Research Project

The Relationship between Tax Sovereignty’s Regulatory Function and State Sovereignty: From the Rise of Nation States to Globalization

Abstract

The concept of tax sovereignty’s regulatory function, as adopted for the purposes of this research project, refers to the use of taxing power to achieve non-revenue-raising public policy goals.

The main goal of this research project is to investigate whether, historically, a link can be identified between tax sovereignty’s regulatory function and the establishment, the exercise and the maintenance of full and effective nation state sovereignty, and, if so, whether such link continues to exist and to have an impact in the current global scenario. The proposed work will discuss this link by identifying and analyzing certain “waves” of regulatory tax policies, some of which arose during the birth of nation states and others which developed during the current era of globalization. Thereafter, it will examine how such regulatory tax policies maintained similar characteristics and functions across the different nation states.

Indeed, this analysis will be divided into two parts. In Part A, the proposed work will examine how certain regulatory tax measures aimed at the achievement of fundamental economic and social reforms (i.e. national industrialization first and wealth redistribution within the society later) played a decisive role in the establishment of full state sovereignty. Generally, at first, by favoring the rise itself of the modern nation states built on the authority of centralized governments at the expense of foreign and local rulers and then by contributing to the consolidation and extension of such central governments’ ruling powers.

In Part B, the proposed work will seek to illustrate that the importance of tax sovereignty’s regulatory function to the existence of full state sovereignty has remained substantially unaltered. This is true despite the fact that the current economic and financial globalization has reshaped both state sovereignty and tax sovereignty by turning their exercise, in many cases, from unilateral state approach to a multilateral approach. Specifically, although the design and implementation of regulatory tax policies addressing certain worldwide issues has resulted in a substantial shift from a purely national dimension to a supranational dimension, which requires cooperation and coordination between nation states, this work seeks to demonstrate that such new supranational level of regulatory tax policy, rather than diminishing national tax sovereignty, actually preserves the ability of national governments to design and implement a given social and economic order within their jurisdiction – that is, the ultimate goal of a sovereign government.
Introduction and Background Regarding Regulatory Tax Sovereignty

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

As with any other human organization, however, no state government activity can be carried on without sufficient resources. Through revenue raised by means of taxation, a state can continue the operation and existence of a functioning government. For this reason, the taxing power has traditionally been considered as “an essential part of the power to govern” and, thus, it has been conflated with the concept of sovereignty. As a consequence, state sovereignty cannot be considered complete without tax sovereignty which allows for full revenue-raising power. The same consideration led Thomas Hobbes - in his most renowned masterpiece, The Leviathan, - to expressly define “the power to raise money” as one of “the rights which make the essence of sovereignty”.

But, as the proposed work will demonstrate, an additional function of tax sovereignty –
certainly less studied and mentioned by legal scholarship – contributes to the exercise of the above-mentioned essential governmental functions and therefore to the existence of full state sovereignty. Indeed, raising revenue is not the only legitimate purpose and effect of the sovereign power to tax. The power to tax also serves as a tool of indirect regulation (or regulation sensu lato), that is, as an alternative or complementary instrument to achieve non-revenue-raising public goals.

In every nation state, tax policy – i.e., the design of the tax system – has been, on many occasions, intentionally and pervasively employed to indirectly regulate certain economic sectors and activities, or to advance economic and social reforms by encouraging or discouraging certain taxpayers’ conducts. Governments have used their tax sovereignty to promote a variety of non-revenue-raising public policy goals in the following ways: to foster national industrial development through the imposition of tax restrictions on foreign products; to help sectors which suffered from industrialization itself through tax incentives or tax reductions; to favor certain businesses over others by granting tax breaks; to punish particular economic sectors or activities through denials of tax breaks, increases in the tax rates or extension of the tax scope; to advance social justice and equality among social classes by graduating the tax rates or by granting tax breaks to specific groups of taxpayers; to make, by means of new special-customized taxes, businesses or consumers internalize certain negative externalities provoked by their behaviors; and to further foreign policy by providing differentiated punitive or more favorable tax treatments to certain goods according to the country where they arise from.

Within legal scholarship, Thomas M. Cooley, one of the most authoritative American constitutionalists of the 19th century, appeared to have noted the importance of the regulatory function of tax sovereignty, stating that “no attribute of sovereignty is more pervading, and at no point does the power of government affect more constantly and intimately the relations of life than through the exactions made under [the taxing power]”. More recently, and more explicitly, Professor Reuven Avi-Yonah also highlighted that “regulation is a legitimate role of taxation” and “in some instances taxation is the most effective way to achieve a specific regulatory goal”.

