*Globalisation and International Taxation in the XIXth Century: Double Taxation Agreements with Special Reference to the "State of the Fund" Principle**

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The roots of the present complex international network of more than 2000 double taxation agreements can be traced back to the late nineteenth century, a phase of intensified economic globalization. This article has two focuses: it analyses the economic and political background of the growing necessity to solve double taxation problems by agreements first within Central European political entities or states with federal structure. The expertise these vanguard-states developed on reducing double taxation problems then enabled them to come to the first international agreements, whereas great economic powers like Great Britain and France stubbornly abstained. While following the history of these first attempts at avoiding double taxation, special attention is given to the so-called "state of the fund" principle, which regulated the allocation of taxing rights in the case of civil servants residing outside the state who paid their salaries or pensions. This principle is still contained, though not uncontested, in article 19 OECD model, which is the basis of many double taxation treaties valid today.

1. Introduction

Since the late eighties of the past century, the global interconnectedness of the world economy has increased dramatically. The implementation of the "Washington consensus" in large parts of the world has led to deregulation and liberalisation, both within the national economies and on an international level. At the same time, there has been a trend the English language literature calls the "regionalisation" of the world economy: this refers to the close economic and/or political convergence of states in a particular region. The most well-known example is the EU, which is arguably the most intensely interconnected

* Translated from German by Martin Herles.

economic federation of sovereign states. Already at an early stage of European integration, the implementation of what is now generally referred to as the principle of the four freedoms[1] had been achieved within the framework of EC law. This, however, seems to be in some contrast to maintaining the member states' sovereignty regarding tax law. The growing mobility of workers, companies' extension of their business to several member states (transnational enterprise) and the liberalisation of the capital markets are all factors that make the question of avoiding double taxation more important than ever. So far, this problem has been approached through a rapidly growing network of bilateral double taxation agreements[2], which in many cases cannot be seen as a satisfactory and final solution[3].

The current acceleration of globalisation, however, is no singular historic development. The nineteenth century was also characterised by a rapidly increasing interconnectedness of the world economy. Starting with the industrialisation of England in the last decades of the eighteenth century, the progressive industrialisation process in Continental Europe as well as in the USA, and some time later also in Japan, brought significant economic and social changes to the fore[4].

The internationalisation of the economy led to intensified trade and traffic connections. Legal provisions, such as the right of establishment, furthered companies' mobility and the establishment of branches at home and abroad. The big industrial nations, England and France, increased industrial growth by means of their foreign investment. Know-how was exchanged, internationally active enterprises built industrial plants and took over railway construction in many European countries, America

[1] Regarding workers see articles 39-42, regarding right of establishment see articles 43-48, and regarding free movement of services and capital see articles 49-55 and 56-60, respectively, of the EC Treaty.

[2] Lang gives a figure of "far more than 1,000". See M. Lang, *Einführung in das Recht der Doppelbesteuerungsabkommen*, 2nd ed., (2002), p. 24.

[3] *Ibid*, p. 99.

[4] For literature on the interconnectedness of the European economy see primarily W. Fischer, "Wirtschaft und Gesellschaft Europas", in W. Fischer (ed.), *Handbuch der Europäischen Wirtschafts- und Sozialgeschichte*, vol. 5, (1985), pp. 1 ff. and W. Woodruff, "Die Entstehung einer Internationalen Wirtschaft", in Cipolla-Borchardt, *Die Entwicklung der industriellen Gesellschaften*, (1977), pp. 435 ff.

and the colonies. Cartels and licence agreements were established and the creation of multinational enterprises[5], and particularly the foundation of bank branches abroad, boosted the trend towards globalisation. The population became more mobile: migration grew to an unprecedented level, both within Europe and to overseas.

Industrialisation and the integration process also influenced tax systems and led to a modernisation of tax law and the removal of tax provisions that had until then made double taxation[6] an everyday occurrence. Increasingly the question how to treat the taxation of foreign enterprises and workers in one's own territory, as well as a country's citizens working abroad, became an issue. Efforts to avoid double taxation resulted in the conclusion of double taxation agreements, at first within states and later between them, from the late nineteenth century onwards.

Against this background, we discuss a particular aspect of such agreements, the so-called "state of the fund principle (Kassenstaatsprinzip)[7]", which is still valid under article 19 of the OECD Model Tax Convention[8]. This provision was similarly phrased in the first double taxation treaties of the nineteenth century. The state of the fund principle "describes the legal principle that income derived from public coffers is generally taxed by the relevant public institution."[9]

[5] G. Jones, *The Evolution of International Business*, (1996), pp. 25 ff.
[6] On this term see H. Dorn, *Das Recht der internationalen Doppelbesteuerung*, VJsch ST. FinR., (1927): "International double taxation (multiple taxation) occurs if several independent, sovereign tax authorities (in particular several independent states) subject the same tax object to a similar tax."
[7] K. Vogel, *Doppelbesteuerungsabkommen*, 2nd ed., (1990), Art.19, p. 873: "The State making the payment – sometimes referred to as 'State of the fund making the payment' or 'State of the fund' for short" (English original).
The term 'state of the fund' is used for 'Kassenstaat' throughout this paper (both terms have been coined by Vogel). Note that the European Court of Justice uses the term 'paying state' instead.
See: Proceedings of the Court of Justice and the Court of First Instance of the European Communities, Case C-396/96, http://www.curia.eu.int/en/actu/activites/act98/9813en.htm.
[8] The OECD has developed model agreements for international tax treaties aiming at avoiding double taxation, which were already conceived by the OEEC, further agreed at the first Model Convention in 1963.
See K. Vogel, *Doppelbesteuerungsabkommen*, (1996), Regarding Art.19, 19a.
[9] M. Rodi, "Das Kassenstaatsprinzip im nationalen und internationalen Steuerrecht", RIW Vol.6 (1992), p. 484.

In order to make the detailed problems more comprehensible, we will analyse some aspects of tax policy in the context of economic development in the nineteenth century in the first part of our paper. Then the specific legislation of those countries that prohibited intrastate double taxation and concluded intergovernmental treaties to avoid double taxation in the nineteenth century will be discussed as an example.

The particular aspect of these agreements we have selected for this paper, the allocation of the taxation rights regarding the remuneration of public servants, is of great interest as regards the history of its development and remains controversial even today[10].

A concluding analysis presents and compares arguments for and against the state of the fund principle in the nineteenth century and today.

2. Integration and double taxation in the nineteenth century

Today's dense global web of agreements to avoid double taxation has a relatively short history. Agreements to avoid double charges, in the sense of taxing the same tax object twice through identical or related taxes of sovereign or partly sovereign states[11], have been around for no longer than roughly a hundred years. The predecessors of these agreements were single provisions in intergovernmental treaties, such as pastures regulations, customs and trade agreements, navigation regulations and the like.[12]

The general question of allocating taxation rights only came up, as outlined in the introduction, in connection with the increasing economic interconnectedness in the second half of the nineteenth century. However, it turned out that at first only few states were willing to make concessions regarding the allocation of taxation rights: Surprisingly, particularly the global players of the era before the First World War showed no interest in international tax agreements.

Globally, the economy with the highest degree of interconnectedness

[10] M. Lang, contribution to *Festschrift* (2004). Also see "Summary and Conclusion" in this paper.

[11] See footnote 36.

[12] G. Lippert, *Das Internationale Finanzrecht*, (1912), p. 599.

was without doubt Great Britain. This country accounted for approximately 40% of all foreign investment[13]. For a long time, Britain was the leading trading nation in the world. The British population was seen as one of the most mobile world-wide. British technicians exported know-how to the continental European countries, to America and to the colonies.

As regards taxation, the Britons had already conceived a relatively modern tax system with the introduction of income tax in 1842 and thus would have met one important requirement for tax agreements. Yet avoiding double taxation was of no interest for them until the income tax reform in 1912. They radically taxed all income at home and from abroad[14]. Still, the British had high tax-exempt thresholds and a low tax rate. Only from 1912 did they start to address double taxation issues within their own global Empire. The first international tax treaty was concluded with Ireland in 1926[15].

From the Britons' traditionally liberal point of view, international concessions in tax matters would have infringed upon the state's sovereignty. In addition, it was believed that collecting taxes twice resulted in twice as much security provided by two states and was thus justified[16].

France, before World War I the world's second largest financier and one of the most important trading nations, reformed its outdated real tax (Ertragsteuer)[17] system as late as in 1914 by introducing personal income

[13] Woodruff (1977), p. 470.

[14] With some exceptions, the "remittance" principle. See J.F.A. Jones, "Taxing Foreign Income from Pitt to the Tax Law Rewrite – The Decline of the Remittance Basis", in J. Tiley (ed.), *Studies in the History of Tax Law*, (2004), pp. 15 ff.

[15] R. Rosendorff and J. Henggeler, *Das Internationale Steuerrecht des Erdballs*, vol. VI, (1936), appendix: list of agreements (Verzeichnis der Verträge).

