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Income Tax Discrimination: Still Stuck in the Labyrinth of Impossibility

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“Income Tax Discrimination:
Still Stuck in the Labyrinth of
Impossibility”

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Income Tax Discrimination: Still Stuck in the Labyrinth of Impossibility
(forthcoming, Yale Law Journal)

Michael J. Graetz* and Alvin C. Warren, Jr.**

In previous articles, we have argued that European Court of Justice's reliance on nondiscrimination as the basis for its decisions did not (and could not) satisfy commonly accepted tax policy norms, such as fairness, administrability, production of desired levels of revenues, avoidance of double taxation, fiscal policy goals, international fiscal equity, and so on. In addition, we argued that the Court cannot achieve consistent and coherent results by requiring nondiscrimination in both origin and destination countries for transactions involving the tax systems of more than one member state. We demonstrated that—in the absence of harmonized income tax bases and rates—the Court had entered a “labyrinth of impossibility.” Ruth Mason and Michael Knoll claim to have discovered a single, normative criterion that not only resolves this dilemma, but also explains the existing nondiscrimination tax jurisprudence of both the European Court of Justice and the United States Supreme Court. In fact, their crucial, but unrealistic, assumption that taxpayers can never move from one state to another confines the actual scope of their analysis to a very small set of cases involving cross-border workers. Although they endorse economic efficiency as the guidestar for judicial decisions regarding tax discrimination, Mason and Knoll fail to provide any evidence that their proposed norm would reduce tax-induced distortions more than competing norms, even in the limited situations to which their analysis applies. Nor do they make a convincing case that they have found the key to understanding the confusing and inconsistent U.S. and EU judicial decisions, which are not confined to cross-border workers. Finally, implementation of their proposed norm by legislation or litigation is not practical, given the particular tax systems that they say would be required. In short, their proposed norm does not provide a way out of the “labyrinth of impossibility” created by a nondiscrimination approach to taxation of international transactions.

The foundational treaties of the European Union establish a unique system of government.¹ In general, they leave decisions about how to levy income taxes and at what

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¹ Throughout this article, we use the plural to refer to the EU foundational treaties, which continue to evolve. The current version is Consolidated Version of the Treaty on the Functioning of the European Union (TFEU), March 30, 2010, 2010 O.J. C 83/47. For further discussion of the current institutional arrangements, see generally Ruth Mason, *Primer on Direct Taxation in the European Union* (2005); Michael J. Graetz & Alvin C. Warren Jr., *Income Tax Discrimination and the Political and Economic Integration of Europe*, 115 *Yale Law Journal* 1186, 1188-1194 (2006).

rates to the member states. If the member states agree unanimously -- a rare occurrence indeed -- the European Commission, Council and Parliament can together issue income tax directives, but so far these few directives have been limited to rather technical matters.² Within Europe, as elsewhere, cross-border transactions involving income taxation are also governed by an extensive network of bilateral income tax treaties that, while reflecting many common principles, often vary in their details.³

In this context, the European Court of Justice (ECJ) is charged with ensuring, to the extent appropriate and practicable, that the member states' income tax laws do not interfere unduly with the "four freedoms" guaranteed by the treaties: free movement of goods, services, labor and capital.⁴ These freedoms of movement were intended to create an economic market relatively free of internal barriers, as well as greater political union within Europe.

There is considerable tension inherent in this structure, in which each member state retains a veto over European income tax legislation, including proposals that would promote the cohesion of the internal market, while the ECJ reviews the tax laws of the member states to ensure that they do not violate the treaties' guarantees of free movement. The national income tax laws at issue vary across the Union, generally providing an important source of revenue and implementing national distributive and economic policy

² For a comprehensive list of the six income tax directives, from 1998 to 2007, see Philipp Genschel and Marcus Jachtenfuchs, *How the European Union Constrains the State: Multilevel Governance of Taxation*, 50 *J. of Pol. Research* 293, 297-300 (2011).

³ See Org. for Econ. Cooperation and Dev., *Model Tax Convention on Income and on Capital* (2004), available at <http://www.oecd.org/dataoecd/14/132/41/47804.pdf>, last visited July 1, 2011, for the OECD Model Treaty which supplies the template for these bilateral treaties. In the "D" case, the ECJ rejected the judgment of its Advocate General and held that income tax treaties in Europe need not apply a "most favored nation" approach, affirming the ongoing status of varying bilateral treaties in Europe. *D. vs. Inspecteur van de Bebtingdiest/Particulieren/Ondernemingen buitenand te Heerlen*, Case C-376/03 (2005).

