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Some Theoretical Aspects of "Comparative Taxation"

I. WHAT IS COMPARATIVE TAXATION?

As surprising as it may seem, even amid voluminous scholarly writings in comparative tax law, tax comparatists usually neglect to define what it is, exactly, they deal with. We have no intention of launching such a scholarly effort here (and this is certainly not the main purpose of this book), but we would like to suggest two possible answers to the question presented in the subtitle above.

Possibly and obviously, "comparative taxation" could be seen as a form of scholarly method of research and teaching. To assert such an argument is also to argue that whatever this method is, it holds its own unique characteristics, processes, techniques, and modes of evaluation. We cautiously assert that to date, no such method can be identified. Rather, legal tax comparatists have usually adopted well-defined comparative methods that are used in general comparative legal studies. Given the wide array of methods available for legal comparison (some of which are briefly surveyed below), there is probably no need to invent a unique method of comparing tax rules.

But "comparative taxation" can also represent a unique body on knowledge. However, this is not immediately apparent. To explain this assertion, we must start by pointing to the obvious: any process of tax comparison will involve, at some point, the juxtaposition of tax laws of several jurisdictions. However, the mere juxtaposition is not, by itself, "new knowledge." Simply looking at the tax treatment of punitive damage awards in the **United States** and in **Germany**, for example, and noting the similarities or differences between them does not tell us a whole lot. These tax laws are already "there." By "comparative tax knowledge," we mean, rather, the new insights and conclusions that can only be reached by way of comparison. An example may illustrate this point.

In a book titled *Tax Law Design and Drafting*, Victor Thuronyi pioneered what may be referred to as the taxonomy of legal "tax families."[1]

[1] Victor Thuronyi, Tax Law Design and Drafting, xxiii–xxxv (International Monetary Fund 1996); Victor Thuronyi, Tax Law Design and Drafting (International Monetary Fund 1998) ; Victor Thuronyi, Comparative Tax Law, 23–44 (Kluwer 2003).

Even though the classification of legal families is a long-established concept in general comparative law, such a comprehensive classification was new to tax laws when introduced by Thuronyi. According to Thuronyi, such classification plays an important role, as it provides "assistance to those seeking to understand the tax law of different countries, whether for the purpose of comparative study or as part of tax practice."[2] Specifically, such a classification is most helpful in generating "relevant questions."[3] The concept of classification is regarded by its proponents as an essential part of the process of comparison,[4] as it suggests which jurisdiction might be "successfully compared" with others. Of course, any such typology may be criticized or completely rejected. But it is obvious that such typology could not have been produced without the comparison of multiple tax jurisdictions and hence certainly qualifies as "comparative tax knowledge." In other words, it is an insight that could not have been achieved absent the process of comparing tax rules.

In the following text, we will try to attach this meaning to the term "comparative taxation."

II. SOME POSSIBLE APPROACHES TO THE STUDY OF COMPARATIVE TAX LAW

One of the main problems with the comparative study of law is that there are probably as many approaches to it as there are comparative scholars. Although over the past three decades or so, legal comparatists have fiercely debated what approaches should be deemed appropriate when conducting a comparative study of law, they have failed to produce any coherent outcome.[5] This is not surprising, since this academic discussion is strictly embedded in the ideological and political stances of its participants. Since ideologies are many times irreconcilable, the same fate may apply to the methodological offshoots of such ideologies.

Some legal comparatists did try to sketch a so-called objective blueprint for comparative research. Professor W. J. Kamba, for example, portrayed legal comparison as a three-phase process.[6] The first phase is the *descriptive phase*, in which the comparatist is expected to describe

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[2] THURNOYI, COMPARATIVE TAX LAW, *supra* note 1, at 23–24.

[3] *Id.* at 8.

[4] John C. Reitz, *How to Do Comparative Law*, 46 AM. J. COMP. L. 617, 622 (1998).

[5] *See, e.g.*, Mathias Reimann, *The Progress and Failure of Comparative Law in the Second Half of the Twentieth Century*, 50 AM. J. COMP. L. 671 (2002).

[6] Walter J. Kamba, *Comparative Law: A Theoretical Framework*, 23 INT'L COMP. L.Q. 485 (1974).

the "*norms, concepts and institutions of the systems concerned.*"[7] The second phase is the *identification phase*, in which the researcher indentifies the differences and similarities among the systems studied. The third phase is the *explanatory phase*, in which the reasons for convergences and divergences are explained. However, even if we accept such a generalized scheme, it is obvious that once executed, it must be filled with some real contents. One must choose which jurisdictions to compare, what laws to compare, which legal and nonlegal texts to read, and so on. In other words, we are thrown back into the realm of subjective choices, which, by definition, are ideologically affected.

