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Chapter 10

Fiscal sovereignty and external constraints

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Models of fiscal response to external constraints

When defining the powers of government to impose taxes – more simply called fiscal sovereignty – the law always assumes that it will be possible to make adjustments to the taxation system, the only limits on this being the will of the people's representatives, and constitutionally-imposed restrictions on the power of government. But in contrast with these extensive decision-making powers enshrined in the constitution, there is the economic reality stemming from the interdependence of economies. This reality is a permanent constraint on taxation policy and on the choices to be made between one method of taxation and another[1] and is particularly stark in the case of a small economy when it opts for a policy designed to attract foreign investment. The formulation of a taxation policy therefore tends to be characterised by a distinct lack of sovereignty.[2] External constraints are reflected in domestic political decisions, thus creating what can be described as various models of fiscal response to the outside world, which succeed one another over time.

In an attempt to characterise and date the various models existing in Portugal, we would place the first between the mid-1960s and 1975, and describe it as the tax haven model. The second, after 1975, could be described as the period of fiscal competition for investment. The third, which began with Portugal's accession to the EC and is the one we are witnessing today, could be called the period of multilateral co-ordination of fiscal policy. It features formal restrictions on sovereignty and a continuation of the period of competition for investment, as well as a number of new characteristics. The most important of these is the possibility of a supra-national solution to the problem of tax competition between small countries with small economies.

The tax haven model

The most interesting feature of this model, which we would place between the early 1960s and 1974, is that its main characteristics were not designed with the aim of attracting foreign investment.[3] They were, to all intents and purposes, natural factors, resulting from a conservative policy in the field of public expenditure and from the absence of political pressures, such as war,[4] for an increase in government spending. However, there is a very marked contrast between rates of income tax which were imposed at that time in the more industrialised countries and income tax rates in Portugal. The low rates of tax – the result of a sovereign decision in the sense of being free from any external constraints on the Portuguese government and tailored to its type of society – played an important role in attracting foreign investment.

This natural factor was brought into play only by the countries with which Portugal was beginning to enter into double taxation agreements. The principle of reciprocity which governs this type of negotiation raised the issue of Portugal's tax haven characteristics, with a low level of income to act as a competitive advantage.

Tax privileges for foreign investment

A completely different behavioural model in relation to foreign investment was that created after the sharp rise in tax rates, in particular on personal income, which occurred after 1974.

The determining principle of the increased tax burden at that time was, in addition to the political crisis, the emphasis placed on the redistributive role of the state's financial activity. This followed on from a widening of the scope of activities it was felt that the government should pursue, with a consequent increase in public expenditure.

The first indications of this transition date back to the final years of the 1933 Constitution, during which the principles of the Estado Social de Direito ('State of Social Entitlement') were invoked to begin setting up the Welfare State and increasing state intervention in the economy. The decisive change of direction, however, was taken with the increase of tax rates on personal income in the 1976 budget. This cancelled out the tax advantages Portugal had offered up to then, compared with more developed countries.

This increase in the tax burden, together with the political unrest of 1974/5 (which caused a rise in the 'risk rate' calculated for foreign investments) and balance-of-payments problems, made the escudo an unattractive currency. This led to the creation of a system of tax concessions for investment by non-residents, under which substantial investment plans benefited from a contractual arrangement whereby tax payments were refunded to the undertaking. This was one of the points which came under discussion during the negotiations.

In addition to the problems inherent in opening up the tax system to negotiation (in view of the strict subordination of tax obligations to the law),[5] we have here a clear renunciation of sovereignty, even as regards the legal form adopted. This was considered a necessary condition to attract foreign capital.

The reduction of taxes, as provided for by the Código dos Investimentos Estrangeiros (Foreign Investment Code),[6] thus emerges as a tool of economic policy. In its second version in particular,[7] it acknowledges the weakening of the Portuguese economy's ability to attract foreign investment, and grants tax concessions and guarantees concerning the repatriation of profits as a special right, or a kind of 'personal regime', for non-residents likely to be interested in investing in Portugal.

