

NEWS LETTER

MAX PLANCK INSTITUTE FOR TAX LAW AND PUBLIC FINANCE

NOVEMBER 2014



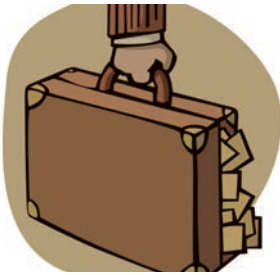
ISSUE 03

GO YOUR WAY BUT PAY THE TAX.....	2
DID RAILROADS IN PRUSSIA BRING MORE BABIES?.....	3
CATCH ME IF YOU CAN.....	4
AN ENORMOUS INFLUENCE.....	5
CONFERENCES AND WORKSHOPS.....	6
CRIME IS DIVERTED TO POOR NEIGHBOURHOODS.....	10
MISCELLANEOUS.....	11
SELECTED PUBLICATIONS.....	14

RESEARCH

GO YOUR WAY, BUT PAY THE TAX

For multinational enterprises it can be crucial to react to market changes or to new opportunities by moving business divisions, assets or personnel abroad. Within the European Market, companies should be able to organise their economic activities irrespective of national borders. At the same time, States need to be able to impose corporate exit taxes when business assets leave their jurisdiction in order to protect their tax base.



© iStock/Anna_zabella

According to Erik Röder, the current design of exit taxation is a significant obstacle to the deepening of economic integration within the internal market. It distorts the cross-border business activities of multinational enterprises and hinders cross-border business reorganisations. Ideally, in his opinion, exit taxation should avoid distortions and at the same time safeguard a State's taxing rights with regard to unrealised gains in business assets. In his article

“The case for a co-ordination of corporate exit taxation in the internal market and beyond”, Röder argues that the problems related to corporate exit taxation can only be addressed in a satisfactory way through co-ordination. When States follow different approaches with regard to the valuation of assets entering or leaving a tax jurisdiction or with regard to the timing of tax collections, double taxation or double-non taxation can occur as well as cash flow and interest disadvantages. He describes how a co-ordinated corporate exit taxation regime should be designed and how it could be implemented within the EU, in the context of a common corporate tax base or through a targeted harmonization measure, as well as outside the EU in bilateral Double Taxation Conventions. According to Röder, it must be ensured that a change of economic ownership is recognized in the exit and in the entry State at the same time and that both States apply the same fair market value. For non-depreciable assets, the taxation of unrealised gains by the exit State should be deferred until the asset is disposed of or written down in the entry State. For depreciable assets, Röder recommends pro-rata taxation, according to the depreciation rate and timing in the entry State.

Röder, E.: The case for a co-ordination of corporate exit taxation in the internal market and beyond. British Tax Review, forthcoming.

DID RAILROADS IN PRUSSIA BRING MORE BABIES?

© Wikimedia Commons



Cities that gained railroad access in the early phase of railroad-network expansion in Prussia subsequently grew an additional 1.7 percentage points faster per year than their unconnected neighbours. This is the result of an empirical study by Erik

Hornung, though the locomotive it is not meant to supplant the mythical role of the stork. In the absence of more direct measures of economic development, studies of pre-modern growth usually resort to using population growth rates as for most of history these were closely associated with per capita income growth. Hornung's study sheds new light on the role of railroads in the industrial growth process for the historical German state of Prussia using a remarkably large dataset of roughly 1,000 cities.

The results suggest that population growth due to railroad access was induced by migration, that is, that railroad access had no measurable effect on birth rates. At the county level, each additional railroad station resulted in an increase in urbanisation by 1.2 percentage points over a period of 15 years. Furthermore, the author finds that railroad access had a strong positive effect on industrial firms in terms of the number of employees but not on the number of firms in a city. This suggests that firms in railroad cities might have faced increasing competition; forcing them to increase productivity by increasing the establishment size. One of the main challenges in the assessment of benefits from investing in transport infrastructure lies in separating the part of growth that is induced by the infrastructure itself from growth that would have occurred anyway due to the fundamental characteristics of cities. Fortunately, highly detailed census data allow a comparison among those cities that were similar in size and economic development prior to the coming of the railroad and which differed only in terms of their access to the railroad. Subsequently, these cities grew 1.7 percentage points faster annually than their economic twins.