Obviously then, we cannot possibly point to a single approach that can be regarded as superior to others. Indeed, given that these approaches represent different ideological views, we would probably not be able to reach an agreement among ourselves as to the most promising method of comparative tax research. Hence, any reader of this book would clearly identify some shifts in the focal points of the discussion, a result of our theoretical agreements and disagreements. Thus, a shift from a functional discussion to a discussion in comparative economics, with side trips to cultural comparativism, should be viewed as an invitation to consider multiple possibilities of analysis, rather than to suggest a "proper" one in each case.

However, this unsolved debate did successfully emphasize the pivotal points of ideological differences. Some "schools of thought" can be clearly identified, each of which has its own basic assumptions and purposes and each of which has its own idea as to how comparison should be executed. In this respect, the key debates revolve around three basic questions: the first is the purpose of comparative legal studies; the second is the objects of comparatives studies, namely which jurisdictions and which laws should be compared; and the third addresses the techniques of actual comparison. The intent here is not to overburden the reader with theoretical aspects of research but rather to briefly survey some of the possible ways by which one might approach a comparative study in the context of tax laws.[8]

Unavoidably, such a short summary tends to generalize and ignores some important nuances. Hence, it does not by any means intend to prescribe in details any technique that should be followed when conducting a comparative study in tax law. But it can still clearly illustrate where the key ideological (and consequently methodological) differences lie. These approaches can thus serve as "ideological rallying points" from which a comparative debate can be launched. We will survey four possible approaches to the comparative study of

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[7] *Id.* at 511.

[8] For a more elaborative survey, see Omri Y. Marian, *The Discursive Failure in Comparative Tax Law*, 58 Am. J. Comp. L. 415 (2010).

tax law: functional, cultural, critical, and economical. It is important to note that each of the approaches described below is full of sub-schools and inner conflicts. Also, none of the scholars mentioned can be purely regarded as adopting a particular approach. Most tax comparatists embody in their writings assumptions and arguments that absorb their vitality from multiple methods and from various traditions. Thus, the reader is encouraged to consider these views openly, rather than completely embrace or reject any of them.

A. The functional approach to comparative tax studies

The functional approach to comparative law has a long-established tradition and is probably the most widely adopted. Comparative legal functionalism rests on the assumption that "the legal system of every society faces essentially the same problems, and solves these problems by quite different means, though very often with similar results."[9] In other words, functionalists see the convergence of legal systems as an inevitable and desirable phenomenon. If legal problems and legal outcomes are the same, unifying the laws (the means to solve these similar problems and to reach the similar outcomes) would save a lot of headache. In their view, legal terminological heterogeneity is only a façade that covers the real similarities that may be unobservable at a first glance. A tax comparatist's job would be to uncover these similarities in the context of tax laws.

The premises of functionalism, as well as the view that tax laws are converging, are widely adopted among international and comparative tax scholars. Such commentators repeatedly point out the remarkable degree of similarity in the tax laws of different jurisdictions, which have started quite far apart.[10] More importantly, a comparative tax functionalist would typically see convergence not only as an easily observed phenomenon but also as a desirable process from a normative perspective. In the functionalist view, there is little sense in adopting different legal rules that are aimed at dealing with similar social problems and to achieve similar results. Thus, when tax functionalists execute their comparative research, they might do so with the purpose of the *harmonization* of tax laws in mind.

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[9] Konrad Zweigert & Hein Kotz, An Introduction to Comparative Law 34 (Oxford University Press 3d ed. 1998).

[10] *See, e.g.*, Carlo Garbarino, An Evolutionary and Structural Approach to Comparative Taxation: Methods and Agenda for Research , 57 Am. J. Comp. L. 677 (2009). Reuven Avi-Yonah, International Tax as International Law: An Analysis of the International Tax Regime (Cambridge University Press 2007); Yariv Brauner, *An International Tax Regime in Crystallization*, 56 Tax L. Rev. 259 (2003).

Garbarino's functionalist approach is a good example.[11] He refers to the European Common Consolidated Corporate Tax Base Project (CCCTB), among others. In 2001, the European Commission "identified corporate taxation across the European Union as one major obstacle to the achievement of a common market."[12] To address this problem, the European Commission launched a project with the aim of mitigating this obstacle by eliminating, as efficiently as possible, double taxation of European corporate groups doing business in multi-European jurisdictions. One of the possible approaches for such a project is to apply an all-European comprehensive solution. Indeed, by late 2004, a CCCTB working group began discussions with the prospects of replacing "national tax systems by a common tax base."[13] Garbarino specifically uses the CCCTB example of comparative tax research to show that through a comparative study of tax laws, we can "reveal the existence of an EU common model of tax consolidation on which agreement can be reached through reinforced cooperation at EU level."[14] In other words, such research should bring about tax harmonization.

