step in.<sup>221</sup> Indirect taxes, however, including excise and turnover taxes, are required to be harmonized "to the extent necessary to sustain the Single Market."<sup>222</sup> Harmonization does not necessarily mean standardization, as illustrated by divergent VAT rates despite the existence of a formal "directive" on the subject.<sup>223</sup> As the EU explains: "There is EU-wide agreement on a minimum rate of 15% for VAT on most goods and services, but exceptions are possible. A higher standard rate is allowed within certain limits. So are lower rates, and exemptions for some items."<sup>224</sup>

Harmonization of direct taxes is highly unlikely in the EU in the foreseeable future. As one EU ambassador put it, "tax harmonization is not going to take place. . . it all comes down to QMV versus unanimity. It is all that matters."<sup>225</sup> One recent attempt at harmonizing a specific area of European taxes illustrates these tensions. Corporations operating in multiple countries in the EU currently face a variety of national tax rules in defining their income tax base. Over the years, the EU directed attention to this issue and floated a number of possibilities.<sup>226</sup> In 2001, the European Commission issued a report on how to achieve an internal market without "tax obstacles."<sup>227</sup> One of the reviewed methods – common consolidated corporate tax base (CCCTB)<sup>228</sup> – became the subject of a working group. In 2005, business groups were invited to participate in the working group process, and in May 2007, further meetings took place with the aim of "lay[ing] the groundwork for proposing a common consolidated corporate tax base . . . in the EU in 2008 with eventual implementation by 2011."<sup>229</sup> The fact that this much progress has been made on the CCCTB proposal reveals that there is a significant amount of support for the plan.<sup>230</sup> But significant, even majority, support is not enough.<sup>231</sup> Although France and Germany support the plan (arguably in an effort to protect their higher tax

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<sup>221</sup> EU website available at : [http://europa.eu/pol/tax/print\\_overview\\_en.htm](http://europa.eu/pol/tax/print_overview_en.htm) (EU overview statement on taxation); see also id. At <http://europa.eu/scadplus/leg/en/s10000.htm> (outlining EU tax treatment in more detail). See also Ruth Mason, PRIMER ON DIRECT TAXATION IN THE EUROPEAN UNION 22 (2005).

<sup>222</sup> Nicoll & Salmon, note \_\_ at 243; see also EU website, available at: [http://europa.eu/pol/tax/print\\_overview\\_en.htm](http://europa.eu/pol/tax/print_overview_en.htm).

<sup>223</sup> Nicoll & Salmon, note \_\_ at 243; see also EU website, available at: <http://europa.eu/scadplus/leg/en/lvb/131005.htm>.

<sup>224</sup> See id. At <http://europa.eu/scadplus/leg/en/lvb/131006.htm>.

<sup>225</sup> Peterson & Bomberg, note \_\_ at 63.

<sup>226</sup> See, e.g., Vireo Certain & Silvia Guanine, "Trends in EU Proposals on Taxation of Transnational Business Profits and Tax Coordination, 31 TAX NOTES INT'L 973, 980-88 (Sept. 15, 2003).

<sup>227</sup> Joann M. Weiner, "Approaching an EU Common Consolidated Tax Base, 46 TAX NOTES INT'L 647, 647 (May 14, 2007) [hereinafter "Base"]; see also Niznik, supra note \_\_ at 982-983.

<sup>228</sup> A CCCTB would "involve[] the creation of a common corporate tax base for all EU multinationals opting for the system. Domestic companies and multinationals that do not join this regime will continue to be taxed under the current national tax systems based on separate accounting." Niznik, supra note \_\_ at 983 (citing Sorensen). The goal is to "allow companies to consolidate their EU-wide profits using a single tax base set of rules and a uniform apportionment formula to divide the profits among the member states." Id. at 983.

<sup>229</sup> Weiner, "Base," supra note \_\_ at 647.

<sup>230</sup> Id. at 647 (reviewing various expressions of support by economic and finance ministers).

<sup>231</sup> Id. As of March 2007, the EU Tax Commissioner indicated that 12 member states indicated strong support for CCCTB (including Austria, Belgium, France, Germany, Italy, and Spain); 8 members indicated "cautious support" and seven states "expressed concern about or opposition to the CCCTB" (including Ireland and the U.K. "which reject the plan outright, saying it would infringe on national sovereignty."). Chuck Gnaedinger and Lisa Nadal, "Kovacs Optimistic on Common Consolidated Corporate Tax Base, 114 TAX NOTES 990, 990 (March 12, 2007).

regimes from the competitive rates of EU newcomers), other countries have been quite hostile to the plan.<sup>232</sup> England, for example, has expressed concern that the plan would hurt the EU's ability to compete for business globally.<sup>233</sup> One tax lawyer in England commented that "the tax base prevents the finance minister in each member country from managing the economy in the ways that they feel appropriate"<sup>234</sup> A tax lawyer in Ireland commented that "the tax base would undermine Ireland's national sovereignty over tax matters."<sup>235</sup>

More generally, while law on direct tax harmonization has been unattainable, "soft law" has been used to some effect.<sup>236</sup> In 1996, European finance ministers agreed on a non-binding resolution to discourage excessive tax competition among EU countries. (Although tax competition is a different problem from the CCCTB, these issues are all intertwined. One of the concerns with CCCTB is that it will lead to harmonization of rates and a de facto attack on tax competition, a step not supported by all EU members). The resolution tiptoes around issues of sovereignty stating that it is "a political commitment and does not affect the Member States' rights and obligations or the respective spheres of competence of the Member States."<sup>237</sup>

As these issues of control over taxation have been debated, whether in the most direct form (the EU voting standard) or in the more circumspect context (e.g., the CCCTB),<sup>238</sup> a variety of fiscal sovereignty arguments emerged. Despite sharing a higher degree of unity (through the EU treaties) than most other nations, the EU members have not hesitated to articulate their sovereignty objection on these tax matters. The following list provides a good sampling of these statements

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(1) Irish views on the EU and taxation:

- (a) Business sector: The CCCTB would increase Irish businesses' taxes either because more income would be subject to tax outside of Ireland, or because Ireland would have to raise its tax rates to provide offsetting revenue "which would come close to an attack on our sovereignty. . . . A further concern [is] whether this [the CCCTB] is a first step towards tax rate harmonization. . . . Member states must

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<sup>232</sup> See text accompanying notes \_\_\_\_.

<sup>233</sup> INT'L TAX REV., Feb. 1, 2007, available at 2007 WLNR 4513754.

<sup>234</sup> INT'L TAX REV., May 1, 2006, available at 2006 WLNR 10913853.

<sup>235</sup> INT'L TAX REV., May 1, 2006, available at 2006 WLNR 10913853.

<sup>236</sup> See, e.g., Nicolls & Salmon, *supra* note \_\_ at 246. Note that soft law is not the only alternative to a formal vote that passes through the Council. In the context of the CCCTB, the EU Tax Commissioner, Laszlo Kovacs has indicated that the "enhanced cooperation" option would be available as a way to implement CCCTB should it fail to obtain unanimous support. Under enhanced cooperation (which has several threshold requirements), a subgroup of member states can adopt EU legislation. Gnaedinger & Nadal, *supra* note \_\_ at 990.

<sup>237</sup> Nicolls & Salmon, *supra* note \_\_ at 245.

