

NEWS LETTER

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RESEARCH

ARE TAXES THE RIGHT TOOL TO TAME INEQUALITY?



Widespread concerns about rising inequality, both in terms of equality of opportunity and the distribution of income and wealth, have recently spurred on the debate on whether tax law is an appropriate instrument to tame economic inequalities. In Germany, at least, there is a widespread consensus that tax revenue should partly be spent to ensure an adequate standard of living for all. But does the welfare state principle, as enshrined in the constitution, also oblige the state to use the allocation of tax burdens as a tool to narrow the gap between the rich and the poor? The debate on whether tax law is the right instrument to redistribute within and among generations has been highly controversial. **Christine Osterloh-Konrad** joins the ongoing international debate by analysing reasons for and against redistributive taxes. Her paper focusses on different theories of justice from contemporary political philosophy and elaborates on whether the philosophical debate has any implications for the constitutional boundaries of taxation. The article starts from the assumption that the legitimacy of redistributive taxation ultimately depends on whether the legitimate goal of the welfare state to reduce economic inequalities implies confining the size of the gap between the rich and the poor as such, thereby going beyond the aim of improving the standard of living of the poorest.

Having defined a concept of redistributive taxation, **Osterloh-Konrad** discusses the ideas of John Rawls and Ronald Dworkin who both offer strong arguments for redistributive taxation. Dworkin's distinction between deserved and undeserved inequalities ("brute luck") seems, as such, plausible. But a thorough analysis shows that this distinction cannot convincingly translate individual responsibility into specific tax burdens. In contrast, Rawls' idea of redistributing for the sake of liberty and equality of opportunities is very convincing and may serve as a reference point to guide redistributive policies. **Osterloh-Konrad** then elaborates on two influential criticisms of fairness-oriented theories of justice, namely Robert Nozick's assumption that redistribution equals theft and Louis Kaplow's and Steven Shavell's welfare-oriented theory. As to the latter, she argues that the very idea behind the strict juxtaposition of "Fairness vs Welfare" is flawed because, as welfare includes all kinds of sources of well-being, it is a black box which encompasses not only self-regarding preferences but also other-regarding preferences. Therefore, the argument that overall welfare should

be the guiding principle of political action is, as such, almost devoid of meaning; one still has to decide on how much weight should be assigned to the multiple sources of well-being, in particular to the “taste for fairness”. Ultimately, what kind of political system may be called “just” and what type of distribution of resources may be considered “fair” is up to negotiation within the democratic process.

Finally, **Osterloh-Konrad** elaborates on the difficulty of translating criteria of justice into constitutional constraints for taxation. Such a translation turns out to be problematic mainly because the law has to develop suitable criteria for assessing individual governmental actions whereas, from the point of view of political theory, a moral assessment of isolated elements of the legal system is nearly impossible without having regard to the overall institutional design of the state and its impacts on society.

*Osterloh-Konrad, C. Zur Legitimation steuerlicher Umverteilung. *StuW* 94/2017, 4, 305–319.*

CALL TO UNIVERSITY OF TÜBINGEN



Prof. Dr. Christine Osterloh-Konrad, a former senior research fellow at the Institute, accepted a call from the Eberhard Karls University of Tübingen. She took over the Chair of Private Law, Commercial Law, Company Law and Comparative Law at the Faculty of Law in April 2018.

From 2002 to 2006, **Osterloh-Konrad** wrote her Ph.D. thesis at the MPI for Tax Law and Public Finance. It was awarded the Law Faculty Award of the Ludwig-Maximilians-Universität in Munich and the Otto Hahn Medal of the Max Planck Society. After a year of practical experience she rejoined the Institute as a senior research fellow. During the 2017/2018 winter term **Osterloh-Konrad** worked as an acting professor for tax law at the Albert-Ludwigs-University Freiburg. While working as a senior research fellow at the institute, **Osterloh-Konrad** wrote her post-doctoral thesis on “Tax Avoidance – Combining Comparative Analysis and Legal Theory”. Starting from a comparative analysis of German, French, British and US tax law, the study develops a functional approach to general anti-avoidance instruments and makes suggestions for their institutional design.