[16] Lippert, *Handbuch des Internationalen Finanzrechts*, 2nd edn., (1928), p. 532. English participants still adhered to this opinion at conferences of the International Law Institute in the first two decades of the twentieth century.

[17] "Thus there developed during the 17th, 18th and the first half of the nineteenth century a system of taxes on things rather than on persons, or a system of taxes on the product of the property rather than on the person of the property owner. This is the system which became known in France under the name of real taxes *(taxes réelles)* as opposed to the old personal taxes and which was termed in Germany *Ertragsteuern* as opposed to the old *Vermögenssteuern*." E.Seligman, *The Income Tax. A study of the history, theory and practice of income taxation at home and abroad*, (1911), p. 13. Other terms in use for *Ertragsteuer* are taxes on product, taxes on earnings, revenue taxes and profit taxes.

tax[18]. Basically, the principle of territoriality prevailed in French tax policy. Only income generated at home was subject to taxation, with French citizens and foreigners being treated equally.

Already in the mid-nineteenth century several agreements regarding administrative assistance in tax matters had been concluded with Belgium, Luxembourg and the Netherlands. These agreements, however, mainly served to uncover instances of tax fraud[19]. Similarly to Great Britain, France did not show any interest in double taxation treaties for a long time. Only in 1930 did they conclude the first agreement with Italy[20].

Contrary to the disinterested attitude of Great Britain and France, double taxation issues were of particular concern for communities of states with a member state concept such as Germany and Switzerland. They took the first steps to remove double taxation within a state and thus paved the way for international tax agreements.

However, some laggards in the industrialisation process also showed great interest in such intergovernmental treaties. One example is the Habsburg monarchy, which aimed at intensifying its economic relations to the German states and for this reason initiated the conclusion of the first international double taxation treaties[21]. Although at the beginning of the twentieth century international tax law was still referred to as a "dream of the future"[22], a step in this direction was taken in 1899 with the treaty to avoid double taxation between Austro-Hungary and Prussia, which then led to further agreements in the period up to 1914.[23]

It is obvious that treaties can only be concluded between states with similar tax systems. Therefore, we will briefly look into the ongoing "harmonization" of tax law in the nineteenth century. Two taxation models

[18] A reason for this reform coming late is given e.g. by E. Schremmer, *Steuern und Staatsfinanzen während der Industrialisierung Europas*, (1994), pp. 85 ff.

[19] Lippert (1928), p. 534.

[20] Rosendorff and Henggeler (1936), p. 1736.

[21] H. Hemetsberger-Koller, "Der wirtschaftspolitische Hintergrund des Doppelbesteuerungsabkommens zwischen Österreich-Ungarn und Preußen 1899", in W. Gassner *et al., Die Zukunft des Internationalen Steuerrechts*, Schriftenreihe zum Internationalen Steuerrecht, vol. 10, (1999), pp. 13 ff.

[22] J. Fischer, *Die Doppelbesteuerung in Staat und Gemeinde*, (1909), p. 1.

[23] Hemetsberger-Koller (1999), p. 32.

prevailed[24]: the English tax system of a General Income Tax and the French model of "objective real taxes".

While general income tax is based on personal income, the real tax was based on an approximate estimate of income, which could greatly diverge in all directions from actual profits made.

For this reason, the real tax was often deemed extremely unfair. The criteria for the tax estimate were based on outward, easily detectable features, such as, in the case of corporate taxation, input common in an industry (number of workers, machinery, amount of raw materials used), or, in the case of taxes on rents, location, number of floors, roof space visible from the street, number of windows, etc. Even the clothes worn by taxpayers were better not to indicate a high income, in order not to attract higher taxes.

This system, which could not take into account the significant changes in returns on economic activities in the course of industrialisation was defended with the argument that the evaluation of the ability to pay based on indisputable outward features was easier, cheaper and less obtrusive on the taxpayers than establishing the actual return made[25]. This determination of the return irrespective of the actual amount resulted in taxes that were too high whenever the profit situation turned bad. On the other hand, the tax authorities forfeited revenue in periods of economic growth[26].

The more the industrialisation process progressed, the more the pressure increased to move onto the income tax principle. The copious tasks of the state led to increased demand for funds all over Europe. It was no longer affordable simply not to tax profits or income[27]. Taxes

[24] Schremmer (1994), several chapters.

[25] F. Hertz, *Die Produktionsgrundlagen der österreichischen Industrie vor und nach dem Kriege*, (1919), p. 137.

[26] See also: Schremmer (1994), p. 197.

[27] The reason for the historical move from real taxes to income taxes was " that it was necessary to combine all the different returns to one income: because taking into consideration the allocation of returns to the individual beneficiaries made possible a financially more fruitful differentiation, which at the same time allowed a more even and fairer distribution of taxes." H. Teschemacher, "Die Einkommensteuer", in Gerloff and Meisel (eds), *Handbuch der Finanzwissenschaft*, 2 vols (1927), p. 88.

were in most cases the state's primary source of revenue, with indirect taxes and tariffs accounting for the biggest share for a long time. In Austria, for example, the ratio between direct and indirect taxes was roughly 1:2 at the start of the twentieth century. In Britain, on the other hand, the share of direct taxes in the state's revenues was higher than that of indirect taxes. There were also a few states whose main source of revenue was business income from state-run companies. The most prominent example is Prussia. The Prussian state was primarily an entrepreneur, almost 75% of its revenue came from state-run enterprises, with the largest part (57%) accounted for by railways.[28]

In most developed economies individual profits, the taxable income, only became the standard tax base at the beginning of the twentieth century. Taking the specific economic and social situation of the taxpayer into consideration was made possible by means of a tax-exempt subsistence income level, progressive tax rates, the deductibility of debts, the relevance of the number of children for tax purposes and, finally, the avoidance of double taxation.

Additionally, in the course of the nineteenth century, improvements in taxation procedure were achieved. Outdated tax collection methods based on quotas (determination of a specific tax amount for a certain area), tax categories (grouping tax payers according to occupation and type of enterprise) or estimates were slowly becoming obsolete.

Technically, a simplification of tax collection was the aim: for this reason, the withholding method would have been preferred for employed earners' income. Still, the withholding method, today a matter of course for the majority of taxpayers, was only common with a few direct taxes. For instance, Austrian entrepreneurs rejected being degraded to acting as an aide to the tax authorities "in view of the fluctuating element of the workers"[29]. In Prussia a first successful step towards an improvement in state revenues was taken by introducing the duty for employers to provide information in 1907[30], which resulted in a general duty to withhold taxes

[28] Schremmer (1994), p. 173.
[29] F. Leiter, *Die Verteilung des Einkommens in Österreich*, (1907), p. 12.
[30] F. Meisel, "Wahrheit und Fiskalismus bei der Veranlagung der modernen Einkommensteuer", *Finanz-Archiv*, vol. 31, (1914), p. 147.

on wages and salaries only in the German tax reform of 1920[31]. How much more efficient this system was can be seen in the inclusion rate of the taxable persons in the example of the Prussian income tax: In 1903 roughly 30% of taxable persons were included, in 1913 approximately 45% and in 1922 about 99%. Austria also managed to introduce the withholding method only after the First World War.[32]

In summary, it can be stated that the intensifying economic relations and the mobility of the workforce in general brought states closer together, but did not result in a reduction in the double tax burden. Economically and politically dominating nations such as England and France were not interested in allocating taxation rights. The German Empire on the other hand was predestined for a law to remove double taxation because of its federal structure, in which the states kept tax sovereignty. Thus, the Germans had the greatest experience in avoiding double taxation towards the end of the century. The basic principles about the avoidance of double taxation in the German *Reichsgesetz* (imperial law) were to become the basis for all international agreements to come. Austro-Hungary, though a late entry in the industrialisation process, turned into an extraordinarily eager partner when it came to regulating international tax problems[33].

Indispensable for intergovernmental tax treaties was the move to a general income tax in the individual states. Through this "harmonisation of tax law" and modern tax procedures it was possible to make the systems more transparent and comparable. Only this made cases of double taxation clearly identifiable.

3. Double taxation agreements in the nineteenth century with special reference to the 'state of the fund' principle

Agreements to avoid double taxation in the last third of the nineteenth

[31] Teschemacher (1927), p. 124. See also H.A. Vogel, "Steuertechnik und Steuerverwaltung", in *Hb der FW* (1980), p. 285, p. 287, pp. 301 ff.
[32] P. Szende, *Der Staatshaushalt und das Finanzsystem Österreichs,* in Gerloff and Meisel (eds), *Handbuch der Finanzwissenschaft,* 3 vols (1929), p. 210.
[33] Hemetsberger-Koller (1999), p. 21.

century were concluded, as described above, between states with a member-state conception or between independent states mostly in the form of governmental treaties, acts, regulations, edicts and provisions in the respective tax legislations.