<sup>238</sup> Recall that the CCCTB is advocated as a solution that will provide more a streamlined and efficient mechanism for taxing across the E.U. borders. Gnaedinger & Nadal, *supra* note \_\_ at 933 (idea for corporate tax base harmonization and the CCCTB grew out of complaints by corporate taxpayers that they faced high compliance costs when dealing with multiple taxing jurisdictions in the EU).

maintain their sovereignty over tax issues and retain their ability to adopt policies suitable to their needs.”<sup>239</sup>

(b) Irish Minister of Finance: “One of the key components of a state’s expression of sovereignty is the right to determine the level of expenditure and the tax rates and structures required to support it. . . . This is a basic part of the democratic process. . . . By having unanimity in taxation matters, we can reach decisions which reflect the concerns and core interests of every member state.”<sup>240</sup>

(2) U.K:

(a) British government: “We have been very clear – nothing on tax. Tax is the province of the national states. . . . Anything to do with tax is about sovereignty, and the Treasury must have control over how and what is collected.”<sup>241</sup>

(3) France:

(a) Chair of the European Joint Transfer Pricing Forum, Bruno Gibert, speaking from the French perspective: “Sovereignty and tax are very linked. It dates back to the way we built our democracy . . . on a revolution . . . against the way taxes were levied. France in 1789 was clearly started on tax issues. So parliamentary control on taxes is very deeply rooted in people’s minds.”<sup>242</sup>

(4) General:

(a) Austria’s goal of encouraging EU tax harmonization “won’t be easy . . . because any agreement will necessarily involve important issues of national sovereignty. Monetary and fiscal policies are considered fundamental to national sovereignty. With the introduction of the euro, responsibility for monetary policy will no longer reside with national governments – that will be the responsibility of the European Central Bank after Jan. 1, 1999. This leaves fiscal policy, and governments aren’t in any great hurry to lose control over that as well.”<sup>243</sup>

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<sup>239</sup> Turlough O’Sullivan, “EU Tax Policy is Bad News for Business,” IRISH TIMES, June 8, 2007, Finance Section at 14 (article by the director general of the Irish Business and Employers Confederation).

<sup>240</sup> “Should Ireland Agree to Phasing Out the Veto on Taxation Voting?,” IRISH TIMES, April 10, 2003, Opin. Sec. at 16 (quoting Minister for Finance, Charlie McCreevy).

<sup>241</sup> Eileen O’Grady, “United Kingdom Holds Its Ground In Opposing EU Tax Harmony,” 31 TAX NOTES INT’L 1121, 1122 (Sept. 29, 2003) (quoting a British government spokesperson in Brussels).

<sup>242</sup> European Competitiveness Roundtable: Competition View with Common Base, INT’L TAX REV., Dec. 1, 2006, available at 2006 WLNR 23404159 (Bruno Gibert, Chairman of the European Joint Transfer Pricing Forum, speaking at a roundtable).

<sup>243</sup> Alex Goldsborough, “Firms Throughout Europe Focus Sights on a Single Corporate Tax Structure,” W.S.J., April 20, 1998, Sec. B 11.

- (b) “In principle, too, taxation should be a matter of national sovereignty. Elections are often fought over how to tax, and how to spend the money that is raised. . . . It is unsurprising, therefore, that several member states, old and new, do not support any move to extend [QMV] to the area of taxation.”<sup>244</sup>
- (c) “Anything to do with tax is about sovereignty, and the Treasury must have control over how and what is collected. The Commission talks about moving to majority voting only on issues of tax administration in Europe, but that is a slippery slope.”

#### *Democracy and Local Control*

Although unanimous voting remains solidly in place for tax issues, several countries are likely to persistently oppose harmonization or changes in voting rules on taxes, although their reasons are divergent. On one hand Denmark as well as the other Scandinavian EU countries, Sweden and Finland, “are ‘high-tax, high-welfare states’ that want to preserve their social welfare systems” and see tax harmonization as a threat because they may be forced to lower their tax rates to some EU standard in the future.<sup>245</sup>

France, though eager to support its social safety net system (a goal similar to the Scandinavian countries),<sup>246</sup> views competition from low tax jurisdictions as the serious threat and views harmonization (of rates or bases) as desirable. In a rather blunt characterization of the motives of France and Germany, a WSJ editorial paints the following picture:

French President Jacques Chirac and departing German Chancellor Gerhard Schroeder have been trying to harmonize tax rates across Europe in order to stop what they call ‘tax dumping,’ particularly from new East European members, several of which have introduced a flat tax with great success. But tax matters fall under national sovereignty and harmonization would require unanimity among governments. Because that is unattainable, France and Germany turned to the second-best option, supporting the Commission’s call for harmonizing tax bases. This would also require unanimity but because it’s a much more reasonable proposal, it might be easier to sell. . . . The problem is that it might set a dangerous legal precedent for eventually harmonizing tax rates as well, even without requiring unanimity. That’s most likely the real reason why France and

<sup>244</sup> Juhan Parts & Tony Blair, “The Enlarged EU Must Be Free to Compete,” *FINANCIAL TIMES*, Nov. 3, 2003, London Edition 1 at 21.

<sup>245</sup> Chuck Gnaedinger, “EU Parliament President Discusses Tax Veto Under Draft Constitution,” 30 *TAX NOTES INT’L* 1312, 1312 (June 30, 2003) (quoting European Parliament President Cox).

<sup>246</sup> “France may not be able to maintain its generous social system without some protection at the European level.” Joann M. Weiner, “European Parliament Committee Holds Hearing on EU Tax Coordination, Member State Tax Reforms,” 21 *Tax Notes Int’l* 1389, 1392 (Sept. 25, 2000) [hereinafter “Parliament”] (referencing comments of Henri Sterdyniak, economist at the OFCE, a French economics institute). See also, George Parker, “EU Tax Harmonisation Plan ‘Ready in Three Years’,” *FINANCIAL TIMES*, May 25, 2005, London Edition 1, Europe at 10 (Noting that “France and Germany [advocate corporate tax rate harmonisation] as a means for ending ‘tax dumping’ by countries with very low company taxes.”); “A Pioneer Group On Corporate Tax?” *BUSINESS EUROPE*, Issue 024 (Aug. 1, 2004) (available at 2004 WLNR 10891205) (same).

Germany support this idea and certainly why countries rightly wary of further encroachment by Brussels on their sovereign rights reject it. Among them: the U.K., Ireland and new members like Estonia and Slovakia.<sup>247</sup>

Indeed, England and Ireland have relatively low tax rates and attribute their above EU-average growth rates to their pro-business competitive tax plans.<sup>248</sup> Their concern is that if they lose control over the rates, they may have to increase their tax rates.<sup>249</sup> Luxembourg is also likely to oppose harmonization, particularly that which could influence rates. In the past, Luxembourg has blocked several tax measures – because it imposes no tax on the savings accounts of nonresidents and would lose a great deal of international investment if this practice were to be replaced by the European norm.<sup>250</sup> Thus, although seeking different endpoints, both the classically “high-tax” jurisdictions (e.g., the Scandinavian countries) and the classically “lower-tax” jurisdictions (e.g., U.K./Ireland) share a common view of tax harmonization: “the same logic would hold in each case – that they want to keep the right of sovereignty intact.”<sup>251</sup>

These “national” preferences incorporate not only ideas of fiscal control – but fiscal control with a particular vision in mind. To the extent that a state’s citizens highly value a strong welfare, the state will view fiscal control as a tool to achieve that end. Similarly, a state that emphasizes the government’s role in fostering an active open market economy conducive to trade and investment will also view fiscal control as valuable in producing such an economy. The opportunity to pursue different goals, through and with the tax system, is one advantage offered by a multistate system. Moreover, the recognition that taxation is inextricably woven into national public policy and discourse indicates that the democratic process for translating that public will into action must be sufficiently transparent and responsive. Consider the following observations from a member of the U.K. Treasury on this subject:

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<sup>247</sup> “The Sly Mr. Kovacs,” W.S.J., Oct. 28, 2005, Europe, Editorial at 12. What is the argument that base harmonization will lead to rate harmonization? The EU Tax Commissioner has maintained that the CCCTB plan does not compromise sovereignty precisely because it does not prescribe tax rates. Gnaedinger & Nadal, supra note \_\_ at 991 (quoting EU Tax Commissioner Kovacs).