Hornung, E.: Railroads and growth in Prussia. Journal of the European Economic Association, forthcoming.

RESEARCH

CATCH ME IF YOU CAN



©iStock/Toonhead

Tax evasion is not only a problem for States that suffer a loss of revenue. Tax cheats can also harm investors who have given credit to a limited liability company and are hoping for good returns. Protected by limited liability, entrepreneurs have an incentive to evade taxes. Since this is illegal, the potential gains from evading taxes – a lower tax bill – typically cannot be referenced in a contract. They are pocketed by the entrepreneur. In the event of detection the entrepreneur is protected by the limited liability status of the company, as long as the government’s claims are sufficiently senior. In this event, as the company has to pay a fine, its ability to repay the investor is reduced. In a recent study, economist Philipp Meyer-Brauns analyses the situation and determines what the optimal financial contract between an investor and entrepreneur should look like when the latter can possibly evade taxes.

Meyer-Brauns bases his analysis on the so-called model of costly state verification, which assumes that the entrepreneur has private information about the realised gains from her business, for example, about a venture’s financial success. The verification of the entrepreneur’s private information is costly and the lender has to pay a monitoring cost. The original work on costly state verification by Robert M. Townsend (1979) and Douglas Gale and Martin Hellwig (1985) suggests that the optimal financial contract is a standard debt contract. Meyer-Brauns discovers that a standard debt contract is neither feasible nor incentive-compatible if the borrowers may evade taxes. Given the particular constraints imposed by tax evasion, an optimal financial contract only stipulates repayments that are feasible even if the entrepreneur’s tax evasion activities are detected. Otherwise the entrepreneur could use the company’s limited liability protection for excessive tax evasion. This would mean repayment of the debt is not feasible and would make the investor, at least partially, liable for the fines should a tax audit occur. Hence, except for very low and for very high realisations the optimal financial contract, according to Meyer-Brauns, combines elements of debt, such as regular repayment, with elements of equity, such as providing for some return to the entrepreneur subject to verification.

Meyer-Brauns, P: Financial contracting with tax evaders. http://ssrn.com/abstract_id=2375604

“AN ENORMOUS INFLUENCE”



As part of the series of lectures “Fundamental Issues in European Tax Law” Prof. Dr. Dr. Juliane Kokott, Advocate General of the ECJ, talked about the role played by the general EU principle of equal treatment in European tax law. According to Kokott, it could have an “enormous influence” on national tax law in particular on direct taxes, which are regulated at the national level.

Up until now the ECJ has primarily tested whether national tax law is compatible with EU law by looking at the fundamental freedoms prescribed by primary law.

However, in the famous case of Åkerberg Fransson the ECJ considered that the general principles, as recorded in Art. 20 of the European Union Charter of Fundamental Rights, are applicable, although the Charter does not contain anything regarding tax law and the case appears to be a purely domestic case. The decision of 26 February 2013 was the subject of highly controversial debates and can be considered a leading judgment that raises the question of whether “the Member States should prepare for a second wave of ,primary legal surprises”, as Juliane Kokott puts it. The Swede Åkerberg Fransson was accused by his tax office of having made false statements regarding value added tax and was sanctioned. In addition, criminal proceedings were initiated against him for tax evasion. The ECJ was required to decide whether this is compatible with the prohibition against double jeopardy under Art. 50 of the Charter of Fundamental Rights. However, first of all it was necessary to determine whether the EU Fundamental Rights are of relevance for this case since criminal tax law regulations are not a part of the value added tax system directive. Juliane Kokott does not share the opinion, held by numerous critics and commentators, that the ECJ has widened the field of application of EU law with Åkerberg Fransson. The Value Added Tax directive requires Member States to guarantee that value added tax will be levied. That also includes combating fraud. Therefore the criminal process against Mr Åkerberg Fransson concerns the “implementation of EU law” within the meaning of the Charter. It will be very interesting to see how the ECJ jurisprudence develops further and what significance will be assigned to EU Fundamental Rights.