Such a purpose would have significant implications for choosing which jurisdictions and tax laws to compare. Since functionalists are looking at "similar" social problems, they only compare things that are indeed "comparable." This means comparing jurisdictions which are "at the same evolutionary stage"[15] and are thus likely to face similar social problems. In addition, in order for the comparative process to be effective, one must also compare those tax laws and institutions which essentially fulfill the same social functions.

Assuming that a tax comparatist adopts such an approach, the tax family classification discussed above becomes an essential tool in selecting the objects of comparison. This is so since classification provides us with an a priori template of "comparable" jurisdictions and "comparable" rules. For example, Thuronyi's classification leads him to suggest a "rule of thumb" for the selection of jurisdictions that are "representatives" of a larger family or tradition. He suggests **Germany, France**, the **United States,** and the **United Kingdom** as natural choices of tax comparison.[16] According to Thuronyi, these countries can be regarded as "leaders in influencing the tax laws of other countries."[17]

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[11] *See* Garbarino, *id.*

[12] Michael Lang et. al., *Preface, in* Common Consolidated Corporate Tax Base 5, 5 (Michael Lang et. al. eds., 2008).

[13] Michel Aujean, *The CCCTB Project and the Future of European Taxation, in* Common Consolidated Corporate Tax Base 11, 32 (Michael Lang et. al. eds., 2008).

[14] Garbarino, *supra* note 10, at 709.

[15] Clive M. Schmitthoff, *The Science of Comparative Law*, 7 Cambridge L.J. 94, 96 (1941).

[16] Thuronyi, Comparative Tax Law, *supra* note 1, at 9.

[17] *Id.*

The functionalist premises suggest that a comparative legal researcher should start by identifying a particular practical problem and question the way in which it is solved in each of the jurisdictions compared (the "problem-solving approach").

Another possible way to address such assumptions is to take an institutional view, namely, to ask which institutions in the countries compared perform the same problem-solving functions ("the institutional approach"). Two comparative methods are worth mentioning here.

The first is the comparison of legal transplants. According to this approach, most legal systems are built upon the borrowing of legal models of other systems. In that sense, transplantation is the main source of legal development and evolution.[18] In the tax context, Garbarino argued that the "pervasiveness of tax transplants challenges the idea that tax law is exclusively a local response to social demands felt by a specific national community."[19] In other words, an effective comparative tax study might be conducted by identifying the tax rules that successfully circulate among various jurisdictions and are being similarly implemented.

A derivative of the transplants approach is the "common core" approach to comparative research. Given that legal rules are borrowed and re-borrowed in the multinational context, it is not unreasonable to assume that models that successfully address common problems will survive, while those unable to do so will disappear. Over time, this may create a "common core" of tax rules that may be shared by many jurisdictions. Comparative tax researchers are sometimes specifically aiming at exposing this core.

A good example for a common core-style project in the tax arena can be found in the book that is regarded as canonic by many, authored by Hugh Ault and Brian Arnold.[20] Their book states its functional orientation at the outset by saying that "the purpose of this book is to compare different solutions adopted by nine industrialized countries to common problems of income tax design."[21] Ault and Arnold approached local specialists in many jurisdictions, who were requested to provide accounts of their home tax systems. Ault and Arnold later synthesized the country reports into a form of general analysis that categorizes the findings into an easily read classification. Their work is primarily oriented to reveal the "many communalities"[22] among the systems compared, thus providing us with a form of tax common core.

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[18] Alan Watson, Legal Transplants: An Approach to Comparative Law (1974).

[19] Garbarino, *supra* note 10, at 696.

[20] Hugh J. Ault & Brian J. Arnold, Comparative Income Taxation: A Structural Analysis (University Press of Virginia 2004).

[21] *Id.* at xix.

[22] Miranda Stewart, *The "Aha" Experience: Comparative Income Tax Systems*, 19 Tax Notes Int'l 1323, 1327 (1999).