The answer has been offered in a critique of German motives: Germany has been “accused” of supporting the CCCTB on the expectation of a “minimum [corporate tax] rate. Because if you narrow a member state’s tax based by harmonizing, that in itself impacts on the rate because you will have to increase the tax rate to get the same revenue . . . They [Germans] want to have a minimum rate.” “Could the EU Be Our Enemy?” BUS. & FIN. MAG.( June 29, 2007) (quoting Ireland’s EU Commissioner Charlie McCreevy). See also the supporting comments of German Chancellor Gerhard Schroder, “We should not have an outright harmonisation of direct taxes but we should tax a step in this direction. . . The first one could be to harmonise the tax base.” Daniel Dombey, “Brussels In Push on Plan for Common Tax Rules,” FINANCIAL TIMES, July 19, 2004, Europe Sec. at 7; Gnaedinger & Nadal, supra note \_\_ at 993 (noting that the clarity and uniformity provided by a common tax base refocuses the spot light on tax rates, and could lead to increased tax competition (over the rates)).

<sup>248</sup> Gnaedinger, supra note \_\_ at 1312.

<sup>249</sup> Id.

<sup>250</sup> Nicoll & Salmon, supra note \_\_ at 246.

<sup>251</sup> Gnaedinger, supra note \_\_ at 1312 (quoting European Parliament President Cox). See also, Weiner, “Parliament,” supra note \_\_ at 1390 (“Another British representative [at the hearing] said that tax systems represent different fundamental views about the role of government in society and that it would be impossible to create a ‘one-size-fits-all’ tax system.”).

It's probably true to say that there is no such thing as absolute sovereignty, certainly not in the modern world with not just the EU but a number of other supranational institutions. There are a number of other factors that any government must take into account when making any kind of policy. . . . There is something about the responsiveness to national preferences expressed by the electorate for the level of public expenditure and the taxation to fund that. . . . And there is also a point about accountability.<sup>252</sup>

Academic examinations of the democratic qualities of the EU express specific reservations about the governance procedures within the EU: "The institutions [of the EU] have since acquired substantial and independent political power, and a new power center and form of governance has been established. The new form, however, is not as responsive, not as accountable, not as accessible to citizen participation, and not even as visible as its predecessors – the national governments of the EU's member states. Worse, the more power it [the EU] gets, the more pronounced the democratic deficit becomes."<sup>253</sup> However, concerns over the democratic dimensions of an expanded grant of taxing power to the EU cannot definitely conclude that the EU should not pursue them regardless. As the EU Tax Commissioner Laszlo Kovacs recognized, the decision to consolidate taxing power carries risks – the question is what benefits does it offer?:

My main priority in the direct tax field, therefore, is the creation of a common consolidated corporate taxation base in the EU. If companies were allowed to apply a single EU wide set of rules for company taxation purposes, they would not encounter most of the tax obstacles that they currently face when they do business in more than one member state. . . . Although a large number of member states are supportive of a common tax base, there are still a few countries opposed to the idea. In some cases this opposition is based on the principle of national sovereignty in tax matters. I am sympathetic to this principle, particularly in respect of tax rates. But it seems to me that there are times when the prospects of

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<sup>252</sup> "European Competitiveness Roundtable: Competition View with Common Base, INT'L TAX REV., Dec. 1, 2006, available at 2006 WLNR 23404159 (U.K. Treasury member John Connor speaking at roundtable).

<sup>253</sup> Greven, supra note \_\_ at 54. See also, Grande, supra note \_\_ at 117-118 ("In transferring legal competencies from the national to the supranational level, the democratically elected parliaments in the EU's member states have lost some of their power to shape and control policies. However, there has been no strengthening of the democratic legitimacy on the supranational level to compensate for this weakening of democracy on the national level. This 'democratic deficit' in European politics has been the subject of much criticism, but persists to this day."); Andrew Moravcsik, *Europe's Integration at Century's End, in CENTRALIZATION OR FRAGMENTATION? EUROPE FACING THE CHALLENGES OF DEEPENING, DIVERSITY, AND DEMOCRACY* 1, 41-42 (Andrew Moravcsik ed., 1998) ("The surprisingly vehement public debate over the Maastricht Treaty in both Denmark and France, as we have seen, raised the issue of a 'democratic deficit' in Europe. To many, the EU is too removed from popular control and oversight to be legitimate. To many as well, the EU appears to be governed by a distant group of unaccountable technocrats in Brussels and autonomous judges in Luxembourg intent on constructing a European superstate."); Christiansen, supra note \_\_ at 102 ("The public debate in recent years has converged around the notion that the EU's problem with legitimacy is essentially its 'democratic deficit.' [Most decision are QMV] in closed session by a collectivity of executives who are, at best, indirectly elected representatives.").

improved European competitiveness can outweigh purely national considerations.”<sup>254</sup>

*Summary:* As in the prior case of tax competition, sovereignty was used as a frequent refrain in critiques by a variety of commentators on EU voting rules and on the move toward the CCCTB. And, once again, the “obvious” connection between sovereignty and taxation was presumed, although one set of comments (by a U.K. Treasury official) did explore the meaning of sovereignty in more detail.<sup>255</sup> Such attention to the question should not be surprising because any surrender here is more formal given the structure of EU relations. Explicit discussions about relations among member states, the EU, and sovereignty have been crucial during the creation and development of the EU.

The same clamoring for fiscal control at the state level that was expressed in the tax competition debate appears in the comments and assessments of EU rules on taxation: (1) “the [CCCTB] prevents the finance minister in each member country from managing the economy in the ways that they feel appropriate;”<sup>256</sup> (2) “Members states must maintain their sovereignty over tax issues and retain their ability to adopt policies suitable to their needs;”<sup>257</sup> and (3) an important part of sovereignty is “the right to determine the level of expenditure and the tax rates and structures required to support it.”<sup>258</sup> The EU members may have felt a heightened concern over preserving fiscal control given the 1999 decision in the EU to harmonize monetary policy through the elimination of national currency and the introduction of the euro. States offered this “loss” of monetary control to justify their desire to “hang on” to the fiscal control left through tax policy.<sup>259</sup>

However, unlike the case of tax competition, the revenue aspect of the taxing power was important in the EU tax sovereignty debate – and each state’s view of the revenue question reflected its underlying assessment of the (anticipated) EU substantive tax policy. The CCCTB (and more generally QMV) was undesirable for some players because it was viewed as a precursor to rate harmonization.<sup>260</sup> States which perceived themselves to have higher than average tax rates because they sought sufficient revenue to support their social welfare systems (e.g., Denmark) feared a possible “forced” rate reduction and corresponding loss of revenue in the future.<sup>261</sup> Conversely, states which perceived themselves to be “attractive” on competition grounds and which viewed efforts to harmonization the corporate tax base or permit QMV for taxation as likely to lead to harmonized higher rates feared a loss of their competitive edge.<sup>262</sup> Thus, on the question

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<sup>254</sup> Laszlo Kovacs, “A Case for Tax Harmonization,” W.S.J. Europe, State of the Union Sec. p. 14 (Dec. 19, 2005).

<sup>255</sup> See text accompanying note \_\_\_\_.

<sup>256</sup> INT’L TAX REV., May 1, 2006, available at 2006 WLNR 10913853.

<sup>257</sup> O’Sullivan, supra note \_\_\_\_.

<sup>258</sup> “Should Ireland Agree to Phasing Out the Veto on Taxation Voting?”, IRISH TIMES, April 16, 2003, Opin. Sec. at 16 (quoting Minister for Finance, Charlie McCreevy).

<sup>259</sup> Goldsborough, supra note \_\_\_\_ at B11.

<sup>260</sup> See text accompanying notes \_\_\_\_.