Income received from the state was, as the examples below will show, "generally taxed in the territory of the state paying out, irrespective of whether it was received at home or abroad".[34] To this day few exceptions from this procedure have occurred. Where taxation rules did not follow the 'state of the fund' principle, tax collection based on the residence principle prevailed.

The best examples of the removal of a double tax burden within a state are to be found in the German Empire, Switzerland and Austro-Hungary. Still, the taxation of income received from the state was subject to country-specific regulations.

International tax law treatment of income received from the state was, in double taxation agreements, generally subject to the 'state of the fund' principle up to the First World War. In order to further the understanding of the detailed problems under discussion here, the economic policy framework of the relevant countries will be outlined.

3.1 The German Empire. The union of the German states and *Reichsstädte* (imperial cities) in the course of the nineteenth century took place in several stages. The *Deutsche Bund* (German Federation)[35], which was established in 1815, at first consisted of 35 individual states and 4 imperial cities. In 1833/34 the Prussians initiated the establishment of the *Deutsche Zollverein* (German Customs Union), which propagated economic integration. In 1866, after the expulsion of Austria, the *Norddeutsche Bund* (North German Federation) was established. In 1871, the "Southern Expansion" resulted in the foundation of the German Empire.

The federal structure of the Empire provided a separate tax

[34] Lippert, (1928), p. 595.

[35] The Deutsche Bund (1815-1866) was a loose federation of states with common political objectives. The member states kept their sovereignty. See *Brockhaus* (1997), vol. 2, p. 346.

constitution for each of the now 26 member states (*Bundesstaaten*[36]), with the individual states' parliaments having the exclusive right to enact new tax laws.

As already explained in the first part of this paper, the tax systems of the individual states depended on the specific economic modernisation process. Similarly to the pan-European development, the industrialisation process developed differently in the individual German states. While Prussia and Saxony were highly developed countries, and thus had modernised their income taxation systems early on (Saxony 1887, Prussia 1891)[37], the southern German states, particularly Bavaria, were still agrarian in nature and stuck to real taxes until just before the First World War.

The economic integration of the German states intensified, particularly from the time when the mobility of entrepreneurs started to increase. This was speeded up by the Freedom of Establishment Act of 1 November 1867[38] and the Trade, Commerce and Industry Regulation Act (*Gewerbeordnung*) of 21 June 1869. The new laws greatly facilitated the rights of residence and establishment, as citizens of other states were now equally able to obtain trade licences. Cases of double taxation now became possible.

First petitions to the Reichstag, partly by Prussian land owners residing in Saxony, partly by workers[39] that were taxed both in their state of

[36] The Norddeutsche Bund (1867-1871) was like the German Empire (1871-1933) a "federal state", a combination of several states into one overall state. The individual states kept their state character and took part in the decision-making of the overall state. Sovereignty was with the overall state, but the individual states had a sovereign right within their authority and constitutional autonomy within the framework of federalism. See *Brockhaus* (1997), vol. 2, p. 346.

[37] Teschemacher (1927), p. 121.

[38] This Act prohibits in Article 1 "any restriction to the right of establishment through cumbersome conditions", See Th. Clauss, "Das Reichsgesetz vom 13.Mai 1870 wegen Beseitigung der Doppelbesteuerung unter vergleichender Berücksichtigung des schweizer Bundesrechts", *Finanz-Archiv*, vol.5, (1888), p. 148.

[39] Saxony taxed any income of citizens from other German states, disregarding the subsistence level completely, if these persons were resident in Saxony but temporarily resided at another location in the German Empire: G. Antoni, "Die Steuersubjekte im Zusammenhalte mit der Durchführung der Allgemeinheit der Besteuerung nach den in Deutschland geltenden Staatssteuergesetzen", *Finanz-Archiv*, vol.5, (1888), p. 441.

residence and the state where they worked, asked for rules regarding the division of taxation rights between the states to be added to the existing Freedom of Establishment Act. It was pointed out that the right to choose one's state of residence should not be "punished by double personal taxation". So the Act should include the following passage: "Each federal citizen is to be exempt from paying taxes to the mother country in the narrower sense, which are only imposed on the individual or his income (in the form of class, income, personal or capital gains tax), if he has to pay the same taxes at his place of temporary residence in the rest of the federal territory".[10]

These efforts were at first futile. However, petitions filed in the following months were successful insofar as the treaty between Prussia and Saxony regulated the limitation of taxation rights of the two states as early as in 1869. Renewed intervention and resolutions of some German states finally prompted the *Norddeutsche Reichstag* (North German Diet) to pass the "Act on the Avoidance of Double Taxation" in May 1870, which, like many other acts of the *Norddeutsche Bund*, was adopted by the newly-established German Empire in 1871.

3.1.1 The Act on the Avoidance of Double Taxation of 13 May 1870.[11]

The German Double Taxation Act made possible the division of taxation rights regarding direct taxes between the member states, in order to get rid of double taxation in the case of similar direct taxes[12]. Depending on the tax object, such as property, house, trade, capital gains or income taxes, one of the states had the right to collect the tax. The taxation right was granted to the state of residence, or, if that did not apply, to the state of temporary residence or, in the case of double residence, to the home state. Property and business establishments were subject to the taxation of the state to which there was an "economic allegiance"[13]. Likewise, the

[10] Clauss (1888), p. 148.

[11] *Act on the Avoidance of Double Taxation of 13 May 1870*, (1874); Act on the Avoidance of Double Taxation of 13 May 1870, Federal Law Gazette no. 14 of 19 May 1870, p. 119.

[12] The Act defines " generally the state with the exclusive taxation right ... and (thus) prohibits taxation through anybody else, irrespective of whether the state exerts its taxation rights". Clauss (1888), p. 155.

[13] On this term see G. Schanz, "Zur Frage der Steuerpflicht", *Finanz-Archiv*, vol. 9, (1892).

collection of taxes on public servants' income, pensions and Wartegelder[14] (temporary pensions) was effected by the paying state[15].

This rule of taxing public servants, the so-called state of the fund principle, which diverges from the principle of taxation based on the concept of residence as defined in the Act[16], will now be discussed in detail.

The state of the fund principle, according to which the taxation rights for income from public service, salaries and pensions was allocated to the paying state, was incorporated in Article 4 of the Act of 1870. It stated that "Salary, pension and Wartegeld received by Northern German military personnel and civilian public servants, as well as their surviving dependants, from a state, are only to be taxed in the state which has to effect these payments."[17]

In contrast to the provisions of the OECD Model Tax Convention[18] found today, only payments made directly by a state were subject to taxation, not those made by non-state public institutions such as *Gemeinde-, Korporations- or Kreiskassen* (local institutions) or the *Reichskassa* (federal level institution). Still, over the years many German states did not comply with this restriction and applied Article 4 to other public institutions as well[19].

[14] On this term see *Meyers Großes Konversations-Lexikon* (1908): "Wartegeld", that part of the salary a public servant or officer in temporary retirement is to be paid until he re-enters public service. The Wartegeld is normally higher than a pension. See also: *Handwörterbuch der Finanzwissenschaft*, vol. 2, (1956) p. 105.

[15] Fischer (1909), p. 28.

[16] "Residence under this Act is defined as when a Northern German has a dwelling at a certain location under such circumstances, which lead to the assumption he intends to keep up this dwelling permanently", *Act on the Avoidance of Double Taxation of 13 May 1870*, (1874).

[17] *Ibid.*

[18] Article 19 of the OECD Model Tax Convention, government service, states in para 1 that salaries, wages and other similar remuneration, other than a pension, paid by a contracting state or a political subdivision or a local authority thereof to an individual in respect of services rendered to that state or subdivision or authority shall be taxable only in that state. Article 19 para 1 sub-para b) restricts this provision by granting the state where the services are rendered the sole taxation rights if the individual is a resident of that state. He has to be a national of that state; or must not have become a resident of that state solely for the purpose of rendering the services. Article 19 paras 2 sub-paras a) and b) refer to pensions. See Lang (2002), p. 184.

[19] Fischer, (1909), p. 58.

The explanatory report of the Reichstag of the Norddeutsche Bund gives the following explanation for this exception: "The motivation for this provision is to ensure that the state that pays salary, pension or Wartegeld also receives the tax deriving from the income it provided from its funds."[50]

The principle was that "these incomes from the state were generally deemed objects[51] for taxation to which the paying state had the first claim; to forbid it to tax these is not deemed appropriate; therefore it alone should have this right."[52] This provision had been taken over from the Prussian-Saxonian Treaty of 1869. It became mainly relevant in regard of retired public servants who had become residents of another state.

Article 4 was controversial from the beginning. Members of the Bundesrat and the Norddeutsche Reichstag fought in vain against this exemption from taxation being based on the residence principle already when the bill was being discussed. They asked for its removal or its restriction to salaries of active public servants.[53]

In 1876, one of the states again asked for its repeal. One argument was: "the state only pays titulo oneroso that which it owes and no right to reduce this payment by taxing it can be derived from that".[54] In addition, practical problems, such as in the case of a mutual appointment of public servants[55] by several states or of income only partly derived from state funds[56], were highlighted.