B. Comparative tax law as a study of cultural differences

Cultural comparatists reject the functional assumptions of similarities of social problems and legal solutions. Rather, cultural comparatists assume that law is part of a broader cultural phenomenon. Each culture contains elements such as values, traditions, and beliefs, which give each culture its uniqueness. This "differentiation of cultures" entails, according to such an approach, that the laws (which are embedded in these cultures) are also necessarily different.[23] Thus, it is not surprising that cultural comparatists also reject harmonization projects, since they call—by definition—for the annulment of cultural identity as expressed in the unique laws of a given society. Writings in comparative legal culture have long celebrated (or urged that we should celebrate) the virtue of "difference," since difference "satisfies the need for self-transcendence."[24] Even if harmonization was somehow desirable, cultural comparatists perceive it as an unattainable goal, since cultural and political differences are irreconcilable.[25]

Rather, according to this approach, comparative analysis should be aimed at *understanding* the cultural; social; political; and ultimately, the legal identities of "the other." In turn, such "understanding" should serve us better when reflecting on our own legal rules and cultural identity. In a sense, cultural comparison is a hermeneutic process; a culture cannot successfully reflect on its own law without the process of comparison and cannot reflect on the process of comparison without questioning its own law.

Such a cultural "difference-oriented" stance is clearly visible in the writings of several comparative tax commentators.[26] Michael Livingston, for example, defines "tax culture" as "the body of beliefs and practices that are shared by tax practitioners and policy makers in a given society and thus provide the background or context in which

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[23] *See* Roger Cotterrell, *Comparative Law and Legal Culture*, *in* The Oxford Handbook of Comparative Law 709 (Mathias Reimann & Reinhard Zimmerman eds., 2006).

[24] Pierre Legrand, *The Same and the Different*, *in* Comparative Legal Studies: Traditions and Transitions 240, 280 (Pierre Legrand & Roderick Munday eds., 2003).

[25] Pierre Legrand, *European Legal Systems Are Not Converging*, 45 Int'l & Comp. L.Q. 52, 61–62 (1996); Julie Roin, *Taxation without Coordination*, 31 J. Legal Stud. 61 (2002) (In the tax context).

[26] *See, e.g.*, Michael A. Livingston, *Law, Culture, and Anthropology: On the Hopes and Limits of Comparative Taxation*, 18 Can. J. L. & Jurisprudence 119 (2005); Michael A. Livingston, *From Milan to Mumbai, Changing in Tel-Aviv: Reflections of Progressive Taxation and "Progressive" Politics in a Globalized but Still Local World*, 54 Am. J. Comp. L. 555 (2006); Ann Mumford, Taxing Culture: Towards a Theory of Tax Collection Law 1 (Ashgate 2002); Assaf Likhovski, *The Duke and the Lady: Helvering V. Gregory and the History of Tax Avoidance Adjudication*, 25 Cardozo L. Rev. 953 (2004).

substantive tax decisions are made."[27] The comparison of such cultures is specifically useful when comparing jurisdictions that are different in their social and cultural background, thus exposing themes of taxation that are affected by local considerations even amid globalization.

On the other hand, it is also helpful to examine arguably "similar" jurisdictions, particularly to show that any similarity might be a superficial one and that the underlying cultural traditions, which are by definition different, significantly affect the execution of such so-called "similar" policy choices, even when the jurisdictions compared face similar problems.

According to the same logic, cultural tax comparatists would probably be very careful in asserting that legal transplantation points to a process of convergence. Rather, the assumption here would be that as the borrowed rule crosses the national border, it undergoes a significant modification that is intended to assure its acceptance in its new local environment.[28] Such alteration might be so heavily influenced by local considerations that the ultimate outcome is a completely different animal than the original rule. Thus, two rules that originated in the same place and tradition will produce two completely different outcomes, even though their titles may still remain similar. For example, Assaf Likhovsky studied the transplantation of British income tax laws in Mandatory Palestine and concluded that in order to survive the transplantation, the original tax rules had to be significantly altered so as to take into account the unique multicultural society of Mandatory Palestine.[29]

Similarly, cultural tax comparatists would probably have a hard time accepting the idea that there is such thing as "common core" tax principles. Rather, their idea is to identify "tax cultures" and by doing so, point to *real differences* in policy choices. It is not exactly clear how one should approach this process of defining tax cultures, but some ideas have been brought forward in this respect. For example, according to Livingston, a tax comparatist must assume a priori that tax cultures are different. He also notes that tax culture does not necessarily correlate with a society's general culture.[30] It is certainly possible, according to Livingston, that political or sociological culture would favor different or even contradicting values to those advanced by the tax culture. Livingston also asserts that narrow and localized factors play a more important role than "broad cultural norms which are often subject to misleading or over stated stereotypes."[31] These arguments

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[27] *See* Michael A. Livingston, *From Milan to Mumbai*, *supra* note 26, at 560.