<sup>261</sup> See supra text accompanying notes \_\_\_\_.

<sup>262</sup> See text accompanying notes \_\_\_\_\_. Note that these are countries unhappy about the possibility of losing their low rates if they are “forced” toward some E.U.-wide middle ground. Other countries, in contrast, fear rate harmonization could force their tax rates (and revenues) down – and impinge upon government expenditure policy.



of corporate tax base harmonization, although tax sovereignty dominated the debate, the states' respective views on the attractiveness of the anticipated outcome figured closely in their support for or rejection of the plan.

Not only do the EU members' differing views on the importance of higher tax rates and revenue influence their positions on EU tax voting rules and on harmonization, they exemplify some of the benefits of sovereign states discussed in Part I. Recall that one identified value for sovereign states was the ability to express the local culture and also to respond to the will of the people. Where different states have strongly different visions of the role of government and the appropriate size of government activity (e.g., extensive social welfare) the continued existence of many states, each able to reach an independent decision on these questions, enables government to more closely reflect the goals of its citizens. Of course not all residents in England, France or Denmark necessarily share the same view of "large government," but there is no reason to anticipate that moving the decision up the chain to the EU would enhance the democratic legitimacy of a decision that directly (or indirectly) impacted revenue and hence government spending. Not only would the process suffer from the democratic deficits recounted extensively in the literature, but it would lack the community support (i.e. *demos*) necessary to sustain the support of the outvoted members. Moreover, as the EU has grown in power, these democracy concerns have correspondingly grown.<sup>263</sup> Advocates for retaining tax policy control at the national level explicitly describe tax as a central part of sovereignty and describe democratic processes as crucial in setting tax policy.<sup>264</sup> With widespread concerns about the democratic qualities of the EU, the reservation of tax policy (which has an explicitly sensitive connection to sovereign power)<sup>265</sup> to the state level could be predicted. One interesting twist from the EU case is that in an attempt to preserve tax sovereignty by declining to pursue certain harmonizing actions at the EU-wide level, the member states have effectively ceded the decision-making floor to the European Court of Justice, at least in a negative way (i.e. the court can strike down domestic legislation, but not enact replacements).<sup>266</sup>

### C. THE WORLD TRADE ORGANIZATION AND THE FSC/ETI CONTROVERSY

The third case study examines the sovereignty arguments that have arisen in the active debate and furor over the World Trade Organization's (WTO's) rulings against the United States and its Foreign Sales Corporation (FSC) regime and its Extraterritorial Income (ETI) regime. The controversy originated in the U.S. enactment of the FSC

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<sup>263</sup> Supra text accompanying note \_\_\_\_.

<sup>264</sup> "One of the key components of a state's expression of sovereignty is the right to determine the level of expenditure and the tax rates and structures required to support it . . . . This is a basic part of the democratic process . . . . By having unanimity in taxation matters, we can reach decisions which reflect the concerns and core interests of every member state." "Should Ireland Agree to Phasing Out the Veto on Taxation Voting?", IRISH TIMES, April 10, 2003, Opin. Sec. at 16 (quoting Minister for Finance, Charlie McCreavy). See also, European Competitiveness Roundtable: Competition View with Common Base, INT'L TAX REV., Dec. 1, 2006, available at 2006 WLNR 23404159 (U.K. Treasury Member John Connor: "There is something about the responsiveness to national preferences expressed by the electorate for the level of public expenditure and the taxation to fund that.")

<sup>265</sup> See, e.g., Parts & Blair, supra note \_\_\_\_ at 21.

<sup>266</sup> See, e.g., Graetz & Warren, supra note \_\_\_\_.

regime in 1984.<sup>267</sup> The regime essentially provided an exemption from U.S. income taxation for certain export sales income earned by a foreign (sales) subsidiary of a U.S. manufacturer. The treatment was elective and required the FSC itself to meet a number of requirements. The United States considered the FSC regime a necessary step to provide a “level playing field” for U.S. exporters who would be competing against foreign companies whose own domestic tax systems levied a combination of consumption taxes and territorial income taxes. Why would the U.S. exporters be at a disadvantage? The view was that foreign exporters (e.g., from the European Union) bear effectively no domestic tax on their active export sales income: (1) their consumption tax system (a valued added tax—VAT) excludes exported goods because the consumption will take place outside the domestic jurisdiction, and (2) their income tax system operates on a “territorial” basis, meaning that active business income earned outside the domestic jurisdiction is not subject to tax (in contrast, at least formally, U.S. corporations are subject to U.S. income tax on their worldwide income). The combination was considered to provide an advantage to foreign exporters over U.S. exporters.<sup>268</sup>

In response to the enactment of the FSC rules, the EU brought a challenge to these provisions to the WTO in November 1997 [more than a decade after their enactment].<sup>269</sup> After unsuccessful dispute resolution attempts, a WTO panel issued a report concluding that the FSC provisions violated WTO rules. The United States appealed the decision and in February 2000, the WTO appellate body ruled against the United States. Thus, in

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<sup>267</sup> The FSC regime was enacted to resolve a prior GATT (General Agreement on Tariffs and Trade) dispute regarding a 1971 U.S. tax regime for domestic international sales corporations (DISCs). Following claims and counterclaims by the European Union and the United States, a resolution was reached in which the United States repealed the DISC rules and replaced them with the FSC rules. See, e.g., Testimony of Kenneth W. Dam Deputy Secretary United States Department of the Treasury Before the Senate Committee on Finance Regarding the WTO Decision on the Extraterritorial Income Exclusion Provisions and International Competitiveness PO-3295 July 30, 2002; Testimony of Barbara Angus, International Tax Counsel, United States Department of the Treasury Before the House Committee on Ways and Means on the WTO Decision Regarding the Extraterritorial Income Exclusion Provisions,” *Treas. PO-1048* (February 27, 2002); Paul McDaniel, “The David R. Tillinghast Lecture: Trade Agreements and Income Taxation: Interactions, Conflicts, and Resolutions,” *57 TAX. L. REV.* 275, 276-78 (2004).

<sup>268</sup> See, e.g., Frederick Bradshaw IV, “Tax Relief and the Competitiveness of U.S. Exporters,” *28 TAX NOTES INT’L* 167, 168 (Oct. 14, 2002); Testimony of Dam, *supra* note \_\_; Testimony of Angus, *supra* note \_\_. Although the U.S. FSC legislation was enacted and justified on the grounds of providing this level playing field, not all analysts agree that foreign exporters from countries with a border adjusted VAT and a territorial income tax have an advantage. See, e.g., McDaniel, *supra* note \_\_ at 298-99 (“The first element I call attention to [regarding ETI] is the subject of competition and the arguments made that U.S. companies are at a competitive disadvantage with respect to companies located in exemption system countries. I place the discussion under politics rather than economics because I can find no economic substance to the argument at all.”).

<sup>269</sup> Testimony of Angus, *supra* note \_\_. Allegations have been made that the EU raised its challenge to the FSC regime in retaliation for U.S. success in the WTO in challenging certain EU trade practices: “After all, the European Union didn’t bring the FSC case (some 15 years after the issue lay dormant) because European companies were complaining. The European Union brought the FSC case in 1999 and sustained litigation after the United States enacted the ETI to replace the FSC in 2000, to obtain negotiating leverage for issues the European Union really cares about -- bananas, beef hormones, genetically modified organism issues, Airbus subsidies, agricultural subsidies, and now, U.S. trade remedies that limit steel imports.” Gary Hufbauer, “Mutating Tax Incentives: How Will the FSC Drama End?” *26 TAX NOTES INT’L* 177, 180 (April 15, 2002).