However, all interventions remained futile until the tax reform 1909, almost four decades later.

3.1.2 The amendment to the Double Taxation Treaty of 1870: "German Double Taxation Act of 22 March 1909"[57]. Following the

[50] *Act on the Avoidance of Double Taxation of 13 May 1870* (1874), p. 14.
[51] See the final chapter of this paper for details.
[52] Clauss (1888), p. 186.
[53] *Ibid.*
[54] *Ibid.*
[55] E.g. customs officials: each state taxed according to its share in the salary.
[56] E.g. when the state made a contribution towards the salary of a teacher at a "höhere Gemeindeschule" (local school), which happened quite often.
[57] Reichsgesetzblatt No.16, p. 332.

abolition of Article 4 in the tax reform 1909, the taxation of the salaries of public servants was newly regulated in article 2 para.3.

The provision of Article 2 para.3 valid until then said that Germans in the service of the Empire or a state could only be taxed in that state in which they were deemed resident for the purpose of their work. This provision was now elaborated: "Germans in the service of the Empire or a state may, as long as they are resident in both the state where they work and another state according to Article 1 para.2 of this Act, only be subjected to direct state taxes in the former state, and if they are not resident in any state according to Article 1 para.2 of this Act, but only are resident for work purposes, they may only be subjected to direct state taxes in the state where they live for work purposes."[58]

The members of the German Reichstag gave the following reasons for repealing Article 4 when they were discussing the bill:[59]

- the exceptional provision was running counter to the basic motivation for the act, taxation following the residence principle
- economic disadvantages could be prevented in the future.

Indeed, a number of public servants were stationed outside the paying state, in particular railway employees. Therefore, a considerable number of tax payers did not pay "their direct state taxes to that state in whose territory they reside and which provides them with state protection and the benefits of its state institutions".[60] The taxes were collected by the state in which the money was withheld directly by the paying institution. The change in the Act now made these states lose revenue and they so experienced considerable financial disadvantages.

The extent of this financial impact could particularly be shown in the example of the largest group affected, the railway employees, when the

[58] Article 1 para 2 says: "A German is deemed resident under to this law when he has a dwelling at a certain location under such circumstances, which lead to the assumption he intends to keep up this dwelling permanently", German Double Taxation Act of 22 March 1909, Reichsgesetzblatt No.16. p. 332. The "place of residence for work purposes" is "the location allocated to a public servant to render his services... irrespective of whether it is at the same time his actual place of residence..." *Finanz-Archiv*, German Double Taxation Act, (1909), p. 373.

[59] German Double Taxation Act, *Finanz-Archiv*, vol. 26-2, (1909), pp. 371 ff.

[60] *Ibid.*, p. 372.

bill was discussed in parliament. Drawing up comprehensive statistics of all public servants affected, all officers, the staff of the marine and postal administrations and other services, as well as the recipients of public servants' pensions and Wartegelder residing outside their state of employment, was seen as too laborious and so these were not presented during the deliberations.

3.1.3 Economic advantages and disadvantages of the abolition of article 4 shown in the example of the railway employees. The main beneficiary of Article 4 of the German Double Taxation Act had been indubitably Prussia. The largest German state extended its railway operations to almost all German states and so employed 14,711 state railway employees outside its own territory. In contrast, only 1,185 state railway employees were stationed in Prussia. In figures, the abolition of Article 4 resulted in a revenue decrease of 379,610 marks in Prussia, while the other states showed a revenue increase of in total 428,734 marks.[61]

Still, Prussia agreed to the changes to the Act. This can be explained by the comparative insignificance of direct taxes for Prussian state revenues (1913: 10,4%). Thus, the revenue shortfall was only roughly 0.01% of regular state revenues, or 0.1% of direct taxes. As already mentioned, the Prussian state mainly acted as an entrepreneur and earned money primarily through its railways (1913: 57.2% of state revenues). "The population financed the state's expenditure more by buying train tickets than by paying taxes".[62]

However, in the German Empire as a whole direct taxes played a much more important role (1913: 35.6% of revenue of the Empire, states and municipalities), therefore other states indeed were able to earn more in taxes.[63]

3.1.4 Reasons for the changes to the Act. According to the Committee

[61] *Ibid*, pp. 377 ff.
[62] Schremmer (1994), p.168.
[63] All figures from Schremmer (1994), pp. 169 and 195.

Report of 6 March 1909[64], it was not the financial effect of the original legal situation that led to the changes in the Double Taxation Act, but the consistent realisation of the principle that every German was to be taxed by that state in whose territory he resided.[65]

It was also referred to the fact that the new provision was more convenient for the persons affected and cases of double taxation could now be avoided. "More convenient" meant that the tax payers were able to avoid the costly and long-winded procedures they had to endure when taking up their right to tax exemption[66]. It happened regularly that people were wrongly taxed twice or had failed to apply for tax-exempt status in time.

In addition, the time limits for appeals of the states were different from those in the Reichsgesetz. The Reichsgesetz of 1870 had failed to make any provisions regarding how to handle court reclaim procedures and when the right to sue would expire[67]. This flaw was rectified with the 1909 amendment.

In most German states income as defined in Article 4 of the Double Taxation Treaty of 1870 was also subject to local taxation. Local taxes were collected by adding surcharges to the state taxes, which amounted to up to 300%. Only in 4 of the 26 states did this income remain tax exempt. It was also quite possible for local taxes to be levied both at the location of the paying state institution and the place of residence, as the abolition of double taxation was not applicable to local taxes. Recommendations of the states to refrain from collecting such unjustified revenues often were ignored.[68]

After a long discussion in the Reichstag, the amendment to the *Reichsgesetz* on the Avoidance of Double Taxation of 1870 was finally published under the name "German Double Taxation Act" on 22 March 1909 in the *Reichsgesetzblatt*.[69]

[64] *Finanz-Archiv*, vol. 26-2 (1909), p. 380.
[65] *Ibid*, p. 373.
[66] *Act on the Avoidance of Double Taxation of 13 May 1870*, (1874), pp. 14 ff.
[67] *Finanz-Archiv*, vol. 26-2, pp. 371 and 380.
[68] See Schanz (1892), p. 32., Antoni (1888), Clauss (1888), and Fischer (1909).
Later international treaties regulated this exemption, e.g. the Double Taxation-Treaty between Austria-Hungary and Bavaria, Reichsgesetzblatt No.243 (1913), p. 864.
[69] Reichsgesetzblatt No.16, p. 332

3.2 Double taxation in Switzerland: income derived from a state.

Although in Switzerland the Federal Constitution of 1848 did not contain any provision regarding double taxation between cantons, a person taxed twice could rely on the articles of the constitution dealing with equality under the law and the freedom of establishment.[70]

From 1862 the Swiss Bundesversammlung (Federal Assembly) had the right to decide on complaints filed on the grounds of double taxation. Thus, over many years, it was possible to create some sort of customary law concerning these matters.[71] The Federal Constitution of 1874 practically prohibited double taxation in general.[72] The Federal Court became responsible for all disputes.

In Switzerland federal tax-legislation was mainly[73] tied to residence, i.e. a Swiss citizen could only be taxed where he had his residence for tax purposes, defined "as a factual relationship, which exists wherever someone intending to stay permanently actually resides".[74] Both for Swiss and foreign citizens, being liable for tax depended on the length of one's stay. This again was subject to diverse regulations in the various cantons.[75]

In Switzerland there was no equivalent to Article 4 of the German Double Taxation Act of 1870. Swiss Federal Law subjected all income derived from the state in double taxation matters to general rules, so it was not the paying state's prerogative to tax it. Two rulings of the Swiss Federal Court on complaints regarding double taxation of public servants provide an example of how the jurisdiction in such matters was handled.

In the first case the state pension of a foreigner was taxed by the foreign state and the canton of residence. The ruling of 11 November 1876 stated that there was no reason "to grant the state paying the pension a primary taxation right vis-à-vis the state of residence."[76]

[70] H. Wetter, *Die internationale Doppelbesteuerung, insbesondere bei Erwerbsunternehmungen,* doctoral dissertation, (1939), p. 38.
[71] Fischer (1909), p. 2.
[72] Wetter (1939), p. 38.
[73] As under German law, the economic relationship was the basis for taxation on property holdings and trades. See the several drafts for a Swiss Federal Law regarding the prohibition of double taxation: A. Spitaler, *Das Doppelbesteuerungsproblem bei den indirekten Steuern,* (1936), p. 4.
[74] Fischer (1909), pp. 7 and 15 f.
[75] *Ibid*, pp. 15 f. and 30 ff.
[76] Clauss (1988), p. 190: Ruling of 11 November 1876, Rulings vol. 2, p. 383.