Despite these subtle renunciations, Portuguese fiscal sovereignty is not legally limited by any external factors. The only restrictions are those which are contained in double taxation agreements[8] which, as bilaterally-produced devices, expressly safeguard the freedom of action of the Portuguese State.

From fiscal bilateralism to fiscal multilateralism

We can consider this period to have come to an end with Portugal's accession to the European Community. One first and major consequence of membership was the introduction of VAT, heralding a period during which the main aspects of the tax system will be determined by agreements and negotiations between the various EC member states.

The emphasis on incentives for foreign capital investment which characterised the second half of the 1970s did not immediately disappear from economic policy: the negotiation of a privileged tax system still plays a part in the preparations for any big international project in Portugal.

However, integration into the EC has given rise to a new situation where the essentials are no longer unilateral measures to stimulate investment or bilateral treaties to avoid double taxation, but rather the harmonisation of taxes within the EC. This process was initiated with the introduction of VAT as a condition of membership, and is now the fiscal component of the completion of a single European market; the more tax borders are removed and restrictions on the free movement of capital lifted, the more complete tax harmonisation will tend to be.

The move from bilateralism to multilateralism sets many problems in a new context.

In a period characterised by bilateralism, the need to attract foreign capital can lead to fiscal abdication; this is what occurred in the period described above. The decision to forgo or reduce taxation on foreign investment, because the benefits of the investment offset the loss in tax revenue, can lead to higher taxation in the home country, which benefits from the competition between less-developed countries seeking to attract investment.

Beyond the need to attract foreign capital, there is the problem of distribution of tax receipts between the country where the profits are generated and the home country of the owner of these profits. With the application of the principle of equality between the various countries (*interjurisdictional equity*), the principle of neutrality of location and the principle of equality as regards the taxpayer,[9] if free movement of capital – one of the main objectives of the internal market – is achieved, the question of obtaining foreign investment through competition with other less developed countries could lose its significance compared with the problems of multilateral relations.

The problem of equality between the various countries involves the equitable distribution ('fair share') of the revenue generated by international flows of capital. The problem of neutrality of location is closely linked to the efficient international investment of resources. Just as internal investment decisions made solely on the basis of tax concessions jeopardise efficiency, so tax incentives can lead to distortions in the choice of country. Thus, the problem of equality of treatment for taxpayers basically has to do with identical treatment for those residents who have domestic income only and those who have additional income from investments abroad.

Having analysed the tactical restrictions of fiscal sovereignty, whereby tax concessions are granted merely to attract investment or correct double taxation through bilateral agreements,[10] we must go on to consider the problems of optimum economic co-operation between various countries and the equitable distribution of tax revenue. The price to pay is obviously a loss or delegation of sovereignty, owing to the transfer of decision-making on fiscal matters from national parliaments to the European Community.

We do not intend here to ascertain whether tax harmonisation will affect this or that area of taxation. It has already affected indirect taxation, it will increase the standardisation of rates of direct taxes, and it will probably spread to other areas. What is important is not the number of areas it will embrace, but rather the qualitative changes it will bring to the concept of fiscal sovereignty.

Fiscal sovereignty: theory and practice

It is not within the scope of this chapter to discuss the ways in which fiscal powers will gradually be transferred from national parliaments to the European institutions.

We may nevertheless assume, as a working hypothesis, that the trend will be towards a gradual increase in joint and central decision-making, with the drawing-up of a common fiscal policy in order to meet the need for larger Community resources, while ensuring that tax laws do not stand in the way of a single market and reconciling the free movement of capital with the problems and requirements of tax supervision.

It may be said with some degree of accuracy that financial decisions are shaped by what we could call the German model: the federal constitution guarantees discipline and financial resources, leaving plenty of room for decisions by the individual states.

'The financial Constitution determines the objective and opportunities with respect to fulfilling federal duties'.[11] The minimum level of financial arrangements within the Community framework would consist of sharing out responsibilities and resources among the various member states and the Community, with an inevitable limitation of national powers and a degree of tension owing to the constitutional role of each of the national parliaments in voting the budget and taxes. This would lead to permanent difficulties in agreeing on the content of each budget or defining rules for sharing the powers between the various Community institutions.[12]

However, although such a transfer of powers from national bodies to Community institutions affects fiscal sovereignty as a whole, it will have different effects on each of its components.