November 2000 the United States repealed the FSC legislation, and replaced it with the ETI provisions which the U.S. viewed as meeting the WTO requirements while providing some competitive support to U.S. exporters.<sup>270</sup> Under the ETI rules, certain foreign sales and leasing income was excluded from U.S. income tax regardless of where the property was manufactured so long as specified activities related to solicitation and negotiation of sales occurred outside the United States. Application of the ETI rules required no election, nor the formation of a special corporation.<sup>271</sup>

Almost immediately following the enactment of the ETI regime the EU brought a challenge in the WTO, and in August 2001, a WTO panel found that the ETI regime, like its predecessor the FSC, violated WTO rules. Again the United States appealed, and the WTO Appellate Body, in a report adopted in January 2002, affirmed the panel's determination against the ETI regime (although it did narrow and limit some of the panel's far reaching language).<sup>272</sup> In October 2004, the U.S. Congress passed the Jobs Creation Act of 2004, which repealed the ETI regime but included transitional relief.<sup>273</sup> In January 2005, the "European Communities" again brought the issue to the WTO.<sup>274</sup> The resulting panel's report in August 2005 concluded that the repeal of ETI in the Jobs Act was insufficient to comply with the WTO's prior rulings, given the nature of the transitional relief: The "Jobs Act maintains prohibited FSC and ETI subsidies through the transition and grandfathering measures at issue, it continues to fail to implement fully the operative . . . recommendations and rulings to withdraw the prohibited subsidies and to bring its measures into conformity with its obligations under the relevant covered agreements."<sup>275</sup> The WTO Appellate body upheld the panel's findings in its February 2006 report.<sup>276</sup>

During a portion of this FSC/ETI dispute the EU had imposed trade sanctions. "[F]rom March 2004 to January 2005 [the sanctions] started out at 5 percent of the WTO-authorized amounts of US \$4 billion and rose 1 percentage point monthly to 14 percent. They mainly targeted U.S. precious stones and jewelry, machinery and mechanical appliances, wood and paper articles, leather articles, and toys and sports equipment."<sup>277</sup> The EU had, following the 2006 WTO ruling in its favor, indicated that sanctions would resume on May 16, 2006, but a May 9, 2006 Congressional agreement on a tax bill<sup>278</sup> resolving the FSC/ETI issued forestalled implementation of the sanctions.<sup>279</sup> One of the acknowledged difficulties in repealing the ETI regime was the reality that the repeal

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<sup>270</sup> Testimony of Dam, supra note \_\_; Testimony of Angus, supra note \_\_.

<sup>271</sup> Testimony of Dam, supra note \_\_; Testimony of Angus, supra note \_\_.

<sup>272</sup> Testimony of Dam, supra note \_\_; Testimony of Angus, supra note \_\_.

<sup>273</sup> Chuck Gnaedinger, Start Date Nears for Second Round of ETI Sanctions," 42 TAX NOTES INT'L 473, 473 (May 8, 2006) [hereinafter "Second Round"].

<sup>274</sup> Report of the Panel of the World Trade Organization, "United States – Tax Treatment for 'Foreign Sales Corporations' Second Recourse to Article 21.5 of the DSU by the European Communities, 05-4147 (September 30, 2005, at 2.

<sup>275</sup> Id. at 28.

<sup>276</sup> Report of the Appellate Body of the World Trade Organization, "United States – Tax Treatment for 'Foreign Sales Corporations' Second Recourse to Article 21.5 of the DSU by the European Communities, AB-2005-9, (February 13, 2006) at 35.

<sup>277</sup> Gnaedinger, "Second Round," supra note \_\_ at 473.

<sup>278</sup> The legislation was signed by the President Bush on May 17, 2006. Cathy Phillips, Worldwide Tax Overview, 42 TAX NOTES INT'L 669, 669 (May 22, 2006).

<sup>279</sup> Gnaedinger, "Second Round," supra note \_\_ at 473.

would create winners and losers among *domestic* corporations, given the inability to replicate the effects of ETI.<sup>280</sup>

Not surprisingly, the U.S. reaction to the WTO dispute was not favorable – and this third case study sharpens the focus on the final sovereignty scenario – a state challenging on sovereignty grounds the actions of an international body to which it has already surrendered certain taxing powers. The United States contended that the WTO’s analyses and decisions were flawed on a variety of grounds. However, one significant objection was that the WTO’s position violated U.S. tax sovereignty because it effectively sought to force the United States to abandon its tax system in favor of another. [Recall that the U.S. income tax is imposed on a worldwide basis, whereas other countries’ tax systems do not typically reach income earned outside that country. Given this situation, U.S. exporters arguably faced a higher tax burden than their foreign competitors. The relief provided by the U.S. (in the form of the FSC and ETI) had been rejected, leaving a more fundamental shift to territorial taxation as the “only” way to provide a level playing field for U.S. exporters.]. A range of governmental officials, tax commentators, and taxpayer advocates criticized the WTO outcome on sovereignty grounds strongly emphasizing both fiscal policy and democratic legitimacy concerns.

### *Fiscal Policy*

As with the first two case studies, commentators considered taxing powers as central to the state’s authority and as a crucial element in designing and controlling fiscal policy:

- (1) Rep. Gil Gutknecht: “Sovereignty: Another problem is that we are being forced to change our U.S. laws to comply with these free trade agreements. Does anyone remember just a few months ago, we had to change our corporate FSC-ETI laws to comply with a ruling made against the United States by the World Trade Organization?”<sup>281</sup>
- (2) Sen. Bob Graham: [In context of extensive testimony and questions on a very broad range of trade topics including FSC/ETI, the following comment was made] “Sen. Bob. Graham (D-FL): Mr. Zoellick, thank you very much for your always thoughtful comments. I’d like to start with a comment and then go to a question. And my comment goes to the issue that you have just been discussing with Senator Snowe. In my opinion, in a number of areas, the United States is losing its national sovereignty.”<sup>282</sup>
- (3) Philip West, former International Tax Counsel for the U.S. Treasury: “If we lose the FSC and ETI cases. . . there’s going to be a request that we change our law,

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<sup>280</sup> See, e.g., Bradshaw, *supra* note \_\_ at 167 (quoting Former Chair of the House Ways and Means Committee Bill Archer on the creation of new winners and losers as the U.S. modified its tax provisions to satisfy the WTO).

<sup>281</sup> Weekly Report from Washington by Rep. Gil Gutknecht, R- Minn July 22, 2005 (HT Media, US Fed News).

<sup>282</sup> Hearing of the Senate Finance Committee, Ambassador Robert Zoellick, U.S. Trade Representative as Witness (March 9, 2004) Federal News Service, Inc.

and [that] will ruffle those who feel this is an affront to our sovereignty. . . I'm not sure there's an easy way out for policymakers."<sup>283</sup>

- (4) Barbara Angus, International Tax Counsel, U.S. Dept. of Treasury: "Few things are as central to a country's sovereignty as the right to choose its own tax system. The ETI provisions, like the FSC provisions that preceded them, represent an integral part of our larger system of international tax rules. These provisions were designed to help level the playing field for U.S.-based businesses that are subject to those international tax rules. As we contemplate our next steps, we should not lose sight of that."<sup>284</sup>
- (5) Kenneth W. Dam, Deputy Secretary, U.S. Dept. of Treasury: "[T]his case highlights significant issues requiring further consideration as the discussion regarding the WTO matters continue in the new round. As I said in my opening statement in the WTO appellate proceedings in this case in Geneva last November, 'few things are as central to a country's sovereignty as how it raises revenue.' The WTO Appellate Body in its report in the FSC case state that the WTO rules do not 'compel Members to choose a particular kind of tax system.' That is a critically important point. Compliance with the WTO decision in this case will require that we make meaningful changes to our tax law."<sup>285</sup>

#### *Democratic Legitimacy*

Being on the losing end of a multinational institution's tax policy decisions quickly unleashes objections to the institution's ability to legitimately represent its members and to impose its will. Criticisms of the WTO following the FSC/ETI decisions emphasize broader democratic objections as well as targeted challenges:

- (1) Claude Barfield: "National Sovereignty and the Reach of WTO Rules into Domestic Policy. The FSC/ETI decisions raise troubling questions about the reach of multilateral trading rules versus the right of national government to determine fundamental tax policy. Because these decisions cannot be overturned short of a unanimous agreement by WTO member states, they also highlight a major constitutional flaw in the WTO that already is operating in this and other cases to undermine its legitimacy."<sup>286</sup>
- (2) Richard Reinhold: "An interesting feature of the GATT is its dispute resolution mechanism under which a government claiming a violation of its rights is entitled to the establishment of an impartial panel with the power to deliver final and binding decisions. The mechanism has drawn criticism in the context of the debate over the so-called 'ETI' tax regime. ETI proponents argue that the GATT

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<sup>283</sup> Cordia Scott, "U.S. Must Make Hard Choices Over Export Tax Incentives, Panelists Say," 24 TAX NOTES INT'L 218, 218 (Oct. 15, 2001).