RESEARCH

THE DETERRENCE EFFECT OF WHISTLEBLOWING



Whistleblowers do not only help to disclose immoral or criminal acts but also to deter imitators, the economists Niels Johannesen and **Tim Stolper** show. They investigated how the stock prices of Swiss banks known to have assisted private clients from abroad in offshore tax evasion reacted to a total of 13 leaks of customer information. The main insights originate from a data leak from LGT Bank, the first leak from a bank involved in offshore tax

evasion to come to the public's attention: In the ten trading days leading up to the LGT leak the share prices of the Swiss "tax evasion banks" behaved inconspicuously. However, in the first two days after the revelations, their prices fell by a market-adjusted amount of 1.1 percent, and in the four subsequent days by a total of 2.2 percent; both numbers being statistically significant. The LGT Bank itself is not listed on a stock market. According to the theory of efficient financial markets as developed by economics Nobel prize winner Eugene Fama, share prices follow the information available and reflect the net present value of expected future profits.

Johannesen and **Stolper** argue that as the Liechtenstein tax affair was the first data leak of its kind, tax evaders and their accomplices had hitherto not (sufficiently) taken into account the risk emanating from data leaks. The first notice of such a risk affected the supply and demand for offshore banking services and reduced the expected profits of offshore service providers. Johannesen and **Stolper** also show that later uncoverings of offshore banking activities, for example the Swiss Leaks in 2009 or the Panama Papers in 2016, did not have any significant effects on the banks' share prices. This also supports the scientists' main hypothesis: after the first data leak became known, the owners of illegal bank accounts and offshore companies as well as their accomplices adjusted their expectations or, in other words, factored in the risk that their criminal schemes might be uncovered. Finally, Johannesen and **Stolper** underpinned their theory with statistics from the Bank for International Settlements. After the LGT leak international bank deposits in tax havens around the world fell by more than ten percent in comparison with deposits in countries not acting as a tax haven. This suggests that the effects of whistleblowing had real consequences, namely frightening off tax fraudsters and their accomplices.

Johannesen, N., and Stolper, T.B.M. The deterrence effect of whistleblowing – an event study of leaked customer information from banks in tax havens, 2017, http://ssrn.com/abstract_id=2976321.

UNMASKING DECEPTION



If you want an honest reaction, you should put your counterpart under time pressure. Those who have to react spontaneously are more likely to speak the truth. Tim Lohse, **Sven A. Simon** and **Kai A. Konrad** conducted an experimental study and found that time is crucial for deceptive behaviour. Participants took part in a computer-simulated lottery, with an 80 percent chance of drawing a low income and a

20 percent chance of drawing a high income. Then, they were asked to report their result by clicking either on a button with the low or with the high income. Hence, participants had the chance to determine their payoff on their own by potentially giving a dishonest report. By imposing two different levels of reflection time, the economists set up a procedure that made sure that some participants became aware of the misreporting opportunity and others not, and yet others could take even more time to think about the implications of a potentially dishonest report.

The good news is: Honesty seems to be the spontaneous, intuitive response. The limitation of eight seconds to report the income reduced the awareness of the misreporting opportunity by nearly 40 percent. As a consequence, the share of dishonest reports was decreased by more than one third under time pressure. However, once subjects gained awareness of the misreporting opportunity, it made no difference whether they had less or more time to reflect: In a so called “contemplation group”, which had 60 seconds of reflection time, 47 percent of the aware subjects decided to report dishonestly, while 49 percent did so for the “time pressure group” with eight seconds reflection time. This result indicates that reflection time has no effect on the conscious decision to misreport beyond its effect on awareness.

When the researchers allowed subjects in the time pressure group to revise their initial report, almost all subjects who deceived under time pressure also deceived 60 seconds later (95 percent). In contrast, a considerable share of 36 percent of honest subjects under time pressure deceived when given a second chance to report. This behaviour is most pronounced for subjects that became aware only after the first report, and thereby highlights the importance of the perception of the misreporting opportunity for dishonest reporting.

Lohse, T., Simon, S.A., and Konrad, K.A. Deception under time pressure: conscious decision or a problem of awareness? Journal of Economic Behavior & Organization, 2018, 146, 31–42.

RESEARCH

WHEN AGGRESSION BECOMES CONTAGIOUS



Whether in Bosnia, Liberia, or Rwanda, violent conflicts have suddenly broken out between ethnic groups that have lived peacefully together for a long time. So far, there is no satisfactory scientific explanation as to why aggression can repeatedly develop such a dynamic. **Jana Cahlíková**, together with colleagues from the Czech Republic and Slovakia, has developed a novel experiment to test how social environment influences hostile

behaviour towards other ethnic groups. The study examines adolescents from schools in eastern Slovakia and their behaviour towards Roma – a minority against whom there are substantial prejudices, and in recent years, have been increasing acts of aggression. The unique element about this research project was that participants were able to act within their natural social environment – their class.