Another ruling, three years later, on 28 November 1879, however, granted the taxation rights regarding a university professor living in canton Fribourg, but lecturing in Berne, to the canton of Berne, as he was a public servant of the latter and under the law was obliged to be a resident of Berne.[77]

3.3 Austria-Hungary. The question of allocating taxes between the two halves of the Empire naturally only came into existence with the creation of the Austro-Hungarian Dual Monarchy in 1867 through the so-called "Ausgleich" (Compromise). From 1850 to 1866 the Austrian Empire had formed a unit also regarding taxation matters, because after the suppression of the Hungarian revolution, the Austrian tax system had also been introduced in the Hungarian territories.[78]

3.3.1 Political and economic structures in Austria-Hungary. In 1867 the "Ausgleich"[79] between "the kingdoms and countries represented in the Reichsrat (the Austrian Diet)", which from now on simply will be referred to as Austria or Cisleithania, and Hungary (in the following: Transleithania) separated the competences regarding direct taxes: this led to differing tax types and tax rates in the two parts of the Empire, while there was some coordination regarding indirect taxes.[80] Common Reichssteuern (imperial taxes), earmarked for the few "common ("k.u.k." Imperial and royal) matters"[81]

[77] Fischer (1909), p. 70, and Clauss (1988), p.190: Ruling of 28 November 1879, Rulings Vol. 5, p.417 and the related footnote 1): "Il n'est point douteux, qu`un canton ... est autorisé à prélever un impot sur la rétribution de fonctions permanantes exercées sur son territoire et salariées par lui, surtout lorsque le titulaire est astreint à élire domicile dans le lieu où il remplit ses fonctions."

[78] See Szende, p. 196 and F. Fellner, "Die Reform der direkten Steuern in Ungarn", *Finanz-Archiv*, vol. 30, (1913), p. 139.

[79] Austrian Staatsgrundgesetz of 21 December 1867, RGBl. 146/1867, as well as Article 12 of the Hungarian Act of 1867.

[80] M. Menger, "Der österreichisch-ungarische Ausgleich", *Finanz-Archiv*, vol. 4, (1887) pp. 843 ff., and A. Wagner, *Finanzwissenschaft*, Part 3, (1910), pp. 358 ff.

[81] These were mainly foreign policy, the k.u.k. army and navy and financial matters related to these areas. Thus, there were only three k.u.k. ministries (Ministry of the Exterior, War Ministry and Ministry of Finance, although there also were an Austrian and a Hungarian Ministry of Finance). Up to 1918, despite numerous crises, there was also a common currency and common central bank. On the latter see also E. Kolm, "Die Österreichisch-ungarische Bank im Spannngsfeld der Nationalitätenkonflikte", in K. Bachinger and D. Stiefel (eds), *Auf Heller und Cent. Beiträge zur Finanz- und Währungsgeschichte*, (2001).

practically did not exist, the common expenses were mainly financed through customs revenues and the so-called "quotas"[82] of the Empire's two parts.[83]

The economic integration of the monarchy's territories proceeded further[84], within the framework of the "common tariff and trade territory", which existed from the removal of the *Zwischenzoll-Linie* (Customs Line) in 1850 until the end of the monarchy, even though Hungarian politicians kept threatening to end the agreement.[85]

Article XIV of the "Tariff and Trade Agreement", which was seminal for the double taxation problem, stated: "Members of one of the parts of the Monarchy who want to become active in trade and commerce or look for work in the other part, are to be treated as equals in regard of the establishment of a trade, its operation and the taxes and other local charges to be paid".[86] For enterprises with branches and offices in the other half of the Empire this meant that they were taxed there and according to the rules prevailing there.[87]

3.3.2 The tax systems in Cis- and Transleithania. The tax systems in Cis- and Transleithania were quite similar after the division of 1867[88], but developed differently in the following decades. This is mainly due to the

[82] A "Quota" was the respective percentage contribution of the two parts of the Empire to the common budget. Quotas were fixed regularly in the negotiations on the renewal of the Ausgleich (basically every 10 years). See Lippert (1928), pp. 703 ff.

[83] Menger, as well as O. Schwarz, *Die Steuersysteme des Auslandes*, (1908), pp. 35 f.

[84] F. Baltzarek, "Integration im Habsburgerreich", in E. Schremmer (ed.), *Wirtschaftliche und soziale Integration in historischer Sicht*, (1996).

[85] For a short discussion see E. Kolm, *Die Ambitionen Österreich-Ungarns im Zeitalter des Hochimperialismus*, (2001), pp. 51 ff.

[86] Austrian RGBl. 62/1878 and 48/1887, renewed in RGBl. 220/1896.

[87] See RGBl. 89/1871.

[88] "...both direct taxation and the inner consumption and transaction taxation principally adhered to the then existing principles of Austrian legislation, as they had been developed in the centralist period since 1850, although with some changes..." (Wagner 1910, p.414). See also S.M. Eddie, "Economic policy and economic development in Austria-Hungary, 1867-1913", in P. Mathias and S. Pollard (eds), *The Cambridge Economic History of Europe, Vol.VIII: The Industrial Economies: The Development of Economic and Social Policies*, (1989), pp. 845 f.

[89] Fellner, p.139, footnote 1.

[90] P. Bairoch, "Economic Equalities between 1800 and 1913", in J. Batou (ed.), *Between Development and Underdevelopment. The Precocious Attempts at Industrialization of the Periphery*, (1991), p. 3.

uneven pace of modernisation of the socio-economic structures in the two parts of the Empire. "The development of the Austrian tax system was on the whole similar to that of the Hungarian taxes, although it was some steps ahead, just as the Austrian economic system reached a higher level of development earlier."[89] Although from an international point of view Austria was a laggard in the industrialisation process[90] and there were great differences in development within the Austrian half of the Empire, it still had a certain head start compared to the Hungarian half, which only undertook significant industrialisation initiatives in the 1880s.[91] Hungary was able to catch up to a certain extent[92], but remained a mostly agrarian state until the end of the monarchy.[93]

In the financial crisis during and after the revolution of 1848/49, the unitary state "Austrian Empire" had introduced something similar to an income tax, which, in fact, basically was an extension of an already existing tax component, the *Erwerbssteuer* (tax on earnings and acquisitions). Originally intended as a temporary stopgap measure, it was still not abolished, but even increased in the war years 1859 and 1866. In the system, which was not very coherent and deemed unfair, frequently the same tax objects were taxed more than once, particularly because, in addition, there still were high local taxes.[94] Resistance to taxes, tax avoidance and an inefficient administration led to low tax revenues and a high national debt.[95]

[91] On the economic development in the two parts of the Empire: K.M. Fink, *Die österreichisch-ungarische Monarchie als Wirtschaftsgemeinschaft*, (1968), pp. 28 ff.; H. Matis "Die Habsburgermonarchie (Cisleithanien) 1848-1918", in K. Bachinger, H. Hemetsberger-Koller, H. Matis, *Grundriss der österreichischen Sozial- und Wirtschaftsgeschichte von 1848 bis zur Gegenwart*, (1987), p. 21.; I.T. Berend and G. Ranki, "Ungarns wirtschaftliche Entwicklung 1849-1918", in A. Wandruszka and P. Urbanitsch (eds), *Die Habsburgermonarchie 1848-1918.*, A. Brusatti (ed) *Vol.1: Die wirtschaftliche Entwicklung*, (1979).

[92] See the comparison of the (higher) Hungarian with the Austrian industrial growth rates: in the business cycles 1872-1884, 1884-1896 and 1907-1912 in J. Komlos, *Die Habsburgermonarchie als Zollunion. Die Wirtschaftsentwicklung Österreich-Ungarns im 19.Jahrhundert*, (1986), p. 114.

[93] In 1913 the share of the primary sector in Hungary's national income was still 64%, that of the secondary sector 23.3%. In the Austrian part of the Empire on the other hand, industry and trade accounted for 44.2% and primary production accounted for 35.9%. See Fink, p. 77.

[94] On the tax system in the first half of the nineteenth century see R. Sieghart, "Die Steuerreform in Österreich", *Finanz-Archiv*, vol. 14, (1897), pp. 5 ff.

[95] On the "material financial situation in Austria" see O. Schwarz, *Die Finanzsysteme der Großmächte (Internationales Staats- und Gemeinde-Finanzwesen)*, (1909), p. 62.