The drawing-up of tax regulations is a central aspect of fiscal sovereignty. Within the limits of negative guidelines (the prohibition of certain types of tax) and positive guidelines (the obligation to ensure that tax legislation contains certain features), these regulations are freely set by Parliament. This is what constitutes fiscal sovereignty, according to certain authors.[13]

It is precisely in this area of sovereignty that the main problems of the limitation of powers lie. Community agreements on the content of tax legislation will substantially impinge on the freedom to shape tax laws by imposing certain provisions and prohibiting others. Suffice it to recall the problem of reconciling the 8 per cent rate set for the services of barristers, legal advisers and solicitors with the commitments under Portugal's Act of Accession to the Communities.[14] With so many more restrictions, the need for harmonisation will be even greater.

The zero rates for VAT granted to Portugal in the Act of Accession had to be abolished in the context of measures taken to complete the single market. And if we recall that where this tax is concerned the definition and exemption criteria are for the most part laid down in the Sixth Directive – a decision taken at Community level – we can see how narrow the national legislator's margin for decision-making really is.

The same can be expected in sensitive areas such as the taxation of capital or the determination of taxable corporation profits. The freedom of parliaments to choose taxation criteria and rates is therefore tending to be restricted to residual fields of a more local nature, such as taxes on rural or urban property.

Fiscal sovereignty, however, is not just the capacity to enact tax laws. It includes a whole range of powers such as the power to allocate tax revenue (*Steuerertragsheit*) or the powers of fiscal administration (*Steuerverwaltungsheit*), all of which make up the financial activity of the state and its tax-collecting function.[15] It is these areas of fiscal sovereignty, together with the public decisions on the level of rates and the forms of taxation with no international repercussions, which will allow the national differences and decisions appropriate for each country.

Decisions regarding the allocation of tax revenue will tend to remain unchanged. Even in a system of regional government, the regions decide on the method of using the tax revenue allocated to them. In Portugal, this is provided for in Article 228, No. 1, paragraph (i) of the Constitution, which confers on the regions the power to 'freely dispose of tax revenue collected in their district'.

Once the financial resources are allocated, it is up to these bodies to decide on their use, with the corresponding political accountability for good or poor use.

The same will occur with respect to fiscal administration powers. Activity in this area is part of administrative activity in general, and this is a form of essentially administrative competence which embraces the possibility of deciding on rates and other special charges.[16]

Conclusion

European integration, with the creation of a single market and the removal of tax borders, will make it even more difficult than before for a small country with an open economy fully to exercise its fiscal sovereignty, because it will multiply constraints and the number of areas liable to be affected by them.

It will also intensify the institutional forms of fiscal policy co-ordination, with the formal transfer of sovereignty. It may, however, also create forms of multilateral co-ordination of taxation policy with countless benefits for bilateral agreements and fiscal co-operation between countries with intermediate levels of development.

Notes

1. Hitherto, writes Heinz Haller, we have always taken as a premise the belief that each country is able to act freely in deciding which kind of tax it should impose, without having to take account of the tax structures of other countries – (Heinz Haller, 1971, *Die Steuern-Grundlinien eines rationalen Systems öffentlicher Abgaben*, Tübingen, p. 337). This tendency of those concerned to give only scant consideration to the changes which international economic relations introduce into theoretical analysis has its counterpart in the activity of tax reformers who, once their work is completed, consider the adjustments to their initial project needed to take account of these relations.
2. Meaning fiscal sovereignty in the precise sense of powers of the State in the face of external groups. On this concept see Luis Cazorla Prieto, 1981, *Poder Tributario y Estado Contemporáneo*, Instituto de Estudios Fiscales, Madrid, p. 132.
3. Tax haven only in the sense of being a country with tax rates lower than the 'normal' rates of developed countries. Regarding this subject see the comments of B. Bradwell Milnes, 1981, *The Economics of International Tax Avoidance – Political Power v Economic Law*, Deventer, the Netherlands, p. 103.