If you read German: http://www.tax.mpg.de/de/pub/aktuelle_meldungen/esr.cfm

CONFERENCE

BASE EROSION AND PROFIT SHIFTING

The Max Planck Institute for Tax Law and Public Finance together with the International Network for Tax Research (INTR) hosted a two-day interdisciplinary conference on the OECD's Action Plan on Base Erosion and Profit Shifting in Munich. Leading scholars from tax law and public finance, practitioners, members of the OECD Centre for Tax Policy Secretariat and country delegates involved in the BEPS project discussed how to combat base erosion and profit shifting and addressed the issues raised by the Action Plan of the BEPS Report. As Wolfgang Schön, Director of the MPI for Tax Law and Public Finance stated in his opening speech, 2013 was a year of political debate, while 2014 should be devoted to technical debate.



"If you want to avoid base erosion and profit shifting, you have to decide which country will get the bill". Wolfgang Schön, Director of the MPI for Tax Law and Public Finance.

Marlies de Ruiter (left) from the OECD chaired the session on "Repairing the Tax Base: Challenges and responses." Johanna Hey (right) from the University of Cologne spoke about the differential treatment of debt and equity. As she stated, double taxation and double non-taxation may be caused by diverse methods of countering counter tax arbitrage. She pleaded for a multilaterally applied best practice model of interest allocation.



Pascal Saint-Amans (right), head of the OECD Centre for Tax Policy and Administration. His belief is that there is no need to reform the international tax system as a whole to cope with BEPS: "We can probably fix the existing system." Michael Devereux (left), Director of the Oxford University Centre for Business Taxation puts it in a nutshell: he describes the thinking behind international taxation as „pretty complicated“.





Hugh J. Ault from the Boston College Law School chaired the session on “Competitiveness, Capital Markets and Tax Administration”. Rosanne Altshuler from Rutgers University in New Jersey spoke about inter-nation competitiveness: governments compete for the tax base and design their corporate taxes to be attractive for business.

Jürgen Lüdicke from the University of Hamburg addressed the problem of tax arbitrage with hybrid entities, which are treated as transparent for tax purposes in one country and as non-transparent in another country. He depicted the challenges and responses that would arise from the introduction of rules against arrangements involving hybrid entities as called for by the BEPS Action Plan.



The two conference days were buzzing with lively discussion and debate not only during the interactive sessions, but also around the coffee tables. Mitchell Kane from the New York University (left) in a conversation with Stephen Shay from Harvard Law School (right).

Bulletin for International Taxation, 2014, Volume 68, No. 6/7

This special issue of the Bulletin for International Taxation on base erosion and profit shifting contains the fruit of the BEPS conference held in Munich at the MPI for Tax Law and Public Finance. The articles are based on the papers presented there.



WORKSHOP

CONTESTS AND POLITICAL COMPETITION

The most eminent international researchers in the fields of Contest Theory and Theory of Political Competition gathered in September 2014 in Munich to discuss their latest findings during a two-day workshop at the MPI for Tax Law and Public Finance.



Kenneth Shotts from the Stanford Graduate School of Business highlighted the role of electoral challengers for the policy of the incumbents and for the political process in general.



Ronny Razin from the London School of Economics discussed how legislative decision making unfolds when special interest and lobby groups control the political agenda.



Workshop participants lined up for a group photo. Please find the conference program, the list of the participants and selected papers in our conference archive:

http://www.tax.mpg.de/de/pub/veranstaltungen/archiv/contest_theory.cfm



James M. Snyder from Harvard University asked whether primary elections are necessary for democracy. He showed that in areas dominated by one party, primaries are good at selecting “high-quality” nominees and why they can play an important role in competitive areas, too.



Pierre Boyer from the University of Mannheim presented a paper on the role of campaign spending in electoral competition. He showed that in a competition with two candidates the candidate who has a group of loyal voters wins with a higher probability, but chooses the same expected budget size as the rival.

GUESTS OF THE INSTITUTE

Our guests from August to December 2014: **Michael Ahlheim** (University of Hohenheim), **Allison Blake** (University of California, USA), **Pierre Boyer** (University of Mannheim), **Sebastian Braun** (Kiel Institute for the World Economy), **Frey Bruno** (Zeppelin University Friedrichshafen), Chang, Seoul, Korea), of Nottingham, United **Formosa** (Vienna University of Business, Austria), **Özge** (University, Turkey), **Dan** (University, USA) **Wolfgang** **Tim Lohse** (Berlin School **Steeve Mongrain** (Simon **Via-Lam Mui** (Monash University, Australia), **Li Na** (Jilin University, China), **Beatriz Guimerá Orero** (University Valencia, Spain), **Alice Pirlot** (Louvain University, Belgium), **Stefano Ronco** (Turin, Italy), **Ronnie Schöb** (Freie Universität Berlin), **Marcel Thum**, (TU Dresden), **Hendrik Vrijburg** (Erasmus University of Rotterdam, The Netherlands), **Sung-Wook You** (Bucheon, Korea), **Floris Zoutman** (NHH, Norway).