In some cases, the regulatory function of the taxing power also has found express or implicit recognition in nation states’ constitutional charters and case law. The most illustrative case is represented by the United States. Article 1, Section 8, cl. 1, of the American Constitution, indeed, grants Congress a taxing power not just “to pay debts and provide for the common defense” but also to provide for the “general welfare of the United States”, a general clause which grants an extensive scope to the taxation power. And, in fact, the federal

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7 AVI-YONAH, R., Taxation as Regulation: Carbon Tax, Health Care Tax, Bank Tax and Other Regulatory Taxes, July 2012, PUBLIC LAW AND LEGAL THEORY WORKING PAPER SERIES, University of Michigan Law School. Available at: http://ssrn.com/abstract=1664045, at 4. It must be noticed that Avi-Yonah adopts a smaller concept of regulatory function of tax sovereignty than we do in this work. Indeed, he distinguishes taxation’s redistributive function, mostly exercised through the individual income taxes, from its regulatory function. See AVI-YONAH, R., Three Goals of Taxation, 60 TAX LAW REVIEW 1, (2006-2007). On the contrary, this work holds that redistribution by means of taxation should be qualified as an exercise of tax sovereignty’ regulatory function.
government has widely used its tax sovereignty not just to provide itself with adequate funds but also to accomplish certain fundamental regulatory policies. Moreover, the U.S. Supreme Court, a fundamental institution for the construction and the interpretation of the American legal system, has in several cases explicitly approved and asserted the use of tax policy to accomplish social or economic (i.e. regulatory) objectives, in addition to revenue-raising purposes. Referring to this regulatory function of taxation, Justice Marshall pronounced one of his most memorable statements: “The power to tax involves the power to destroy”, where the subject of such 'destruction' is any social or economic activity. In several subsequent cases, and even recent decisions, the U.S. Supreme Court has confirmed that Congress can legitimately use its taxing power to indirectly regulate non-tax behaviors and areas that it may not regulate directly under the “enumerated powers rule”. The Court expressly stated that “every tax is in some measure regulatory” and that “it is beyond serious question that a tax does not cease to be valid merely because it regulates, discourages, or even definitely deters the activities taxed”. This position was recently reaffirmed by Chief Justice Roberts in his controlling opinion on the constitutionality of the Patient Protection and Affordable Health Care Act (so-called “Obamacare”), when Roberts wrote that “taxes that seek to influence conduct are nothing new” and cited Justice Story’s proposition that “the taxing power is often, very often, applied for other purposes, than revenue.” Such case law, indeed, has been fundamental for the enlargement of the federal government’s powers and, as a result, for the development and preservation of complete national (i.e. federal) sovereignty over that of the states.

Furthermore, even the European Court of Justice’s case law has played a very important role in defining the scope of European nation states’ tax sovereignty by identifying its regulatory public policy function. In particular, the European Court of Justice, in its exercise of scrutiny of the Member States’ legislation to ensure their consistency with the EU rules concerning the principle of non-discrimination and the prohibition of state aids, has incipiently tantum often highlighted the legitimate use of tax policy for non-raising-revenue purposes. Indeed, in recognizing the legitimacy of many national laws providing special tax advantages or disadvantages to certain categories of taxpayers as long as they are not discriminatory towards other taxpayers on the basis of their country of residence or nationality, the ECJ has repeatedly and constantly affirmed that tax policies constitute, in principle and to the extent that

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8U.S. SUPREME COURT, McCulloch v. Maryland. See 4 WHEATON 316 (1819).
9 According to the “enumerated powers rule”, the U.S. Congress and government are entitled to exercise only those powers expressly provided for in the Constitution, while all of the remaining powers are attributed to the States. Among the enumerated powers are coining money, raising taxes, collecting taxes, regulating interstate commerce and commerce with other nations, regulating immigration, creating and maintaining the army, declaring war, and others. See SULLIVAN, K.M., GUNTHER, G., CONSTITUTIONAL LAW, (New York: Foundation Press, 2010).
11United States v. Sanchez, 340 U.S. 42 (1950), 44.
13 For a detailed review of this case law, please see MASON, R., Federalism and the Taxing Power, 99 CALIFORNIA LAW REVIEW (2011), 975. This position was recently reaffirmed by Chief Justice Roberts in his controlling opinion on the constitutionality of the Patient Protection and Affordable Health Care Act (so-called “Obamacare”), when Roberts wrote that “taxes that seek to influence conduct are nothing new” and cited Justice Story’s proposition that “the taxing power is often, very often, applied for other purposes, than revenue.” National Federation of Independent Business v. Sebelius, 132 S. Ct. 2566, 2596 (2012)
14In the form of tax breaks like special deductions, exclusions or deferral, for example. Such types of tax measures fall within the general category of the so-called “tax expenditures”. 
they do not violate the EU principles of non-discrimination and a legitimate tool for governments to implement economic, social, environmental and many other types of non-revenue-raising public policies.\footnote{See, for example, \textit{European Court of Justice}, \textit{Case C-148/77}, at par. 16, where the Court states that “tax advantages of this kind may serve legitimate economic or social purposes”. See also \textit{Case C-140/79}, judgment of 13.1.1981, at par. 13 and 15; \textit{Case C-46/80}, judgment of 14.1.1981, at par. 12; \textit{Case C-132/88}, judgment of 5.4.1990, at par.17.}