4. The impact of wars on the structural increase of government spending has been very prominent in recent research. See Dennis Mueller, 1987, *The Growth of Government*, IMF Staff Papers, March, p. 117.
5. The central aspect of the modern interpretation of the constitutional principles of taxation was precisely that it fell within the rule of law (*Herrschaft des Gesetzes*) as opposed to the imposition of taxes according to the will of the typical monarch of the Absolute State. On this subject see R. Walz, 1980, *Steuergerechtlichkeit und Rechtanwendung*, Hamburg, p. 17. The constitutional principle of the general applicability of taxes and the principle of equality in their distribution depend on this.
6. The granting of tax breaks to industrial firms as practised by some of the countries whose development is lagging behind, such as Ireland, tends to give rise to a sort of tax war. The beneficiaries of this are those companies which can choose where to invest. More successful, although also controversial within the European Community, is the concession of special advantages to *holding* companies, as in The Netherlands and Luxemburg. V.A.J. Easson, 1980, *Tax Law and a Tax Policy in the EEC*, London, 1980, p. 205.
7. Published in 1976 with the objective of improving the conditions for attracting foreign investment.
8. But even though they are subject to bilateral negotiation, these agreements are governed by a model treaty, drawn up by the OECD, which exerts a strong standardisation influence on the creation of a framework to express the will of the various countries. This standardisation is a precondition to be observed by the authorities and taxpayers so as to eliminate double taxation, which was a considerable obstacle to the development of economic relations between the various countries. See 'Relatório do Comitê dos Assuntos Fiscais da OCDE' in *Modelo de Convenção de Dupla Tributação sobre o Rendimento e o Capital-OCDE*, 1977, Lisbon, Centro de Estudos Fiscais, 1989.
9. Peggy B. Musgrave, 'Interjurisdictional Coordination of Taxes on Capital Income', in S. Cnossen (ed.), 1987, *Tax Coordination in the European Community*, Deventer, p. 201. On the same subject: 'Tax Harmonisation in the European Community'; Coopers & Lybrand 'Relatorio ao Congresso do 50° Aniversário da IFA', *The Financial Times* Business Information, p. 33.
10. These agreements, negotiated on the basis of reciprocity, restrict themselves to obtaining the equivalent of withholding taxes imposed by each country, without solving the fundamental problem of the unequal rates charged by countries, thereby showing themselves to be incapable of solving the problem of equality between countries. P. Musgrave, op. cit., p. 214.
11. As outlined and developed by Franz Klein, 1985, 'Probleme einer europäischen Finanzverfassung' in *Der Bundesfinanzhof und seine Rechtsprechung Grundfragen-Grunglagen-Fst. für Hugo von Wallis*, Bonn, p. 491.
12. The ongoing difficulty in coming to an agreement on the drawing-up of the European budget is only 'a myth which hides the real crisis within the Community: that of its aims and means', René Milas, 1988, 'Le Budget communautaire sur analyse systèmique', *Revue du Marché commun*, No. 317, May. The difficulties of decision-making in the present situation and the structural difficulties of transferring power to the European Parliament essentially have to do with setting objectives.
13. According to Garcia Bereijo, the incompatibility of the concept of fiscal sovereignty with legal restrictions on the power of the state leads to including the concept of fiscal sovereignty in the theory for producing tax rules. A. Garcia Bereijo, 1976, *Introducción al estudio del derecho financiero*, Madrid, p. 204.
14. In the opinion of Xavier de Basto, neither the zero rate nor the 17 per cent were contrary to Community law, but the 8 per cent rate was. See Xavier de Basto, *A Aplicação do IVA a jurisconsultos, Advogados e Solicitadores: uma crítica ao Decreto-Lei no 290/88*, Fisco No. 5, p. 41.
15. On the overall aspects of this classification see K. Tipke, 1983, *Steuerrecht - Ein Systematischer Grundriss*, 10 Ed. Cologne, p. 76.
16. This area includes the many different types of non-fiscal measures, from the collection of additional charges to parafiscal charges. Paul Kirchoff, 1982, 'Verfassungsrecht und öffentliches Einnahmensystem' in Karl-Heinrich Hansmeyer (ed.), 1982, *Staatfinanzierung im Wandel*, Berlin, p. 52.