INTERVIEW

“CRIME IS DIVERTED TO POOR NEIGHBOURHOODS”



Prof. Steeve Mongrain presents his findings during his visit to the Institute.

According to Steeve Mongrain, the less you have, the more you can lose. The Professor of Economics at the Simon Fraser University in Burnaby, Canada looked at the relationship between property crime and household income, taking into account the correlation between criminal activity and the level of private protection a household has. Mongrain and his colleagues designed a model to understand the interaction between houses targeted by criminals and a household's private protection measures. Then they tested the model using data from a Canadian victimization survey matched with census data at the neighbourhood level. It seems that households in poorer neighbourhoods are more often subject to crime. While visiting the Institute in June 2014 Mongrain presented his findings.

What are your major findings? The link between property crime victimization and income is a complex one. To fully understand it, one must also look at the effect that the characteristics of both individuals and neighbourhoods have on the incentive to invest in private protection and on victimization rates. We found that the level of household protection increases with household income but also with the income level, the level of household protection and the level of victimization in the neighbourhood. As a consequence we found that in Canada, low income neighbourhoods support higher crime rates whereas overall victimization is unaffected by income. The rationale is that criminals like to target richer individuals in a given neighbourhood. Disproportionate investment in private protection in richer neighbourhoods chases crime to poorer neighbourhoods. In the US where private protection is easily available and at low cost, victimization decreases with income, while in Scandinavian countries the relationship is the reverse: victimization increases with income.

What makes your approach different from the others? We designed a model to understand the interaction between criminals' choices and the private protection decisions made by households and tested the mechanisms of our model with the Canadian

General Social Survey. The predictions of the model correlate strongly with assessments made using the Canadian Data.

Can you derive policy recommendations from your findings? One of the important findings of our model is that people in rich neighbourhoods invest heavily in private protection. The main driving force is that in rich neighbourhoods, households like to be better protected than their neighbours, to avoid being targeted. They enter a rat race of private protection. In fact, we estimate that one house installing an alarm increases the total number of alarms in the neighbourhood by 1.4. This is a strong social multiplier. As a consequence, crime is diverted to poor neighbourhoods. One easy policy implication is that more public enforcement resources should be diverted to poor neighbourhoods.

MISCELLANEOUS

SCHMÖLDERS PRIZE FOR NADJA DWENGER



Dr. Nadja Dwenger (middle) with Prof. Dr. Ronnie Schöb (left) and Prof. Dr. Stefan Traub (right) from the Verein für Socialpolitik.

Economist Dr. Nadja Dwenger, Senior Research Fellow at the Institute, has been honoured with the Schmölders Prize from Verein für Socialpolitik. The prize, which is endowed with 3,000 Euro, was awarded for the paper “Extrinsic and Intrinsic Motivations for Tax Compliance: Evidence from a Field Experiment in Germany”, which Dwenger wrote together with Prof. Henrik Jacobsen Kleven from the London School of Economics, Prof. Imran Rasul from University College London and Prof. Dr. Johannes Rincke from the Friedrich-Alexander University Erlangen-Nürnberg. “This is a convincing

piece of work due to the field experiment’s original approach and the excellent linking of theory, data collection in the field and economic analysis”, said Prof. Dr. Ronnie Schöb from the Verein für Socialpolitik in his award-giving speech.

MISCELLANEOUS

WOLFGANG SCHÖN NEW DFG VICE PRESIDENT

On 2 July in Frankfurt/Main the General Assembly of the DFG (German Research Foundation) elected Prof. Dr. Dr. h.c. Wolfgang Schön as the new Vice President. As one of three new members of the DFG Executive Committee, Prof. Schön replaces the Berlin legal academic Prof. Dr. Christine Windbichler. The other two new Vice Presidents of the DFG are the biochemist and molecular biologist Prof. Dr. Katja Becker (based in Giessen) and the mathematician Prof. Dr. Marlis Hochbruck (Karlsruhe). The DFG is the self-governing organisation responsible for promoting science and research in Germany. It funds knowledge-oriented research without stipulating concrete topics and allocates resources on a competitive basis in order to select the best projects in terms of scientific quality. Professors Rüdiger Wolfrum (Human Rights Law), Klaus-Jürgen Hopt (Private Law) and Ferdi Schüth (Kohlenforschung/Carbon Research) are members of the Max Planck Society who have previously been members of the DFG Executive Committee.