[28] *See, e.g.*, Anthony C. Infanti, *The Ethics of Tax Cloning*, 6 FLA. TAX. REV. 251 (2003); Mark D. West, *The Puzzling Divergence of Corporate Law: Evidence and Explanations from Japan and The United States*, 150 U. PA. L. REV. 527 (2001).

[29] Assaf Likhovski, *Is Tax Law Culturally Specific? Lessons from the History of Income Tax Law in Mandatory Palestine*, 11 THEORETICAL INQ. L. 725 (2010).

[30] *See* Livingston, *The Hopes and Limits of Comparative Taxation*, *supra* note 26.

[31] *Id.* at 132.

suggest that tax cultures are best understood as a general category from which narrow indicators can be subsumed and easily compared. Such indicators might be the education and training of tax elites; the relationship between lawyers, economists, and other tax professionals; the nature of tax administration; the attitudes toward tax compliance and evasion; and the unwritten traditions that govern the making and implementation of tax policy in the country in question.[32]

C. The critical approach to comparative tax studies

At the most general level, critical studies in comparative law are aimed at exposing the pretentious apolitical nature of so-called mainstream discourse in comparative law and to suggest alternative discursive agendas. Critical scholars of comparative law often see mainstream comparative law as a hegemonial-ideological project aimed at either assimilation or inclusion of other traditions, a process culminating in projects of harmonization.[33] Such scholars argue that comparative legal studies should be a "liberating project," releasing us from the cognitive cage of abstract relativist dichotomies (such as common law/civil law, Western/Oriental, self/other), which are wrongly perceived to be "objective."[34]

In the tax arena, critical comparisons can be easily associated with Infanti. For example, Infanti explains his choice of comparative tax studies as a tool of tax reform by noting that "[t]he ensuing debate over how to reform the ailing U.S. international tax regime has largely been shaped by the traditional concerns of efficiency, fairness, and simplicity."[35] He further notes that "[t]he traditional focus on these concerns may stem from the fact that they lend themselves to the theoretical analysis preferred by commentators."[36] Professor Anthony Infanti suggests that tax reform debates should shift their perspective. He believes that placing the reform debate in a comparative perspective is needed in order to liberate current discussion from its own "parochial" view.[37] By doing so, Infanti expresses a true critical stand, aiming at exposing the true nature of current "mainstream" tax policy debate and to suggest an alternative agenda.

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[32] *See* Livingston, *From Milan to Mumbai*, *supra* note 26, at 557.

[33] Anne Peters & Heiner Schwenke, *Comparative Law Beyond Post Modernism*, 49 INT'L & COMP. L. Q. 800, 822–24 (2000).

[34] Gunter Frankenberg, *Critical Comparisons: Re-thinking Comparative Law*, 26 HARV. INT'L. L.J. 411, 444–45 (1985).

[35] Anthony C. Infanti, *Spontaneous Tax Coordination: On Adopting a Comparative Approach to Reforming the U.S. International Tax Regime*, 35 VAND. J. TRANSNAT'L L. 1105, 1113 (2002).

[36] *Id.* at 1119.

[37] *Id.* at 1119–20.

To do so, one must step out of the usual choices of objects and jurisdictions to compare. One must specifically "free herself" from the commonly selected issues of tax comparison in order to expose what the common paradigmatic discourse prefers to avoid. Indeed, Infanti explained his choice to compare the tax treatment of contributions made by domestic taxpayers to foreign nonprofit organizations for its marginality, specifically "because it was not a topic about which academics studying international tax normally write."[38] Part of his purpose in doing so, he continues, "was to try to move the international tax discourse beyond the usual subjects."[39]

Frankenberg portrays the actual process of critical legal comparison as a three-stage process.[40] Critical study should start, according to Frankenberg, where other studies end: the conceptualization of complicated social phenomena into abstract terms, which can be easily fitted with a legal framework. Then, the critical comparative scholar is asked to deconstruct the process of legal decision making, questioning, and exposing the political interests underlying the process. Once we are in clear view of the abstract "objective" legal framework on the one hand, and the underlying political interests on the other, the third step is to reintroduce the legal process, showing how its discourse "ignores, marginalizes or transforms."[41] Namely, the third step shows how interests shape legal understanding and create the abstract concepts with which we started.

D. Comparative tax study as an exercise in economic analysis

Comparative Law and Economics (CLE) is sometime categorized as an approach of its own right, but it may also be viewed as an offshoot of functionalism, taking a more self-aware ideological turn: efficiency.[42] Instead of simply asking which laws or institutions fulfill which functions, it asks which do so in the most efficient way.