<sup>284</sup> Testimony of Angus, supra note \_\_\_\_.

<sup>285</sup> Testimony of Dam, supra note \_\_\_\_.

<sup>286</sup> Testimony July 7, 2004, To House Committee on Small Business by Claude E. Barfield, in "Scholar Testifies to House Committee on WTO, U.S. Tax Policy" Federal Information and News Dispatch, Inc. State Department (July 7, 2004).

override was unconstitutional, (1) under Article III of the Constitution . . . and (4) based on a so-called ‘sovereignty argument.’”<sup>287</sup>

“The sovereignty argument stems from the fact that a WTO Member State will not be able to block consensus adoption of a dispute report under the dispute resolution mechanism adopted during the Uruguay round.”<sup>288</sup>

- (3) Daniel Mitchell: “The World Trade Organization (WTO) has ruled that portions of the U.S. tax law – specifically, the Foreign Sales Corporation/Extraterritorial Income (FSC/ETI) Act – provide an impermissible ‘export subsidy.’ . . . The bad news is that the WTO is interfering with America’s fiscal sovereignty by insisting that Congress repeal the FSC/ETI legislation or run the risk of more than \$4 billion of compensatory tariffs on U.S. exports to the European Union nations.”<sup>289</sup>

“The European Union also is interfering with U.S. tax policy by asking the World Trade Organization to rule that provisions of our tax code, such as the foreign sales corporation (FSC) regime are impermissible. . . . International tax harmonization schemes would mean pervasive erosion of U.S. fiscal sovereignty.”<sup>290</sup>

- (4) Duncan Bentley: “The irony is that modern international groupings designed to preserve sovereignty and further individual nations’ aspirations have their greatest effect when they intrude on the sovereignty of their members. . . . Yet that sovereignty is increasingly limited by binding agreements at the supranational level.”<sup>291</sup>

“[After describing the history of the WTO rulings on the FSC and ETI legislation] he observes that “[P.B.] Stephen suggests that [the FSC/ETI events] are an example of the WTO constraining U.S. tax policy.”<sup>292</sup>

- (5) Paul McDaniel: “In this Section, I first address the question whether the FSC/ETI decisions constitute an unacceptable intrusion into U.S. sovereignty. . . . Certainly, few problems touch more sensitive sovereignty issues than taxation. Probably every country – certainly the United States – views its fiscal system as sacrosanct from invasion by other nations or international bodies. . . . If there is an

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<sup>287</sup> Richard L. Reinhold, “Some Things That Multilateral Tax Treaties Might Usefully Do,” 57 TAX LAW. 661, 701 (2004).

<sup>288</sup> Id. at 701 n.199.

<sup>289</sup> Daniel Mitchell, “Job Creation and the Taxation of Foreign-Source Income,” The Heritage Foundation Reports, January 26, 2004 [hereinafter “Job Creation”].

<sup>290</sup> Daniel Mitchell, “Tax Harmonization Threatens the U.S. Competitive Advantage in Global Economy,” 25 TAX NOTES INT’L 1079, 1081. (March 11, 2002) [hereinafter “Harmonization”].

<sup>291</sup> Duncan Bentley, “International Constraints on National Tax Policy,” 30 TAX NOTES INT’L 1127, 1128 (June 16, 2003).

<sup>292</sup> Id. at 1131.

invasion of U.S. sovereignty by the WTO rules and procedures, it is one to which our elected representatives have agreed.”<sup>293</sup>

*Summary:* Once again, sovereignty serves as “universal” rhetoric for why a nation’s loss of control over tax policy is considered problematic. Some of the comments even specifically reiterated the importance of taxation to the sovereign state, including International Tax Counsel Angus’s statement: “Few things are as central to a country’s sovereignty as the right to choose its own tax system.”<sup>294</sup> Similarly, the functional concerns of revenue (e.g., “few things are as central to a country’s sovereignty as how it raises revenue”<sup>295</sup>) and fiscal policy more generally (e.g., “The U.S., after all, fiercely guards its fiscal sovereignty;”<sup>296</sup> “The bad news is that the WTO is interfering with America’s fiscal sovereignty;”<sup>297</sup> and “United States -- views its fiscal system as sacrosanct from invasion”<sup>298</sup>) were cited as an elaboration of the harm suffered when the U.S. was forced to cede control over part of its tax system.

Democracy issues played an important role in the debate over the WTO and its handling of the FSC/ETI complaint. A number of statements reflected reservations about and criticisms of the legitimacy of WTO procedures. Unlike the analysis in the context of the EU, the comments were not concerned with the representation of the *people* (here, of the United States) through the actions of the supra-national body, but instead with the representation of the *nation* in that body. The difference likely arises from the distinct roles of the EU and the WTO. The EU, although not susceptible to a single label, seems more akin to a federal body with possible aspirations of superseding the member states. A body that could potentially take much or all of the place of the nation-state, must carefully consider its relationship to individual citizens. In contrast, the WTO is an organization of states which have agreed to certain terms and dispute resolution mechanisms regarding trade, and owes its responsibility to the signing states.

The unanimous voting provisions in the WTO generated some of the legitimacy concerns (“Because these decisions [of the WTO body] cannot be overturned short of a unanimous agreement by WTO member states, they also highlight a major constitutional flaw in the WTO that already is operating in this and other cases to undermine its legitimacy;”<sup>299</sup> and “The sovereignty argument stems from the fact that a WTO Member State will not be able to block consensus adoption of a dispute report under the dispute resolution mechanism [of the WTO]”<sup>300</sup>). The distinction between the debate about FSC/ETI and the debate in the EU case was again sharpened by McDaniel’s observation that if there is any sovereignty problem with the “WTO rules and procedures, it is one to which our elected representatives have agreed.”<sup>301</sup> Unlike the tax sovereignty debate in the EU which was primarily forward looking and questioned the desirability of ceding of

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<sup>293</sup> McDaniel, supra note \_\_ at 297-98.

<sup>294</sup> Testimony of Angus, supra note \_\_.

<sup>295</sup> Testimony of Dam, supra note \_\_.

<sup>296</sup> *A Taxing Challenge for Congress: An Illegal Policy Risks Being Replaced by a Bad One*, The FINANCIAL TIMES, Mar. 2, 2004, London Edition 1 at 18.

<sup>297</sup> Mitchell, Heritage Foundation Report, supra note \_\_.

<sup>298</sup> McDaniel, supra note \_\_ at 297.

<sup>299</sup> Testimony of Barfield, supra note \_\_.

<sup>300</sup> Reinhold, supra note \_\_ at 701 n.199.

<sup>301</sup> McDaniel, supra note \_\_ at 297-98.

any significant state taxing powers to the EU, the disagreement in the FSC/ETI case concerned displeasure with the functioning of a process to which the United States had formally committed.