To examine hostile behaviour, the researchers had the young people play a “Joy of Destruction game”: a game in which the participants – if they so wish – can live out their willingness towards destruction. Two players receive two euros each and simultaneously choose whether to pay 20 cents to reduce their counterpart’s income by one euro or simply keep the money unchanged. The researchers used a list of typical names to inform the participants of whether their counterpart was a member of the Slovak majority population or the Roma minority. In addition, the scientists designed the course of the game in such a way that some of the players knew the decisions their classmates had made before. It turned out that the willingness to act aggressively grew significantly when a player had observed destructive behaviour by her or his peers. It was striking that this influence more than doubled when hostility was directed against Roma. In a second related experiment, the researchers asked young people to assess whether the hostile behaviour shown in the first experiment was appropriate. Here, too, it became clear, that the social environment is crucial: In an environment without hostile peers, aggressive behaviour towards Roma or the subject’s own social group was rated negatively to a similar extent. However, knowing that one player showed destructive behaviour after his or her classmate has been hostile to a Roma, this behaviour was rated as more appropriate.

Bauer, M., Cahlíková, J., Chytilová J., and Želinský, T. Social contagion of ethnic hostility. Proceedings of the National Academy of Sciences of the United States of America, 2018, 115 (19), 4881–4886.

IS THE EURO SUSTAINABLE – AND WHAT IF NOT?



Conference organisers and keynote speakers Jörg Rocholl, president of the ESMT Berlin (above), and Kai A. Konrad, director at the MPI for Tax Law and Public Finance (right).

Leading international economists have met to discuss how to cope with a possible break-up of the Eurozone. The international business school ESMT and the MPI for Tax Law and Public Finance chose Berlin as the venue for the 14 March talks. The conference addressed the question of political resilience, experiences from comparable events in the past, and the management of consequences and expenses of a potential collapse.



Christoph M. Schmidt, president of the RWI – Leibniz Institute for Economic Research, analysed the current economic state of the Eurozone and examined the broad argumentative spectrum of the political discourse on reforming the Eurozone architecture.

Albrecht Ritschl, professor of economic history at the London School of Economics, presented historical evidence on currency union break-ups and drew conclusions on how to deal with the aftermath of possible disintegration. He claimed that in the past the disintegration of a monetary union usually also led to the disintegration of the corresponding customs union.



Clemens Fuest, President of the ifo Institute, stated that it might be a good time to discuss an Euro exit clause as an element of the reform of the Eurozone. Such clauses have the advantages of reducing the cost of exit if it occurs, and will protect individual countries against exploitation. However, they might increase the likelihood that countries will follow the exit example. This argues in favour of high procedural hurdles for exit, but not for having no rules at all.

CONFERENCE

THE FUTURE OF INTERNATIONAL TAX POLICY



What does the future of international taxation look like? Will the Base Erosion and Profit Shifting project (BEPS) succeed in the drive for coordination or will international tax competition and unilateralism further intensify? In December 2017 an interdisciplinary conference at the MPI for Tax Law and Public Finance linked around 40 experts from law,

economics and international organisations in a momentous debate on International Tax Policy in a Disruptive Environment. The papers of the conference were published in a special issue of the Bulletin for International Taxation in April 2018.



Michael Keen from the International Monetary Fund reviewed the relationship between tax competition and coordination and noted that these are not incompatible but rather mutually influencing. Even a successful BEPS outcome that closed down all avenues for avoidance would not—and was not intended to—restrict all instruments of tax competition.

Michelle Hanlon from the MIT Sloan School of Management discussed the potential benefits of country-by-country reporting (CbCR) and potential costs, such as increased compliance costs, and shed light on what implications CbCR might have for the international allocation of taxing rights. Her considerations are based on data she collected from tax executives, tax consultants and former government officials when learning of their experiences with implementing CbCR.



Allison Christians from the McGill University in Canada spoke on the OECD Inclusive Framework, an initiative that brings together over 100 countries and jurisdictions to collaborate on the implementation of BEPS. She pointed out why inclusivity in authenticating a global tax policy mandate is critically necessary for the international tax regime, and turned to global governance experience to explore what might be required to achieve it.