CLE starts with an assumption that "there is a competitive market for the supply of law."[43] Legal transplants, from an economic point of view, are actually a competitive circulation of legal models, a process in

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[38] Anthony C. Infanti, *A Tax Crit Identity Crisis? Or Tax Expenditure Analysis, Deconstruction, and the Rethinking of a Collective Identity*, 25 WHITTIER L. REV. 707, 796 (2005).

[39] *Id.* at 796–97.

[40] Gunter Frankenberg, *Critical Comparisons: Re-thinking Comparative Law*, 26 HARV. INT'L. L. J. 411, 450–52 (1985).

[41] *Id.* at 452.

[42] *See* UGO MATTEI, COMPARATIVE LAW AND ECONOMICS (Michigan University Press 1997).

[43] Raffaele Caterina, *Comparative Law and Economics*, *in* ELGAR ENCYCLOPEDIA OF COMPARATIVE LAW 161 (Jan M. Smits ed., 2006).

which only successful (or efficient) models survive, hence leading to convergence.[44]

From a methodological point of view, CLE "seeks to begin the comparison from a 'neutral scale' that can be validated by observable data: economic efficiency."[45] In essence, CLE research is aimed at comparative inquires into the deviations of different jurisdiction from an economically efficient benchmark: a so-called "model legal institution."[46] From that perspective, CLE can be either "problem-solving oriented"[47] (asking how we can solve a common problem in the most efficient way) or "institutional oriented" (asking which existing institution is the most efficient).

At least one legal tax comparatist adopted a similar approach. Barker asserted that a comparative tax analysis should seek to measure how tax systems deviate from a well-known benchmark: the Haig-Simons model.[48] Under Barker's approach, this model has to be used as a reference point for the identification of similarities and differences among tax systems.

Yet, unlike the traditional approach to law and economics, Barker sees comparative law and economics as aimed at distributive justice rather than efficiency. Such an assertion has an important implication with respect of the choice of laws to be compared: if we seek tax benchmarks of distributive justice, we should probably study tax laws that deviate from the Haig-Simons formula by way of actual "distribution." Barker provides some examples of significant tax laws that should be regarded creating "exemptions and tax preferences" rules,[49] namely those which affect economic distribution. For example, with respect to the taxation of service income, he includes deferred compensation arrangements, the tax preferential treatment of health and other insurance, and fringe benefits. With respect to the taxation of capital gains, he notes the inclusion of interest and dividend income, the deduction of interest payments, rules for capital cost recovery, the deductibility of current versus capital expenditures, timing of income and deduction, and the deduction of net operating losses.

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[44] *Id.* at 161–62.

[45] Oliver Brand, *Conceptual Comparisons: Towards a Coherent Methodology of Comparative Legal Studies*, 32 BROOKLYN J. INT'L L. 405, 421 (2007).

[46] MATTEI, *supra* note 42 at 182; Ugo Mattei & Fabrizio Caffagi, *Comparative Law and Economics*, *in* THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND LAW 346, 347 (P. Newman ed., 1998).

[47] The language of this approach is the one mainly adopted in this book.

[48] William Barker, *Expanding the Study of Comparative Tax Law to Promote Democratic Policy: The Example of the Move to Capital Gains Taxation in Post-Apartheid South Africa*, 109 PENN. ST. L. REV. 703, 712–714 (2005).

[49] *Id.* at 715–16.

1. The economic principles of taxation: efficiency, equity, and simplicity

As noted above, this book is intended to serve as a supplement to the basic tax class. Thus, many times this book stops exactly in the juxtaposition of tax rules and only briefly compares them using the economic principles of taxation. Therefore, even if the book is not a scholarly effort to produce "comparative tax law knowledge," it follows, to a certain extent, a comparative law and economics perspective in a problem-solving-oriented manner. This is why it is worth offering a few words about the three general economic principles of taxation: efficiency, equity, and simplicity.[30] However, this mode of explanatory analysis is primarily technical. Namely, it does not seek to advance a particular normative choice but rather to use economic analysis as a handy tool to illustrate differences and similarities. Particularly, even though each of the terms explained below is in essence an economic term, each represents a completely different (usually competing) ideological choice that may be exemplified using economic language but can probably be explained only by looking at social, cultural, and historical perspectives. To summarize, the "economics" underlying this book are not really "comparative" economics in that they do not advance a particular policy choice. Similarly to Barker, we occasionally adopt an economic technique, but we do not necessarily advance an efficient (or any other, for that matter) outcome in particular in this book.

1. *Efficiency*–The concept of efficiency is the one which is usually associated with comparative economics, i.e., the comparative search for the most efficient solution. The concept of efficiency moves from the invisible hand theorem by Adam Smith: under certain conditions, an *unfettered free-market economy* will be *efficient* and will move on its own, like if it was an invisible hand.