An interesting overview by Bentley captured the pervasive tension faced by nations today as they contemplate whether to solve their global problems through global solutions (and institutions) despite the likelihood (and virtual necessity) of surrendering some significant sovereignty in the process: “The irony is that modern international groupings designed to preserve sovereignty and further individual nation’s aspirations have their greatest effect when they intrude on the sovereignty of their members.”<sup>302</sup> Is that trade off best characterized as a loss of sovereignty, or as the use of an international institution to enhance a single state’s capacity to achieve its goals? The FSC/ETI case study suggests that the answer may depend in part on satisfaction with the outcomes.

### III. SOVEREIGNTY IN INTERNATIONAL TAX POLICY

#### A. IMPLICATIONS FOR SOVEREIGNTY THEORY

This article directs attention primarily at the question of the relationship between sovereignty and international tax and makes several arguments: (1) A loss of tax sovereignty can undermine both significant functional roles played by a nation-state (revenue and fiscal policy) and important normative governance values (accountability and democratic legitimacy); (2) sovereignty rhetoric, though capable of being misused and of obscuring critical issues, nonetheless provides a valuable signaling benefit; (3) sovereignty language in the debates surrounding the three case studies draws upon these sovereignty values and benefits; and (4) no satisfactory method for balancing competing claims of tax sovereignty has been articulated, although inter-nation equity has implicitly formed the basis of at least one claim. The tax case studies, however, have implications for sovereignty theory more generally and this subsection highlights three major points: (1) the role of nonstate actors, (2) the importance of domestic conflict, and (3) democracy dimensions of sovereignty.

#### 1. NONSTATE ACTORS AND SOVEREIGNTY IN THE GLOBAL ERA

Traditionally sovereignty concerned the relations between states or potential states. In the past century, though, sovereignty has focused increasingly on the relationship between states and nonstate actors (typically international organizations) and the sovereignty implications of their cooperation.<sup>303</sup> All three case studies in Part II exemplify the importance of international organizations in creating the framework for the very cooperation that could undermine state sovereignty. Although states remain the actual actors (their tax systems and rules are in dispute), international organizations play a mediating role (important distinctions among those roles are considered below in Part III.A.3). States favoring enhanced cooperation on some issue (e.g., tax competition or CCCTB) work through a relevant organization to establish a structure or approach for cooperation. States challenging the cooperation as an infringement of their tax sovereignty direct these critiques not only at the other states, but also at the organization

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<sup>302</sup> Bentley, *supra* note \_\_ at 1128.

<sup>303</sup> See text accompanying notes \_\_\_\_.



itself for facilitating the infringement. One unique dimension of the EU case is the fact that the potential cooperation could be characterized not as a usurpation of state sovereignty by an international organization, but rather as the gradual move from many smaller European states to one European mega-state. Seen through that lens, the international organization (i.e. the EU) is not an interloper undermining the sovereignty dynamics among nations, but instead the precursor of a new state that too will vigorously defend its sovereignty rights.<sup>304</sup>

Potential differences between the EU and the OECD as they relate to sovereignty also appear in the context of the “new sovereignty” idea that sovereignty is better understood as not just rights but also duties. The claim, for example, is that in the United Nations, “membership” is not simply a validation of state sovereignty, but also an obligation to meet certain duties. This more interactive understanding of sovereignty can make sense for *members* of the international organization. However, when an organization like the OECD directs some activities toward non-members<sup>305</sup> (e.g., the tax competition plan), the effect might be better described as a clash between two groups of states on sovereignty grounds. The fact that one group has organized *its* exercise of sovereignty through some shared decision in an international organization does not change the sovereignty conflict. The other group of states will maintain that they have no connection to the organization and no duty to follow its proposals. They will claim their sovereignty independent of and unrelated to the activities of the organization.

Regardless of distinctions between the EU and the OECD, their roles in tax cooperation constitute examples of the modern view of sovereignty, which holds that international organizations do not undermine states. Instead, state sovereignty is preserved by relying on a new tool (international organizations) to help the state respond to global forces.<sup>306</sup> For example, the OECD tax competition plan was defended on the grounds that given the nature of modern finance, commerce and communications, individual states would have a difficult time enforcing their own domestic tax laws and preventing “harmful” tax competition. Certainly from these states’ perspective, OECD-organized cooperation enhanced their sovereign right to implement their own tax systems. Similarly, the EU’s proposed CCCTB effectively asks the member states to consider relinquishing some direct control over setting the corporate tax base in return for reducing transaction costs that have escalated with the increase in cross-border operations. Given that states seek to facilitate investment and commercial activity with their tax rules, cooperating on the corporate tax base is more effective than clinging to tax sovereignty. What looks like the surrender of sovereignty could ultimately enhance the states’ ability to achieve its primary tax system goals.

## 2. DOMESTIC DIMENSIONS

Typically discussions of state sovereignty envision the state as a single actor, seeking to preserve its sovereign power against both grasping international organizations and against other states. This focus on the state is not unique to sovereignty; much of IR

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<sup>304</sup> There is no accepted or uniform view on *what* the EU is; nor is there consensus on whether its structural goals for the future should be identified and mapped out or whether EU members should simply allow the passage of time and let the course of events dictate the EU’s future.

<sup>305</sup> This need not be exclusive; which arguably it was not in the case of the tax competition plan.

<sup>306</sup> See *supra* text accompanying notes \_\_\_; Chayes & Chayes, *supra* note \_\_\_\_.

theory directs its attention to state actors, and treats them as monolithic entities. The tax competition case study and the FSC/ETI case study, however, highlight the importance of one trend in IR theory of the past several decades—recognizing the global effects of domestic politics.

As the U.S. side of the tax competition story reveals, even on sovereignty questions nations do not have monolithic positions. The U.S. administration in place during the late 1990s actively participated in and supported the OECD work on harmful tax competition. In their calculus, this involvement posed no sovereignty problem for the United States. Instead, it offered an opportunity for the United States to shore up enforcement of its own tax laws. The next administration (2001), however, was receptive to the claims of groups such as the CFP that the United States would be harmed by the OECD plan and that it would infringe upon our tax sovereignty. Even though the new administration ultimately took a position on the OECD plan that was less hostile than initially voiced in 2001,<sup>307</sup> there nonetheless was a marked shift in U.S. position which reflected the shift in political power in the United States. It would not be possible to appreciate (or predict) the U.S. stance without examining the domestic conflict on these issues. Similarly, the FSC/ETI conflict included an imbedded domestic debate between U.S. manufacturers which benefitted from the ETI provisions and those which did not. Although, there was general resistance in the United States to the WTO's rulings, there was significant disagreement over the best U.S. response. As the case study indicated, the repeal of ETI would inherently create domestic winners and losers among taxpayers because the repeal could not fully replicate the ETI's effects. These tensions contributed to the difficulty that Congress experienced in trying to comply with the WTO's rulings.

To the extent many countries utilize some form of democratic government, changes in national policy (at least to some degree) are likely as political parties gain and lose power within the government. Although a broad national consensus might exist on vague questions of sovereignty, the more concrete the questions of international cooperation become, the more likely the state does not have internal agreement, despite the fact it must speak on the international stage with a single voice.

### 3. DEMOCRACY DIMENSIONS OF COOPERATION AND SOVEREIGNTY

The three case studies, with their distinct scenarios, demonstrate that sovereignty fears arise at three important stages in a nation state's efforts to interact with other states on issues beyond the national sphere. In the first stage, represented by the tax competition debate, two countries (or groups of countries) each defend their tax practices and plans on the grounds of tax sovereignty and the right of nations to control fiscal policy. Essentially this is what the OECD nations and the haven nations were doing, despite finding it advantageous to avoid this characterization. Is this description undermined by the fact that one of the groups was acting through the OECD? No -- the conflict was not (at least until the CFP tried to frame it this way) a debate between OECD members, but instead a debate between some nations who developed their position with the assistance of an organization and another group of states. The clash of sovereignty claims lacked obvious resolution because, as discussed earlier, no clear priority of sovereignty arguments has been established.