PRESTIGIOUS MUNDELL-HUANG DA LECTURE



Prof. Dr. Kai A. Konrad was honoured to deliver the prestigious Mundell-Huang Da Lecture at Renmin University of China on 25 September 2017. His presentation “Escalation in dynamic conflict: On beliefs and selection” is related to a paper co-authored with Prof. Dr. Florian Morath, a professor at Goethe University Frankfurt and a research affiliate at the MPI for Tax

Law and Public Finance, that contributes both to the theory of conflict and to the methodology of conflict experiments and related strategic interactions.

Established in 2001 jointly by the School of Finance at Renmin University in Beijing and the Chinese Financial Policy Research Center to bridge academic communication between China and the rest of the world, the Mundell-Huang Da Lecture Series is named after both the Nobel laureate in economics, Robert Mundell, and Da Huang, a financial economist from China, professor at the Renmin University of China. The lecture series invites famous economists to present their cutting-edge research. Former presenters of the Mundell-Huang Da Lectures include leading academics from economics, such as Jean-Jacques Laffont and Robert J. Barro, and winners of the Nobel Memorial Prize in Economics such as Michael Spence, Edmund S. Phelps and Robert J. Shiller.

ACADEMIC PRIZE FOR CARSTEN HOHMANN



Dr. Carsten Hohmann’s doctoral thesis was awarded the Academic Prize (Wissenschaftspreis) of the Munich Chamber of Tax Consultants. It deals with § 8c Corporate Income Tax Act (KStG), according to which a company’s carried forward losses are partially or even completely forfeited in the case of share transfers.

Dr. Hohmann (above, from left to right: Dr. Hartmut Schwab, Carsten Hohmann, Günter Helmhagen) compares the regimes in Germany, Austria, Switzerland, the United Kingdom and the USA and puts forward proposals for tax reform in Germany.

MISCELLANEOUS

CASTELON'S DISSERTATION AWARDED THREE TIMES



Dr. Marta Castelon's dissertation "International Taxation of Income from Services under Double Taxation Conventions – Development, Practice and Policy" has been awarded three prizes: the prize of the Munich University Society, the Science Prize of the German Scientific Institute of Tax Consultants (Deutsches wissenschaftliches Institut der Steuerberater e.V), and the

third place in one of Germany's most highly remunerated awards in the field of economics and social sciences, the Social Market Economy Research award (Forschungspreis Soziale Marktwirtschaft 2018) by the Roman Herzog Institute.

In her dissertation **Dr. Castelon** (above with Dr. Raoul Riedlinger, Chairman of the DWS Institute) analyses the international taxation of services under double tax conventions from a legal history, a legal comparative and a legal policy perspective. The work was supervised by **Professor Wolfgang Schön** alongside Professor Luís Eduardo Schoueri from the University of São Paulo in Brazil.

PARADA WINS SORBONNE TAX THESIS AWARD

Dr. Leopoldo Paradas's doctoral thesis entitled "Double Non-Taxation and the Use of Hybrid Entities. An Alternative Approach in the New Era of BEPS", written at the MPI for Tax Law and Public Finance, was awarded the Sorbonne Tax Thesis Award 2018. Granted by the Université Paris 1 Panthéon-Sorbonne, it promotes an outstanding Ph.D. thesis in the domain of tax law.

The jury of the Sorbonne Tax Law Prize stated that "**Dr. Parada's** work was extremely



valuable, both in terms of technical content and in terms of theoretical reflections. It provides for an interesting approach to double non-taxation and offers very challenging suggestions in order to solve issues raised by the most problematic situations raised by hybrid entities."

Leopoldo Parada successfully defended his Ph.D. thesis at the University of Valencia. It was supervised by Professor Francisco A. Garcia Prats.

ALBERT J. RÄDLER MEDAL FOR DUQUE DOS SANTOS



Amanda Duque dos Santos, a research associate at the MPI for Tax Law and Public Finance, has been honoured with the Albert J. Rädler Medal 2017 (on the left with Frits Sobels, Prof. Piergiorgio Valente and Albert Rädler). The prize was awarded for her master's thesis "Transfer-Pricing Rules and State Aid" in Brussels, on 19 April 2018.

The jury was "impressed by the au-

thor's analysis of State Aid law as part of the EU legal framework and in particular the argument of how State Aid is placed within the context of the fundamental freedoms of the EU Treaty, in line with the approach pursued by **Professor Wolfgang Schön**".