Various attempts at reform before the *Ausgleich* failed[96] and even afterwards it took almost thirty years until the reform of 1896 adapted the tax system to the changes in the economic and social situation in the Austrian part of the Empire.[97] One item of particular importance was the introduction of a general income tax worthy of that name: "In contrast to the income tax we had so far, which was a misnomer for a rigid real tax system, its successor will be a genuine income tax, i.e. it will adjust the tax to the individual capacity, it will take into account the person receiving the return…" emphasised the tax expert and subsequent top bank manager Rudolf Sieghart.[98]

In Hungary life went at a slightly slower pace:[99] as a first try at reform, after the *Ausgleich*, a general income tax surcharge to the already existing real taxes was introduced in 1875.[100] The comprehensive reforms from 1909 to 1912 were intended to take into account the economic changes of the last few decades and aimed at a more even and fair distribution of the tax burden. The complex old system, which had included eleven taxes, was modernised by introducing a general, personal income tax, in addition to the old real taxes still assessed on a more object-oriented basis.[101]

From this brief historical view we can summarise: in line with the economic and social development of the two parts of the Empire, the Austrian and Hungarian tax systems first developed in different directions from a common basis in 1867, especially after the Austrian reform of 1896; however, they converged again shortly before the First World War.

3.3.3 First provisions to avoid double taxation. The necessity to avoid double taxation became clear in the 1870s, as it stood in stark contrast to the freedoms of capital and labour[102] agreed upon in the "Tariff and Trade Agreement" .

[96] Von Lesigang, "Die bisherigen Versuche zur Reform der direkten Steuern in Österreich, in *Finanz-Archiv*, vol. 6 (1889), pp. 538-766.
[97] A short overview of the system in 1896 can be found in Schwarz (1908), pp. 69 ff. For a more comprehensive sketch see e.g. Sieghart (1897), pp. 14 ff.
[98] Sieghart, p. 59. See also Wagner (1910), pp. 405 ff.
[99] Szende, pp. 216 ff., Fellner, pp. 136 ff.
[100] *Ibid*, p. 152.
[101] Fellner, pp. 159 ff., Wagner (1910), pp. 414 ff., Schwarz (1908), pp. 98 ff.
[102] See footnote 87.

A first such attempt was made with the "Agreement between the k.k. (imperial-royal) Austrian and the k. (royal) Hungarian ministers of finance regarding the division of taxes on enterprises that operate in both territories"[103], concluded in 1869/70 but announced only in 1871. This law regulated the competence in tax matters regarding the Austrian state railways, as well as banks, insurance companies and factory enterprises with branches in the other state territory. In 1873, it was followed by a law regulating the income tax of the First Danube Steamboat Company which also operated both parts of the Empire[104].

We will now only select those of the many double taxation agreements that are of relevance for the state of the fund principle. In this connection, the Austrian Act of 25 October 1896[105], regulating the relationship with Hungary in the following sections, is of particular interest: the first main section (referring to the general tax on earnings and acquisitions), Article 8: here the continued validity of the provisions of Article XIV of the Tariff and Trade Pact[106] is underlined. In addition, the fourth main section (referring to personal income tax and the tax on higher public salaries), Article 153[107]: in paragraph 1 the liability to pay taxes for Austrian citizens was regulated: this was the case automatically when they were living in Austria, "regarding their total income".[108] If they resided outside Austria (for example, in Hungary[109]), only "their total income derived from the territory covered by this Act"[110] was to be taxed. This wording also covered, without explicitly mentioning it, the income Austrian public servants stationed abroad received from the state. Lippert also stresses this point: "Income derived from the state ... is universally taxed in the

[103] RGBl. 89/1871. See also Lippert (1928), p. 531.

[104] RGBl. 54/1873, amended in line with the Agreement on the Avoidance of Double Taxation 1907.

[105] RGBl. 220/1896, quoted from R. Reisch, *Das Gesetz vom 25.October 1896, R.G.B. Nr.220, betreffend die directen Personalsteuern sowie die neben demselben in Geltung verbliebenen bezüglichen Gesetze und Verordnungen,* (1896).

[106] Renewed in RGBl. 62/1878 and RGBl. 48/1887.

[107] This paragraph was only applicable to living persons, as the taxation of legal entities was covered by the second main part. See Sieghart, p. 60, footnote 2.

[108] Article 153, para.1 a).

[109] No distinction was made between Hungary and other countries.

[110] Article 153, para.1 b).

territory of the state paying, irrespective of whether they are received at home or abroad ... The Austrian PStG. (tax law) of 1896 ... does not separately mention this kind of income for Austrians, but their being subject to domestic taxation was clear under Article 153, paragraphs 1 a and b."[111]

In paragraph 2 the liability to personal income tax was regulated for those persons that were not Austrian citizens, in short all foreigners, also including Hungarian citizens. These were liable to tax "if they are resident in the territory covered by this Act or stay within this territory for the purpose of earning income or stay for more than a year, in respect of the income they earn in these territories or receive from abroad. However, income coming from another country is exempt from taxation, if it can be proven that it is already subject to income tax or an equivalent tax."[112] In addition, persons were liable to tax who "operate an enterprise or pursue another profitable occupation in this country, or are partners in such an enterprise or profitable occupation, or derive an income from salaries or pensions from an inland state source, in respect of the income derived from these sources."[113]

In summary, this means that irrespective of a person's nationality and whether he lives in Austria or not: income derived from a domestic state source is always taxed domestically.[114]

The Hungarian tax reforms of the years 1909 to 1912 mentioned above mirrored the relevant provision of the Austrian Personal Income Tax Act of 1896: Hungarians living abroad were only liable to tax in Hungary in respect of the income earned in Hungary. Foreigners living in Hungary

[111] Lippert (1928), p. 595.
[112] Article 153, para.2 a); As can be seen from the Austrian files, it was checked in every single case whether a tax was "equivalent". This allowed some room for interpretation and frequently resulted in double taxation. The wording was changed in the reform of 1914.
[113] Article 153, paragraph 2 b).
[114] However, the provisions of paragraphs 1b) and 2b) were constricted in reference to Article 285, "ensuring reciprocity". This Article was also important because it gave "the Ministry of Finance the right to enact changes to statutory provisions ... by concluding international treaties to avoid double taxation, by decreeing measures to ensure reciprocity..." O. Szombathy, "Die österreichische Einkommensteuerreform von 1914", *Finanz-Archiv*, vol. 23, (1915), p. 616.

in principle had to pay tax on their total income, but income coming in from abroad remained tax exempt if it had already been taxed there.[115]

3.3.4 The first double taxation agreement between Austria and Hungary (1907). As early as in 1897, Rudolf Sieghart in his comprehensive commentary on the Austrian tax reform criticised that the provisions to avoid double taxation contained therein were not sufficient: "The provisions on international income tax law do not *a priori* prevent all double taxation. It would be desirable if, in this important but as yet uncertain field, it were possible to manage an agreement on certain material legal principles to avoid double taxation and to implement the principle of reciprocity."[116]

While Austria on an international level soon entered into the first double taxation treaty with Prussia[117], the first comprehensive double taxation treaty between the two parts of the Empire was only concluded on the occasion of the renewal of the *Ausgleich*[118] in 1907. The explanation for this delay was that "…the most important precondition, the existence of a tax equivalent to the Austrian personal income tax in the countries of the Hungarian kingdom does not seem to be the case…", however, "even currently some measures have been taken to make amends in at least some frequently occurring cases…"[119]. The inclusion of the double taxation issue in the provisions of the Ausgleich legislation was necessary, because "…the manifold interactions between the two tax laws pushed to the surface"[120], i.e. the problems in this area were mounting. The two

[115] G.-A. X of 1909 and G.A. LIII of 1912 (Hungarian Acts), quoted from Fellner, p. 208.
[116] Sieghart, p. 61.
[117] See the extensive discussion in H. Hemetsberger-Koller, "Der wirtschaftspolitische Hintergrund des Doppelbesteuerungsabkommens zwischen Österreich-Ungarn und Preussen 1899". In W. Gassner et al., *Die Zukunft des Internationalen Steuerrechts*, (1999), pp. 13 ff.
[118] The conditions of the Ausgleich were renegotiated every 10 years, which frequently involved crises and an increasingly tense relationship between the two parts of the Empire, resulting in delays in the conclusion of these negotiations.
[119] L. Wittmayer, *Die Ausgleichsgesetze vom 30. Dezember 1907, samt Durchführungsbestimmungen und sonstigen Vereinbarungen. Mit Erläuterungen aus den Materialie unter Berücksichtigung der älteren Normen*, Erläuternde Bemerkungen der Regierungsvorlagen, (1908), p. 119.
[120] *Ibid*, p. XI.

finance ministers settled on an agreement to avoid "double taxation of such enterprises, which operate in both states, as well as on several other matters relating to direct taxation"[121]. The 3rd part ("Referring to the avoidance of some cases of double taxation") explicitly addressed the question of how to deal with the taxation of public servants rendering their services in the other part of the Empire. Article 17 in particular applied to public servants and military personnel rendering their services in the "common" institutions and established that in Austria "Hungarian citizens, who, in the kingdoms and countries represented in the *Reichsrat*, are employed at the Highest Court, at the common ministries and the common Highest Audit Court or at the Royal Hungarian Ministry at the Highest Court in Vienna, or in the common army or navy, … are not to be subjected to capital gains tax and the personal income tax in respect of the income they derive from the countries of the holy Hungarian Crown". Reciprocally this provision also applied to Cisleithanian citizens in "equivalent positions" in the "countries of the holy Hungarian Crown".[122]