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<sup>307</sup> This shift was likely due, in part, to some inaccurate views they held on the actual harmful tax competition plan. See *infra* text accompanying note \_\_\_\_.

In the second stage, represented by the EU case study, the conflict concerns *whether* a nation-state should surrender to a supra-state body (the EU) its tax sovereignty on a significant array of tax questions. Here, prioritizing of sovereignty claims is not critical, rather, the question is how to weigh the loss of sovereignty with the benefits of coordinated action on tax policy matters that reach beyond the single state. Central to this debate is accurately assessing the harm from loss of sovereignty—including the accountability and legitimacy risks to the EU democratic processes. The inquiry extends beyond a formalistic assessment of the procedural picture in the EU to ask the more elusive question of whether the EU as a community is ready to act as one on such matters—whether there is an adequate *demos*, or sense of shared commitment to sustain the “losing” members. The controversy over the CCCTB and its implications for tax rates and revenue suggest that there is a wide divergence of opinion on desired policy, and that states continue to view their divergence as reflective of their national character.

In the third stage, represented by the FSC/ETI debate, the nation-state has already surrendered some sovereignty to an international organization (here the WTO, through agreement). The controversy arises when the international organization then uses some of that transferred power to make binding decisions. When the losing state disagrees, it might object on the grounds of sovereignty as did the United States – but what does that mean? One possibility is the organization exceeded its grant of power from the states – in which case, we might be in a position more similar to the tax competition case study. Alternatively, the sovereignty claims might reflect a sense that the organization’s process was not “legitimate” – or more generally, that the losing state did not have faith in the “community” to produce a fair, even though arguably wrong, decision. Unless the United States’ sovereignty claims fall into the first camp, it not clear what to make of its buyer’s remorse. There are important reasons, as explored in Part I, to question the transfer of power to an international body, but those are questions that should be examined in advance. Presumably when the United States joined the WTO, the balance tilted in favor of surrendering some sovereign powers. But given the inherent accountability, legitimacy and *demos* problems with international organizations, it should have been no surprise if and when these problems surfaced, much to the displeasure of the losing state.

The FSC/ETI case study raises an additional question about the decision to surrender some powers—does it matter what form the surrender takes and what exit strategy exists? The EU and the WTO are very different international bodies in terms of their relationship to the member states and the relations among the member states. As reiterated a number of times, the EU cannot be readily classified, but it is more likely to approach “super-state” status than the WTO, which is granted a limited amount of authority to enforce a set of agreed upon rules in trade. Should we think about surrender of sovereignty differently in each case? Is one a more desirable format for joining together to solve global problems? Alternatively, what about an organization such as the OECD which lacks the authority to bind its members? Certainly these are questions which merit extensive investigation. However, a few observations can be made based on the sovereignty analysis.

First, no single organizational form is likely to be superior because they each serve different needs and make sense for different communities of states. The degree of sovereignty transferred in the EU seems implausible for a group of countries without the level of community and commitment that the European nations exhibit. Conversely, the

OECD can explore a range of issues with some increased flexibility because its positions are not binding (consider for example that although the OECD has a Model Income Tax Treaty, the United States, which is an OECD member, has its own model as well).

Second, within an organization changes can be made to accommodate sovereignty concerns (e.g., accountability and legitimacy) for different issues. The experience of the EU with a range of complex voting rules suggests that this type of flexibility allows a single organization to expand its umbrella. Though centralization of decision-making inherently reduces local variation and increases the layers between the people and the decisions, the upside is the ability to resolve supranational problems. The EU example and the formulation of QMV (with multiple requirements) demonstrate the possibility of creatively designing the structure to maximize its legitimacy.

Third, an important dimension of the international organization's "form" is the exit strategy it makes available to states. To the extent a state objects, either on a specific matter, or more universally, is exit from the organization possible? Is it at all realistic? The United States may challenge the WTO but it is a more serious step to fail to comply. That said, funding issues and subsequent treaty rounds provide opportunities to either retreat or express dissatisfaction. Certainly, the more readily a state can exit from a decision or an organization, the weaker the organizational power.

Finally, organizations also interact with each other in addressing international problems. For example, the EU, which can establish a "uniform" voice for the European countries, can interact with the OECD, which represents a different scale and nature of membership. A number of international organizations, cognizant of their increasing role and increasing responsibilities in international tax, formed the International Tax Dialogue – a "collaborative arrangement involving the IDB,<sup>308</sup> IMF,<sup>309</sup> OECD, UN and World Bank Group to encourage and facilitate discussion of tax matters among national tax officials, international organisations, and a range of other key stakeholders."<sup>310</sup> One possible effect is that a multiplicity of international organizations with overlapping membership could decrease sovereignty fears vis a vis any particular organization.

## B. THE FUTURE

What should we make of the swirl of sovereignty debate surrounding tax issues? One way to contemplate the relationship between sovereignty and international tax is to imagine two scenarios and consider the reactions of various states. First, what if the EU were to invite the United States to join the EU on tax policy (perhaps on a level similar to Norway which is not a member, or perhaps even more fully)? What sovereignty arguments would be raised against the idea? Would they be stronger than those generated against the OECD tax competition plan? Second, what if the U.S. and the EU were to consider joint rate setting and collection of income (with spending decisions to remain at the national level)? By all accounts this would seem to constitute a clear sovereignty problem, even among those commentators who found sovereignty fears exaggerated in other settings. How could such a step be reconciled with a system based on sovereign states? Are there ways that the collaboration could be structured to satisfy these concerns? More generally, would moving to this system seriously threaten the

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<sup>308</sup> The International Development Bank.

<sup>309</sup> International Monetary Fund.

<sup>310</sup> International Tax Dialogue website <http://www.itdweb.org/Pages/Home.aspx?lang=3>.

“system” of sovereign states, or merely infringe upon a traditional state power? Even though we are unlikely to see either of these events soon, exploration of such questions helps push our understanding of the meaning of sovereignty in international tax.

The prognosis for the future of tax cooperation seems uncertain. Tax policy broadly raises two very contentious issues – the size of government and the allocation of tax burdens (redistribution). Both of these are very “political” as opposed to technical questions, and require the support of the populace more than the assistance of experts. Given the difficulty in reaching agreement in the United States on these questions, it is hard to imagine substantial reconciliation among nations. Nonetheless, there remain a multitude of tax problems that are more technical in nature which can benefit from international cooperation. However, the closer these questions come to affecting total revenue and the allocation of the tax burden, the more likely sovereignty arguments will surface.

#### CONCLUSION

The evolving meaning of sovereignty, with its increased focus on the state’s responsibility for its citizens, is reflected in international tax arguments for sovereignty. The close link between taxing powers and the ability of the state to fulfill its obligations to its citizens explains why states articulate sovereignty as a defense to certain international tax overtures. Although, sovereignty can serve as rhetorical camouflage for unprincipled points, it can also highlight the need to protect certain decision-making powers that the state considers its prerogative. The cooperation and harmonization plans under consideration today in the OECD and the EU are not likely to impact the existence of, nor the stability of, the state-based political system. However, on a case-by-case basis, with potential cumulative effects, it is not unreasonable for states to raise sovereignty objections. In a world in which being a sovereign state is a valuable and important classification, states should ask whether a particular decision will compromise sovereignty – and for what benefit? In the case of taxation, the sovereignty costs may implicate the surrender of decisions intimately linked to the local, democratic, political process. Of course, cooperation itself may be the key to preserving sovereignty – the question is whether all states can be persuaded to believe.