In addition, the dual prerogative of taxation has certainly been an essential part of the ambitious and not yet completed project of construction of the European Union and of one of the first steps of a progressive transfer of political sovereignty to its institutions. Indeed, as the EU Treaty itself reflects, the suppression of internal custom duties and the complementary implementation of a common customs tariff for relations with third countries have been aimed at achieving two main objectives: providing the European Union’s institutions with their own resources for a general budget (revenue-raising prerogative) and promoting free circulation and trade of goods between the Member States as a means to come to a common market (public policy-regulatory prerogative).\footnote{\textsc{Mortelmans, K.J.M.}, \textit{The Functioning of the Internal Market: The Freedoms}, in \textbf{The Law Of The European Union And The European Communities}, (P.J.G. Kaptyn, A.M. McDonnell, K.J.M. Mortelmans, C.W.A. Timmermanseds.), (Alphen aan den Rijn: Wolters Kluwer, 2008), 575 and 601-602.}

**Goals and Structure of the Work**

In light of the observations above, it emerges that full tax sovereignty means the government’s use of taxation not just for revenue-raising purposes but also for regulatory purposes - that is, to implement non-revenue-raising public policies.

The proposed work will indeed aim to investigate whether a link can be identified between tax sovereignty’s regulatory function and the establishment, the exercise and the retention of full and effective nation state sovereignty, and, if so, whether such link continues to exist and to have an impact in the current global scenario. Such investigation will be conducted by analyzing certain “waves” of regulatory tax policies implemented in various western nation states which present significant similarities in their rationale and their functioning. Where relevant, the work will also discuss case law - in particular in the U.S. Supreme Court and the European Court of Justice case law - which most significantly contributed to the affirmation of the legitimacy of regulatory tax policies and their capacity to strengthen state sovereignty.

The analysis will be divided into two parts. In Part A, the proposed work will investigate whether a link can be identified between certain regulatory tax measures aimed at the achievement of fundamental economic and social reforms (i.e. national industrialization first and wealth redistribution within the society later) and the establishment of full national state sovereignty.

In particular, Part A will aim at examining:
- first, whether certain regulatory tax policies – such as tariffs – effectively favored the rise itself of nation states built on the authority of centralized governments at the expenses of foreign and local rulers; and

- second, whether the subsequent shift from regressive tax systems based on indirect proportional taxes to overall progressive tax systems based, on the one hand, on individual income taxes and corporate income taxes (inspired by redistributive and supervisory goals), and, on the other hand, on the pervasive use of so-called tax expenditures (inspired by social justice and other non-revenue raising goals) effectively played a role in the extension of national government power vis-à-vis local and private power.

Assuming that Part A reflects that a relationship exists between certain waves of regulatory tax policy and the establishment of full state sovereignty over the modern nation states, Part B will demonstrate how, although current economic and financial globalization has reshaped both state sovereignty and tax sovereignty by turning their exercise, in many cases, from a unilateral state approach to a multilateral approach, the importance of tax sovereignty’s regulatory function to the existence of full state sovereignty has remained substantially unaltered.

Specifically, Part B of the proposed work will seek to provide evidence on such point by examining certain regulatory tax policies whose design and implementation, to be effective, requires multilateral cooperation between national governments (often within the framework of international organizations such as the OECD, the IMF or the World Bank). The regulatory tax policies that will be analyzed include (i) those policies aimed at countering the so-called “base erosion & profit shifting” (“BEPS”) aggressive tax planning techniques implemented by multinational enterprises (such regulatory tax policies may involve a revitalization of the regulatory function of corporate income taxes); (ii) the regulatory tax policies proposed and, in few cases, implemented to reduce and internalize the financial sector’s negative externalities in order to prevent a new systemic crisis like the 2008 financial crisis; and (iii) regulatory tax policies aimed at protecting the environment and specifically at reducing the effects of global warming.

After an examination of these regulatory tax policies, which have a global impact, the work aims to show that the relatively new supranational level of regulatory tax policy, rather than diminishing national tax sovereignty, actually preserves the ability of national governments to design and implement a given social and economic order within their jurisdiction – that is, the ultimate goal of a sovereign govern.

The outcome of the proposed work may contribute the following insights about regulatory tax policy to the tax law field:

a) filling in the current gap of knowledge about the effective role of regulatory
taxation in the establishment of nation state sovereignty; and
b) the correct identification of the nature of certain multilaterally-designed tax
policies as regulatory tax policies and understanding of the critical role played
by such measures in the preservation of nation state sovereignty.

The research will be based on library resources. It will require access to both historical and
current US and international (comparative) legislative, case law, public policy materials and
journals.

For your reference, please find below a draft of the table of contents of the proposed work:

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