PRESTIGIOUS PRIZE FOR ANDREAS EGGERT

Andreas Eggert has been awarded the prestigious Mitchell B. Carroll Prize for 2014 by the International Fiscal Association (IFA) for his dissertation on the Common Consolidated Corporate Tax Base Directive (CCCTB). In his dissertation, written at the Max Planck Institute for Tax Law and Public Finance, the jurist compares the computation of corporate profits for tax purposes under the CCCTB rules with the computation methods under the German Commercial Code (HGB), the German Income Tax Act (EStG) and the International Financial Reporting Standards (IFRS). He examines the differences and similarities between these different sets of rules to ascertain whether the proposed profit computation method is a feasible tool for tax harmonization in the EU. The prize-giving ceremony took place during the course of the 2014 Congress of the International Fiscal Association, October 12–17, 2014, in Mumbai, India.



TWO PRIZES FOR CHRISTIAN MARQUART

Dr. Christian Marquart's doctoral thesis, which appeared under the title "Interest Deductions and the Allocation of Profits for Tax Purposes" has been distinguished with the Esche Schuemann Commichau Foundation's advancement award. The Foundation grants advancement awards each year to academic alumni in the legal, economic and tax consultancy sectors. The dissertation was also awarded the "Wissenschaftspreis" / "Academic Prize" of the Munich Chamber of Tax Consultants. Dr. Christian Marquart was a scholarship holder with the Corporate and Tax Law Division at the Institute until the end of 2011. He wrote his doctoral thesis under the supervision of Prof. Dr. Dr. h.c. Wolfgang Schön. In his dissertation Marquart discusses the deductibility of interest payments, which provides businesses with the ability to shift profits to States with the most attractive tax regimes. Because this practice means that countries with higher tax rates experience significant losses, many countries have placed limits on interest deductions. The examination first of all brings the legal, economic and eco-political aspects of the problem together. Based on a legal comparison with Australia, Canada, the United Kingdom and the United States, Marquart develops his own regulatory approach, which should not only offer effective protection for the tax base but also seeks to avoid negative effects on a location's appeal.



©iChamber of Tax Consultants

(from left to right) Dr. Hartmut Schwab, President of the Chamber, Dr. Christian Marquart, and Günter Helmhagen, Member of the Board of the Chamber.

Based on a legal comparison with Australia, Canada, the United Kingdom and the United States, Marquart develops his own regulatory approach, which should not only offer effective protection for the tax base but also seeks to avoid negative effects on a location's appeal.

DO YOU REMEMBER US?

The alumni association of friends, supporters and former members - especially research assistants, fellows and staff - of the MPI for Tax Law and Public Finance aims to bring together all those who feel close to the Institute and its scientific activities:

<http://www.tax.mpg.de/en/pub/alumni.cfm>



SELECTED PUBLICATIONS

Schön, W. International Taxation of Risk. *Bulletin for International Taxation*, 2014, Volume 68 (6/7), pp. 280 - 294.

Konrad, K. A., Lohse, T., and Qari, S. Deception detection and the role of self-selection. *Journal of Economic Behavior & Organization*, forthcoming.

Heber, C., and Sternberg, C. Over-the-Counter Derivative Markets in the Light of EMIR Clearing Obligations and the Financial Transaction Tax. *Derivatives & Financial Instruments*, 2014, Volume 16 (3), pp. 107-116.

Hanging together or hanged separately: the strategic power of coalitions where bargaining occurs with incomplete information

Kai A. Konrad and Thomas R. Cusack

Journal of Conflict Resolution, forthcoming.