Article 18 dealt with all other public servants. Their "salaries, including pensions, which were paid out by state, Hof (court), Länder (Austrian regions), Komitats (Hungarian regions), Stadt (town), Bezirks (district) or Gemeinde (municipality) institutions will … only be taxed in favour of and under the tax laws of the state that made the payment". This provision, which again reflected the state of the fund principle, applied to a certain number of former public servants of the lower hierarchies, as they were advised, in view of their low pensions, "to resettle in places where they could afford living according to their economic means and so were able to make some economies…"[123]

[121] RGBl. 278/30 December 1907, as well as with explanations Wittmayer, pp. 105 ff.
[122] As the central k.u.k. institutions (the 3 common ministries and the Audit Court) were located in Vienna, this provision for public servants affected mainly Hungarian citizens: of the 832 public servants at the k.u.k. Foreign Ministry, 229 were Hungarians, at the k.u.k. War Ministry, however, they were less numerous, with 42 of a total of 614 public servants. See K. Megner, *Beamte. Wirtschafts- und sozialgeschichtliche Aspekte des kk. Beamtentums* (Vienna 1985), p. 255. On the other hand, in the last years of the monarchy there were hardly any public servants with Austrian citizenship in Hungary, as they had all been either forcefully retired or driven away after the Ausgleich at the latest. See *ibid*, p. 235.
[123] Quoted in Megner, p. 150.

The implementation of these provisions in regard of military personnel was regulated by a decree of the k.u.k. Finance Ministry[124], in which it was established that the provisions of Article 17 only applied to military personnel in active service in the k.u.k. army and navy, as well as persons on leave with Wartegeld.

Regarding the "tax treatment of military pensions"[125] Article 18 stated that the retired members of one of the two Landwehren (militias)[126] were to be taxed in the state whose Landwehr they had been members of. The costs of both Landwehren were, after all, borne separately by the two parts of the Empire.[127]

Those retired persons, on the other hand, who had formerly been active in the common (= k.u.k.) army, were to be taxed where they lived in their retirement, "in respect of their total military pensions". Thus they would "be exempt from taxation in the other territory". In this case, and only then, was the residence principle applied to former public servants.

3.3.5 The personal tax amendment of 23 January 1914: principle of residence and explicit definition of the state of the fund principle. The move towards the principle of residence was clearly stressed in the Personal Tax Amendment 1914:[128] as mentioned before, the Act of 1896 primarily differentiated between citizens and foreigners[129], with citizens of the Hungarian part being treated like all other foreigners. The criterion of citizenship was completely abandoned in the following years: As amended in 1914, Article 153, paragraph 1 held all persons to be liable to income tax "who are resident in the territory covered by the Act or stay there for more than a year", although only "Austrian citizens who are resident outside the territory covered by this Act for the purpose of their work as Austrian

[124] Of 31 December 1907, RGBl. 11/1908.
[125] Officers were deemed to be "used to territorial mobility". See Megner, p. 150.
[126] There were three different army formations: the k.u.k. army (including navy), the Hungarian Honvéd and the Austrian Landwehr. See W. Wagner, "Die k. (u.) k. Armee – Gliederung und Aufgabenstellung". In A. Wandruszka and P. Urbanitsch (eds) *Die Habsburgermonarchie 1848-1918*, vol. 5: Die bewaffnete Macht, (1987), pp. 315 ff. and T. Papp, "Die Königlich ungarische Landwehr (Honvéd) 1868 bis 1914", in *ibid*, p. 634.
[127] W. Wagner (1987), p. 588.
[128] See Szombathy, p. 138.
[129] Sieghart, p. 60.

public servants or rendering services for a "common" institution were seen as a special case and " insofar they were not subject to the relevant direct taxes there" were liable to income tax in Austria. The significance of the residence principle is underlined by the Implementation Regulation of 24 March 1914:[130] "Apart from the special provision of Article 153 paragraph 1 sub-paragraph 2, the law does not distinguish between citizens and foreigners, both are subject to income tax alike."

In sub-paragraph c) of paragraph 2 (as amended in 1914) the state of the fund principle was explicitly defined and it was established that "income from salaries or pensions from a domestic state, court, country, district, or municipal institution" was to be taxed in Austria.[131]

Regarding the special relationship with Hungary, the Implementation Regulation referred to the Agreement to Avoid Double Taxation of 1907.

4. The first international double taxation treaties before 1914: establishment of the state of the fund principle

As much as Adolf Wagner, one of the authoritative voices of financial theory in the second half of the nineteenth century, welcomed the Act to Avoid Double Taxation in the German Empire, little did he believe in a further development of this idea in international treaties: "It is hardly to be expected that the principles of this Act, which are arguably right for Germany, will be generally accepted between foreign states. A country without a developed real tax system and with many rich expatriates otherwise would find itself in a dire situation."[132]

Wagner's pessimistic point of view was contrary to the opinion of Austrian experts, who one and a half decades later were convinced that the first international treaty to avoid double taxation, which was concluded between Austro-Hungary and Prussia in 1899[133], formed the foundation "for establishing an international tax law following unitary

[130] RGBl. 62/1914, 1st part (liability to tax, tax exemptions), Article 1, liability to tax (Article 153).

[131] RGBl. 13/1914 (Personal Tax Amendment). See also Lippert (1928), p. 595.

[132] A. Wagner, *Finanzwissenschaft*, Part 2, (1880), p. 314.

[133] This was largely modelled on the German Act to Avoid Double Taxation of 1870, see footnote 42.

principles for the whole Central European web of states"[134]. Today one would say that the Austrians already envisaged some kind of "model convention", which decades later was actually created.

In the eighties and nineties of the nineteenth century there were numerous complaints from tax payers also on an international level, who fought against the double tax pressure in respect of that income derived from abroad for which taxes had to be paid in both countries.

If, once again, we select the special cases of salaries derived from state sources, taxation in practice in the German states already allowed for a diverse range of the assessment of affected foreigners.

- In a few states there was full tax exemption for foreign salaries, pensions and Wartegelder.
- When determining the liability for income tax, often only that part was taxed that was necessary for one's livelihood.
- In some cases it was enough to prove the payment of an equivalent foreign tax in order to become tax exempt.
- Some states taxed the "residence for work purposes"[135],
- Other tax payers could deduct the tax already paid abroad.

"Poorer" states granted tax exemptions for immigrants. This was motivated by economic calculation and was intended to attract pensioners contributing to the indirect tax load through consumption.[136] This, from today's perspective, extremely modern idea nowadays plays a fairly important role for some pensioners when selecting their residence in retirement.

Although in retrospect the actual tax burden on income a hundred years ago was much lower than today, due to low tax rates, it was still considered to be too high and led to massive complaints in the case of double taxation.[137]

[134] ÖStA (Austrian State Archives)/FHKA, GZ 4334, FM 1897. See Hemetsberger-Koller (1999), p. 26.

[135] A public servant's "residence for work purposes" was where he rendered his services, Clauss (1888), p. 166.

[136] This is also referred to by Wagner (1880), p. 313 and Antoni (1888), p. 448, as well as Clauss (1888), p. 145.

[137] Many authors at the time believed that the tax rate, when including all surcharges and special taxes by municipalities, in some cases "exceeded all bearable norms and this led to low tax morale..." Meisel (1914), p. 156 and the literature quoted there.

An example of the state of the fund principle taken from Austrian tax files illustrates this problem in the time before the conclusion of double taxation agreements: a retired Bavarian officer took up residence in Austria and thus had to pay taxes on his pension both in Bavaria and Austria. In a report in a Munich newspaper this example, as well as others, led the journalist to point out this problem of double taxation in such cases: "that property acquired abroad and the income made abroad through artistic, business or other activities is subject to the tax laws of the respective state is disputed by no one. Less clear is the question whether salaries received in your home country, or pensions of retired public servants and finally widows' and dependants' pensions are to be taxed abroad. A foreign state taxes what it deems to be taxable according to its laws. This cannot be seen as retaliation, as this reprisal is the state's right." Furthermore it was argued that the pensions of retired public servants and the support received by widows and surviving dependants of officers and public servants, which were taxable in their home country, should not be taxed a second time abroad, as they merely "consume" money and do not earn it.[138] These cases were also regulated quite quickly by means of an agreement between Bavaria and Austria. Again, the state of the fund principle was legally established in the agreement.[139]

The first international double taxation treaty between Austria-Hungary and Prussia in 1899 was followed until 1914 by four more treaties to avoid double taxation between Austria-Hungary and German states (Saxony 1903, Württemberg 1905, Hesse 1912, Bavaria 1913), two agreements by means of regulations with Liechtenstein in 1901 and Bavaria in 1903, and one on a statutory basis with Hungary in 1907. All agreements established the state of the fund principle.