Unfettered economy means that there is no government interference or a minimal government intervention (i.e., government should not intervene).

Free-market economy means that there is perfect competition. The conditions in order to have perfect competition (i.e., the conditions needed for the invisible hand theorem to work) are the following:

- Small agents: each agent has to be small enough so not to single-handedly affect the economic market. For example, no matter how many pops one buys, it will not affect the prices (this brings in the assumption that we cannot have monopoly, otherwise prices would be affected). In other words, each participant needs only to

[30] For an in-depth analysis of these three principles, see JOEL SLEMROD & JON BAKIJA, TAXING OURSELVES. A CITIZEN'S GUIDE TO THE DEBATE OVER TAXES (The MIT Press 2008).

know about his or her own preferences and constraints. There is no need to manage a huge amount of information like in a planned economy;

- Rational agents: each agent has to be a rational one: rational agents are agents who try to maximize their profits;
- No public goods[51] or externalities: the theorem works only when there are not public goods, because the free market economy would not be able to produce public goods in an efficient way. There is an externality when actions of one individual or firm affect other individuals or firms, other than through the price system; and
- Perfect information: buyers are well informed about prices and quality of what they may purchase. In fact, imperfect information leads to adverse selection (which is information asymmetries between buyers and sellers) and moral hazard (which is every situation in which a person does not bear the full adverse consequences of his actions).

However, in the real economy, the above-mentioned conditions are not met. In fact, we could always identify market failure, government failure, and people failure.

There is market failure because there are monopolies (and therefore there are not only small agents), public goods, externalities, and imperfect information (adverse selection and moral hazard).

There is government failure because unfettered economies do not exist; since governments do intervene and interfere (tax policy would probably qualify as one of the most significant forms of government interventions).

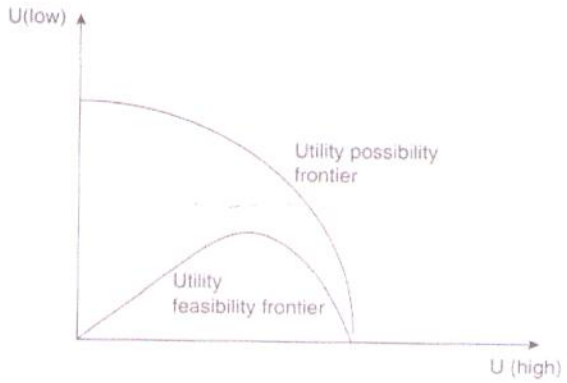
Finally, there is people failure because very often, people do not make choices that are in their own interest. This field is also known as behavioral economics.[52] For example, it has been proven that people are susceptible to framing (the same person in the same situation may choose differently depending on how the situation is framed).

The concept of (Pareto) *efficiency* is that "no one can be made better off without making someone else worse off. In other words, resources are not wasted."

Let's assume we have two kinds of people in the economy. They only differ in their ability to sell their services; that is why we have highs and lows. The more resources one has, the higher her well-being is. The theorem of the invisible hand assumes that the unfettered free market economy will always be on the frontier (the utility possibility frontier or UPF). The assumption is that when we are on the utility

[51] A public good is a good that if it is consumed by one person does not diminish its availability to anyone else.

[52] *See* BEHAVIORAL PUBLIC FINANCE (E.J. McCaffery & J. Slemrod eds., 2006).



possibility frontier, no resources are wasted or, in other words, no one can be made better off without making someone else worse off.

Every point inside the curve means that there is a waste of resources, because, theoretically, it is still possible to reach a point where both parties are better off.

It is noteworthy that the theorem does not tell anything about fairness. Therefore, saying that an economy operates efficiently says nothing about the distribution of well-being among the citizens. This means that an efficient economy is not necessarily a fair one. The distribution may be deemed to be inequitable, although the grounds for making such a judgment are ethical rather than economic.

However, the concept of efficiency is fundamental in analyzing or comparing different tax systems. Most taxes have efficiency costs because they distort taxpayers' decisions. For example, income taxes make leisure more attractive. Generally, for a given amount of tax revenue collected, efficiency cost is higher the greater is the behavioral response to taxes. For example, a tax on food is not necessarily inefficient because it would raise revenue without causing major behavioral responses (besides the ethical problems that may arise). Similarly, a tax on skies is not inefficient because it would reduce leisure and would therefore induce people (at least theoretically) to spend more time working. Efficient taxes are those that correct negative externalities or create positive ones.