The CFE Albert J Rädler Medal was launched in 2013 to encourage academic excellence among young tax students in the field of European taxation, and to recognise Professor Albert J Rädler's contribution to the field of taxation.

GERMANY'S STRONGEST ECONOMIC RESEARCHERS



Prof. Dr. Kai A. Konrad ranks fifth in the category "Lebenswerk – Gesamtforschungsleistung" (Lifetime Achievement – Overall Research Performance) of the "Handelsblatt VWL-Ranking 2017". The Handelsblatt ranking measures the research strength of all economists in German-speaking countries, as well as German-speaking economists abroad, based on their publication performance in peer-reviewed economic journals. The ranking lists are drawn up by the institutes KOF (ETH Zurich) and DICE (University of Düsseldorf). The project is supported by

the Verein für Socialpolitik.

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MISCELLANEOUS

STARK MEMBER OF THE FUTURE FACULTY



Dr. Johanna Stark, a senior research fellow at the MPI for Tax Law and Public Finance, has been invited to help shape the jurisprudential project Future Faculty (Zukunftsfakultät), funded by the research network Recht im Kontext and the Wissenschaftskolleg zu Berlin. As part of the Future Faculty, a group of 15 postdoctoral scholars from various subdisciplines of legal studies have been meeting every six months since July 2012 to discuss their own discipline(s), develop ideas and think ahead.

The aim of the faculty is to critically debate the tasks, theories and methods of a modern jurisprudence and to provide intra- and interdisciplinary impulses for future scientific teaching and research.

“BREMEN TAX KEY” FOR WOLFGANG SCHÖN

Prof. Dr. Dr. h.c. Wolfgang Schön was awarded the “Bremer Steuer-Schlüssel” (Bremen Tax Key) in recognition of his outstanding achievements in the field of tax law. This prize was awarded for the first time by the Forum for Accounting and Taxes (Forum für Rechnungslegung und Steuern e.V.) on June 25, 2018 in Bremen.

The jury said that over the last three decades Wolfgang Schön has dealt more intensively than any other German jurist with the legal framework provided by private law and tax law for national and multinational corporations, which has a major influence on both their structure and individual business decisions. The laudatory speech was given by Prof. Dr. Franz Jürgen Marx (above, from left to right: Prof. Dr. Franz Jürgen Marx, Prof. Dr. Dr. h.c. Wolfgang Schön, Prof. Dr. Helge Bernd von Ahsen). The Accounting and Tax Forum was established in 1999. Its members are auditors, tax consultants, lawyers, scientists and executive managers from the world of business and from associations.





SELECTED PUBLICATIONS

Ten Questions About Why and How to Tax the Digitalized Economy

Wolfgang Schön

Bulletin for International Taxation, 2018, Vol. 72, No. 4/5, pp. 278–292.



International organisations, tax scholars around the world and business experts are intensely debating the future shape of the taxation of the digitalised economy. Starting from the assumption that any “ring-fencing” of the digitalised economy should be avoided, it is far from easy to develop a framework in the context of the corporate income tax to capture profits derived by cross-border digital transactions in an orderly way.

As **Wolfgang Schön** points out in his recently published article, general notions like “economic allegiance” or the “benefit principle” are unhelpful when it comes to sharing the pie between production countries and destination countries. Empowering the market countries can follow two different trajectories: a set of rules based on the notion of “digital presence”, which simply looks to the demand side of the market, or a set of rules based on the notion of “digital investment” as a proxy for a productive source of income set up by the taxpayer with regard to market.

While these pathways should be explored in the next couple of years, any search for a “quick fix” might not only be distortive and inefficient, it might also stand in the way of a new international consensus built around a new set of overall tax principles. Temporary measures might easily translate into permanent measures. **Wolfgang Schön** suggests that anybody who attempts to introduce a specific tax treatment for the digitalised economy should be as transparent as possible with regard to the ten major policy questions outlined in his article.

Identifying the Source of Incumbency Advantage through a Constitutional Reform

Mariana Lopes da Fonseca

American Journal of Political Science, 2017, Vol. 61, No. 3, pp. 657–670.

The advantage incumbents experience in electoral races is well-documented. Those economists who tried to credibly identify it have so far either emphasized the personal incumbency advantage with the officeholder as the driver for the electoral success or the partisan incumbency advantage which assesses the benefits that accrue to a candidate from running for the incumbent party.