Switzerland, on the other hand, kept up taxation of income from work based on the residence principle (including public salaries,

[138] ÖstA/FHKA, PZ 9598, 1903. In Austria liability to tax was tested according to Article 153 para. 2a). Taxation ensued, if the tax paid in Bavaria was not categorised as income tax or equivalent tax.
[139] Reichsgesetzblatt No. 123 of 11 November 1903.

Wartegeld, pensions, widows' and dependants' pensions etc) even in international agreements after the First World War.[140]

5. Conclusion

The emergence of a modern national and international tax law in the nineteenth century was based on:

- The modernisation of the economy through the industrialisation process
- New taxation principles, by moving from the system of real taxes to a general income tax and improvements in tax procedures
- The liberalisation of economic systems, especially by means of laws on free movement
- A rapidly growing interconnectedness of national economies
- National and international double taxation agreements

The main pioneers of providing a legal framework for the abolition of double taxation in the nineteenth century were without doubt the German states. Switzerland failed to move beyond the draft stage for separate legislation on double taxation, but in fact the Federal Constitution of 1874 prohibited double taxation within the country. In Austria-Hungary, which following the Ausgleich of 1867 was divided into two practically sovereign countries in tax matters, several tax hurdles were dismantled in various decrees and regulations; however, a double taxation treaty between the two parts of the Empire only saw the light of day in 1907. On an international level, several double taxation treaties were concluded after the turn of the century. Here, too, those states took the lead that had already gathered some experience within their own country.

The contents of the taxation agreements to avoid double taxation were very similar. Basically a person's residence primarily determined one's liability to tax. Real estate and trade enterprises, as well as partly the income arising from these, were taxed following the source principle.

[140] See Treaty between the German Empire and several Swiss Cantons to Avoid the Double Taxation of Income from Work, 24 March 1924, *Finanz-Archiv*, Vol. 21, pp. 109 ff.

Only the German and the Austrian legislations, but not the Swiss one, had an explicit rule that exempted the salaries of public servants from taxation based on the residence principle.

Following the state of the fund principle of the German Double Taxation Act of 1870, the state institution paying the salaries could withhold the taxes at source. This exception was controversial right from the start. Although it was removed completely in the tax reform of the German Empire in 1909, it was still to be found in international treaties after 1909. Within its territory, Austria-Hungary established the state of the fund principle for public servants and military personnel in the Double Taxation Treaty with Hungary in 1907, with one exception: retired military personnel of the common army paid their taxes according to the residence principle.

The justification for the state of the fund principle is mainly found in the literature on financial theory of the nineteenth century: the opinion prevailing then was that the paying state should not forfeit state revenue it was rightfully due, because of the emigration of its citizens.

Arguments that such a situation was economically disadvantageous can be found in Adolph Wagner: "The expatriates' staying abroad have many economic and social disadvantages for the country. Showing particular consideration for these people by exempting them from tax is not necessary, even if these persons are then threatened by double taxation due to the foreign tax. Conversely, even a special tax on expatriates can be seriously considered. All the more so, because the domestic state always suffers a loss in revenue, namely in consumption taxes, but also some transaction taxes and other fees. It is not the home state that should consider these tax payers, but the foreign state, which naturally benefits economically from the presence of such persons staying within its territory".[141]

It could be argued that Wagner's views were those of the year 1880 and thus became out-of-date later. At this point it is also advisable to refer to the fundamental and much-quoted treatise of Georg Schanz of 1892, who, when discussing the question of liability to tax, advised to take the

[141] Wagner, (1880), p. 313.

"economic allegiance" (*wirtschaftliche Zugehörigkeit*) into account as a basis for any decision. Regarding salaries of public servants, he was of the opinion that the economic affiliation to the paying state was given: "Granting the paying state the taxation right corresponds with the economic allegiance".[142]

Gustav Lippert also sums up: "Income derived from a state's institution, such as public servants' salaries, Wartegeld, pensions etc. are generally taxed in the territory of the state that pays out these monies, irrespective of whether the income is received at home or abroad. There would be no reason for letting a foreign state and its economy benefit from this income created by the domestic economy".[143]

In order to understand the state of the fund principle, it is furthermore essential to analyse the special status of the public servants compared to all other employed earners. This special status can be traced back to the Middle Ages.[144] It is remarkable that in contrast to income from general employment, the salaries of public servants were subject to object taxation. Sources that were territorially linked included real-estate holdings, business enterprises in respect of their operations in the respective country and salaries and pensions derived from public institutions.[145]

Public servants were paid according to the Alimentationsprinzip (support principle), following which the public employer had to provide an appropriate livelihood. From a legal point of view, salaries and support payments were not seen as remuneration for services rendered, but as alimentation. The service was not emphasised, but the support.[146]

For public servants that location was of relevance: "where he fits into a closed organism, which was to be his source of the most important rights and obligations."[147] So his income "as a territorially linked source" was subject to a real tax.

[142] Schanz, (1892), p. 32.
[143] Lippert, (1928), p. 595 and reference to Garelli, p. 106.
[144] B. Thiemer, *Das Alimentationsprinzip*, (1992), p. 17.
[145] R. Egger and O. Watzke, "Österreich", in Rosendorff/Henggeler, *Das Internationale Steuerrecht des Erdballs*, (1936), p. 1119.
[146] B. Thiemer, pp. 11 ff., Megner, (1985) pp. 89 ff.
On this question see also g. Schmölders, *Finanzpolitik*, (1970), pp. 211 ff.
[147] Clauss, (1888), p. 166, and the source quoted there.

In the course of the modernisation of income taxation at the end of the nineteenth century and the step-by-step move to a general income tax, the real taxes on work were pushed into the background. Even public servants were, as economic entities, treated more and more like other receivers of income.[148] Public servants' income was thus deemed to be income from work, but the tax on it continued to be withheld at source by the paying institution to keep it simple. The state was not willing to give up this prerogative, as it was known that tax morale in cases of individual declaration of taxes was low. Although Prussia was not the first state within the German Empire to introduce a general income tax, the change was implemented most radically there.[149] So the ground was prepared for changes that in the German Empire made it possible for taxation following the residence principle to achieve a breakthrough, even for public servants' income.

It is interesting to compare today's discussion on the state of the fund principle to the historical arguments. Very similar to more than a hundred years ago, opinions are divided. According to the commentary on the OECD Model Convention, Article 19 has been created to "take into consideration the rules of international politeness and mutual respect between sovereign states".[150]

Debatin and Wassermayer see the state of the fund principle with a critical eye:"...the provision is old hat unsuitable for today. It infringes upon the right to a free choice of residence for public servants. ...Taxation of employees must not be principally based on the person of the employer. There is no reason for a particular employee being taxed differently just because his employer is a public institution. This neither complies with the principle that each person is to be taxed according to his abilities, nor with the principle of equality."[151]

On the other hand, reasons for retaining the state of the fund principle are that it is not reasonable to have the state "differentiate the salary and

[148] Teschemacher, (1927), pp. 75 ff.
[149] Ibid, pp. 121 f.
[150] Vogel, (1996), p. 985.
[151] H. Debatin and F. Wassermeyer, *Doppelbesteuerung*, Vol.1 of the Commentary on the OECD Model Convention, (2002), p. 17.
[152] Vogel, (2003), Article 19. Rodi, p. 1511. See also the arguments from the point of view of constitutional and European law, *ibid*, pp. 1511 ff.

remuneration levels according to the tax level in the state of residence of its public servants. The special personal and material link in responsibility when rendering public services … is an argument in favour of keeping the right to issue directives, the duty to care and fiscal sovereignty all in one hand."[153]

In addition to the justification of the state of the fund principle arising from the financing of remuneration from the paying state's tax revenue, a further argument for taxation by the paying state is the "close link of the public servants to the state", in other words the fact "that the paying state has a special legal relationship with its public servants regarding their employment."[153]

Apart from these arguments brought forward in the discussion from the point of view of financial and legal theory, other motives for keeping the state of the fund principle might equally have played a role, also for the time just after the First World War. Georg Schanz, for instance, presumed in an article in 1923 that one reason for the experts of the League of Nations[154] not incorporating the changes of the German Double Taxation Act of 1909 (abolition of the state of the fund principle) was the convenience of withholding at the source. A breach of this principle would have been "cumbersome".[155]

As a matter of fact, the state of the fund principle was not seriously questioned in the course of the interwar years during which international double taxation treaties where concluded more numerously.[156]

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[154] Bruins, Einaudi, Seligman, Stamp, *Rapport sur la double imposition*, (1923)

[155] G. Schanz, "Die Doppelbesteuerung und der Völkerbund", in *Finanz-Archiv*, Vol. 40 (1923), p. 11.

[156] See F. Kolm, 'The Emerging System of Double Taxation Agreements in the Late XIXth and XXth centuries', *Development and Finance*, Quarterly Hungarian Economic Review, 2/2005.

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