Regarding progressive income tax systems, these are inevitably accompanied with a waste of resources. This is because the more progressive the income tax system is, the more influenced the behaviors are, which in turns involves a waste of resources. According to the invisible hand theorem, the only neutral tax is the lump sum tax, which does not grant any redistribution of wealth.

2. *Equity*–The *vertical equity* principle states that the wealthier a person, the more taxes she should pay. In a progressive income tax system, a taxpayer's tax liability, as a fraction of income, rises when

higher income is Produced. In a proportional income tax system, all taxpayers are subject to a "flat rate" tax at the same percentage of their income, regardless of the amount of income. In a regressive income tax system, as the income increases, the tax percentage decreases.

Vertical equity could be introduced in our analysis using one of two principles.

The first is the so-called "benefit principle": the tax burden is proportionate to the benefits received by the taxpayers. According to this principle, taxes are seen as a charge for the services provided by the government. However, the benefit principle precludes redistribution policies, and valuation issues for public goods may also emerge.

The second is the "ability to pay" principle, according to which, as a taxpayer's well-being increases, so does her ability to pay. However, this principle provides only vague guidance for progressivity and ignores the expenditure side of the government budget. Theoretically speaking, this may be a well-established principle, yet it seems too abstract to actually be implemented. Yet, in many European countries, the "ability to pay" principle is a constitutional one.

Another way to deal with vertical equity is to analyze the trade-off between equity and efficiency. Refer to the diagram of the utility possibility frontier. The efficiency costs of redistributing via progressive tax and transfer policies are represented by the "utility feasibility frontier" that lies within the utility possibility frontier. The more the UFF lies within the UPF, the greater is the efficiency cost of progressivity. This, in turn, depends on the behavioral response to such policies.

The principle of *horizontal equity* is also fundamental for analyzing and comparing different tax systems. According to this principle, individuals (or families?) at the same level of well-being should have the same tax burden.

Finally, the principle of *intergenerational equity* has also to be considered: first, because a tax policy that may seem not equal in a year-period horizon could be considered equal in a lifetime horizon or the other way around; second, because certain tax policies may create tensions between different generations.

3. *Simplicity*–Simplicity is not really an independent criterion (and for that matter, not a strictly an economical one, though it carries with it economic implications), because unnecessary complexities waste resources (inefficiency) cause a capricious assignment of tax burden (inequity).

Simplicity is usually measured by looking at compliance and administrative costs.

Compliance costs measure the time and money spent by taxpayers to comply with the tax system. They represent the time and resources expended by taxpayers to interact with the income tax system. These costs include the value of individuals' time spent learning the tax law, maintaining records for tax purposes, completing and filing tax forms, and responding to any correspondence from the tax administration

(including tax audits). Compliance costs also include amounts paid to others to conduct any of these tasks on behalf of an individual or a business.[53] If compliance costs are too high, taxpayers may have an advantage not to comply with the tax system (therefore reducing compliance costs) if the risk of detection and the other costs are relatively low.

Administrative costs[54] measure the time and money spent by the government to implement the tax system.

We are left with the fact that the simplest tax system may not be the fairest. The fairest tax system might have efficiency costs. The most efficient system is probably not the fairest.

E. What to expect next

From here, what to do with the information supplied in this book is for the reader to choose. The examples to follow are the start, not the end, and are intended to ignite modes of thinking that are not usually applied in basic tax classes. The foreign examples will be based primarily on the foreign countries covered in depth in Hugh Ault and Brian Arnold's *Comparative Income Taxation: A Structural Analysis*, namely, Australia, Canada, France, Germany, Japan, The Netherlands, Sweden, and the United Kingdom. Italian and Israeli tax systems, for obvious reasons, will also be addressed. We will also use examples from developing countries in order to emphasis the policy choices made by countries with less familiar social and political backgrounds and in which the income tax system plays different roles in economics and politics. This is why occasional examples will also be drawn from the tax law of other countries other than those mentioned above.

The organization of the book is designed to help the tax student follow the book in parallel with the regular tax casebook that he or she is using. Since most U.S. tax casebooks follow a basic pattern (income, deductions, the taxable unit, timing, capital gains, and so on), the book will follow the same order. A critical comparatist will probably be quick to note this construction and may even criticize us for trying to manipulate foreign tax systems to accommodate the "mainstream" American discourse. Point taken. We invite, by all means, critical tax comparatists to bring forward a critical analysis on the construction of comparative tax discourse around these usual focal points. This would be a much-needed (and long overdue) contribution the comparative tax discourse.

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[53] Slemrod & Bakija, *supra* note 50.

[54] *See* The President's Advisory Panel on Federal Tax Reform, Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System (Government Printing Office 2005).