Mariana Lopes da Fonseca's study provides one of the first causal estimates of both the personal and the partisan effect that contribute to an incumbent's advantage at the ballot box. Her approach relies on a natural experiment that keeps the incumbency status of the party constant but creates an exogenous variation in the incumbency status of the candidate – the introduction of mayoral term limits in Portugal – as well as on a combination of two quasi-experimental methods, the regression discontinuity and the difference-in-discontinuities design. The economist finds that positive returns accrue to the rerunning officeholder by virtue of his or her incumbent status independent of the incumbency status of the party. Even though it would be reasonable to assume that parties play a significant role in attracting and retaining votes, she finds no evidence of a partisan incumbency advantage. This result has implications for politics at large since under these circumstances parties have an incentive to renominate officeholders as well as to acquiesce to their demands. Electoral mechanisms such as term limits might be useful in this case to stimulate competition.

Quantitative Rechtswissenschaft

Corinna Coupette and Andreas M. Fleckner

JZ – JuristenZeitung 2018, Vol. 71, No. 8, pp. 379–389.

Quantitative methods rank among the standard techniques of many researchers – not only in the natural sciences but also in the social sciences and the humanities. Little is known, however, about the value of quantitative methods for legal scholarship. Therefore, one recent publication of the **Otto Hahn Group on Financial Regulation** at the Max Planck Institute for Tax Law and Public Finance is devoted to quantitative legal studies: the statistical analysis of discrete data to answer legal questions.



Die Kompetenzverteilung im Rahmen der Austrittsverhandlungen nach Art. 50 EUV unter besonderer Berücksichtigung bestehenden Sekundärrechts

Caroline Heber

Europarecht, 2017, Vol. 52, No. 5, pp. 581–659.

Who has the competence to negotiate an exit treaty if one Member State decides to withdraw from the EU – the remaining Member States, the EU or both? Art. 50 of the Treaty on European Union lays down a basic roadmap of the actions which have to be taken in case of an exit and determines that the exit treaty should set out the arrangement for both the withdrawal and the framework for the future relationship between the leaving Member State and the EU. However, the provision does not spell out whether the EU is allowed to conclude the exit treaty without the consent of the remaining Member States. Such a consent is of particular importance when it comes to the future relationship of the EU and the leaving Member States.

Caroline Heber points out that the existence of secondary EU law plays a crucial role when it comes to deciding whether or not the Member States have to be granted the right to participate in the negotiation process. In the light of competence to negotiate the exit treaty, existing secondary law can be divided into several categories. Only secondary EU law which has a nexus to states outside the EU or achieves a full harmonisation transfers the competence to the EU, and thus allows the European Institutions to negotiate the exit treaty without any participation of the remaining Member States. Other forms of secondary EU law do not grant the EU an exclusive competence in the negotiation process. Accordingly, in these fields the remaining Member States cannot be excluded from the negotiation process.

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Large Investors, Regulatory Taking and Investor-State Dispute Settlement

Kai A. Konrad

European Economic Review, 2017, Vol. 98, pp. 341–353.

Investor State Dispute Settlement (ISDS) provisions, part of many bilateral and multi-national free trade agreements, are highly debated. They enable foreign investors to sue host country governments at international arbitration tribunals and demand compensation, claiming damages for regulatory policies implemented by the host country after an investment has been made. A prominent example is the claim of the Swedish energy firm Vattenfall against Germany to the amount of US \$5.8 billion plus 4 percent interest, arising out of Germany's enactment of legislation to phase out nuclear power plants. While the positive effects of ISDS regimes that have been identified in the literature rely on a well-functioning mechanism, criticism mostly relies on possible deficiencies or the malfunctioning of the regime with ISDS. So, is the desirability of ISDS a question of the quality of its design?

Kai A. Konrad shows that ISDS may have a dark side, even under rather ideal conditions with an efficiency-oriented, transaction-cost free mechanism, and untouchable, fully reliable and unbiased judges. The reason is strategic investment: In general, high investment with major set-up costs protects domestic firms from regulatory expropriation and this induces strategic investment. A regime with an ISDS strengthens this effect, as the threat to the host country's government of having to compensate foreign direct investor under ISDS makes a regulatory ban even more expensive. Consequently, not only domestic but also foreign investors have an incentive to overinvest. While the time-consistent regulatory policy might already be overly permissive, the introduction of an ISDS makes it even more permissive. The adoption of an ISDS might reduce global welfare.

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>