Whether the European Union is negotiating rescue packages, during climate summits or in international negotiations with tax havens, it is not easy to develop successful negotiation strategies when two or more parties have to agree with a third party. A recent analysis by Kai A. Konrad and Thomas R. Cusack analyses the strategic role of being a member of an intergovernmental group that requires unanimity while negotiating with a third party in a setting with incomplete information. The economists show that being part of a group has a strategic effect compared to negotiating alone. It reduces the demands of the external party. At the same time, it may cause inefficiencies as the decisions of the coalition parties must be turned into a joint decision. Overall, coalition groups tend to perform well for the members of the coalition group in comparison to fully decentralised negotiations. Interestingly, this is the case particularly if the objectives of the members of the coalition groups are not perfectly aligned.

Comparing Apples and Oranges? Public, Private, Tax and Criminal Law in Financial Markets Regulation

Alexander Hellgardt

W.-G. Ringe, P.M. Huber (eds.), *Legal Challenges in the Global Financial Crisis: Bail-outs, the Euro and Regulation*, Oxford (Hart) 2014, pp. 157-176.

The financial crisis revealed major problems in the regulation and management of financial institutions across the world. According to Alexander Hellgardt it is remarkable that the general discussion about reforming financial regulation is focused on the substantive standards to be established with new rules while neglecting the problem of choosing the right regulatory instruments. In his article the jurist analyses the relative strengths and weaknesses of four basic instruments of law enforcement - administrative sanctions, civil liability, corrective taxation and criminal sanctions - and employs a cost-benefit analysis. It turns out that civil liability – while limited in its scope – exhibits the best cost-benefit ratio. Criminal law, by contrast, seems very inefficient. Administrative law and corrective taxation come in second best. However, according to Hellgardt, the return from using these instruments has to be assessed on a case-by-case basis.

Implementing Quotas in University Admissions: An Experimental Analysis

Sebastian Braun, **Nadja Dwenger**, Dorothea Kübler and Alexander Westkamp
Games and Economic Behavior, 85 (2014), pp. 232-251.

The mechanism currently used by the central clearinghouse for university admissions in Germany harms top-grade students who are intended to benefit from reserved seats. This is one of the results of a recent experimental study by Nadja Dwenger and co-authors. In a controlled laboratory environment the economists compared the performance of a sequential assignment of university seats, as implemented by the German Central Clearinghouse, with a simultaneous allocation mechanism based on the so called modified student-proposing deferred acceptance algorithm. The experimental results suggest that the mechanism, in which reserved and unreserved seats are allocated simultaneously, improves the match outcomes for the top-grade students, who are the intended beneficiaries of reserved seats. One of the explanations is that these students often fail to adopt a strategically optimal behaviour, which would be necessary in the sequential but not in the simultaneous assignment procedure in order to be admitted to the preferred university.

Die Kommanditgesellschaft im Rechtsvergleich: Hintergründe der unterschiedlichen Karriere einer Rechtsform

Erik Röder

RabelsZ, 2014, Volume 78, pp. 109-154

The limited partnership originated centuries ago in France, from where it spread - inter alia - to Germany, the US and, finally in 1907, to England. The practical importance of limited partnerships in each of these jurisdictions today differs widely. In France, the *société en comman-*

In England and the US, used predominantly as the German *Komman-* significant role as a legal medium-sized enter- shows that the different



dite is virtually extinct. limited partnerships are investment vehicles. Only ditgesellschaft plays a structure for small and prizes. Erik Röder's article

fate of the limited partnership in France, England, the US and Germany can be explained by the interplay of three factors: limited liability, tax transparency, and the ability of the limited partner to manage and control the partnership.

Interested in more scientific research results?



Read the discussion papers of the research fellows of the Max Planck Institute for Tax Law and Public Finance on:

<http://www.ssrn.com/link/Tax-MPG-RES.html>

IMPRINT

Publisher: Max Planck Institute for Tax Law and Public Finance

Prof. Dr. Kai A. Konrad and Prof. Dr. Dr. h.c. Wolfgang Schön

Marstallplatz 1, 80539 Munich, Germany - Website: www.tax.mpg.de

Editor / Layout: Christa Manta

Contributors and proof-readers: Erik Hornung, Harald Lang, Jennifer Rontganger, Anna Wilson

Photos Christa Manta (5,6,7,8,10), Jan Rausch (6.7), Max Neumann (8), iStock (9,14), VfS (11), MPI for Comparative and International Private Law (16)

Email: newsletter@tax.mpg.de

Print: Flyeralarm GmbH, ISSN: 2192-3108