⁴ Discrimination on grounds of nationality is also prohibited. TFEU, *supra* note 1, articles 18, 45, 49, 54, 56, 63.

goals in light of each member state's internal political dynamics and conflicts. Variations in income tax laws and rates across Europe affect private parties' decisions about where to work, live, and invest, as well as tax planning efforts about where to locate income and deductions to minimize income tax burdens.⁵

In the 1980s, the European Court of Justice began deciding income tax cases designed to strengthen the Union and to limit the member states' ability to favor their own residents or to favor domestic over foreign investments.⁶ While there is considerable doctrinal confusion in the decided cases, the essential construct used by the ECJ to achieve its goals is the concept of discrimination against cross-border transactions as compared to purely domestic transactions.⁷ While a number of commentators, including us, have criticized these decisions as being incoherent in terms of tax policy, doctrinally confusing, sometimes conflicting, and constitutionally questionable in terms of democratic decision-making, those decisions have no doubt contributed to the economic and political union in Europe.⁸ In recent years, after the expansion of the European Union to twenty-seven members, which in turn expanded the membership of the Court and created even greater diversity among the member states' economies and income tax laws, and after the rejection of a proposed European constitution, the Court has become less aggressive in striking

⁵ E.g., Phillip Genschel, Achim Kemmerling and Eric Serls, *Accelerating Downhill: How the EU Shapes Corporate Tax Competition in the Single Market*, 49 *J. of Common Market Studies* 585 (2011).

⁶ The vast majority of income tax cases decided by the ECJ have been brought by private litigants—most often corporations—challenging national measures. Genschel and Jachtenfuchs, *supra* note 2, at 302-03. This, of course, tends to reduce national revenues since private parties litigate only when victory will reduce their tax liability. In the 1990s, these private litigants succeeded in more than 80 percent of the cases. *Id.*

⁷ See, e.g., Malcolm Gammie, *Non-Discrimination and the Taxation of Cross-Border Dividends*, 2 *World Tax Journal* 162, 170 (2010) (discussing “single non-discrimination principle”).

⁸ See, e.g., Ruth Mason, *Tax Discrimination and Capital Neutrality*, 2 *World Tax J.* 126, 137 (2010) (“The EC non-discrimination principle has been expounded primarily by the ECJ, an institution with a clear political agenda to promote the integration of Europe.”); Miguel P. Maduro, *We the Court: The European Court of Justice and the European Economic Constitution* 70-76, 110-126 (1998) (discussing political consequences of ECJ decisionmaking).

down aspects of member states' income tax laws, accepting justifications offered by the member states that in earlier times the Court would have rejected.⁹

Competition in Europe has had a notable effect on income tax structures and rates in the member states. Although efforts to harmonize income taxes in Europe to alleviate downward pressures have been advanced since the 1960s,¹⁰ such harmonization efforts have proved unavailing; income tax rates and bases differ markedly throughout the EU. Indeed, one recent quantitative study concludes that "tax competition is stronger among the member states of the EU than in the rest of the world."¹¹

In two previous articles, we criticized the Court's income tax jurisprudence.¹² We argued that its reliance on nondiscrimination as the basis for its decisions did not (and could not) satisfy commonly accepted tax policy norms, such as fairness, administrability, production of desired levels of revenues, avoidance of double taxation, fiscal policy responsiveness to economic circumstances, inter-nation fiscal equity, and so on. In addition, we argued that the Court could not achieve coherent results by requiring nondiscrimination simultaneously in both origin and destination countries when goods, services, individuals or capital move from the first country to the second. With regard to

⁹ Suzanne Kingson, *The Boundaries of Sovereignty: The ECJ's Controversial Role Applying Internal Market Law to Direct Tax Measures*, 9 *Cambridge Yearbook of European Legal Studies* 287, 303-310 (2006).

¹⁰ For a brief description of these efforts, see Graetz & Warren, *supra* note 1 at, note 143. For a description of the European Commission's current project for a "common consolidated corporate tax base", see http://ec.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/index_en.htm (accessed July 31, 2011)

¹¹ Genshel et al, *supra* note 5, at 595. See also W. Kerber, "Interjurisdictional Competition within the European Union," 23 *Fordham Int. L. J.* 217, 234 (1999) (describing competition as "an integral part of the constitutional structure of the European Union.")

¹² Graetz & Warren, *Yale Law Journal*, *supra* note 1; Michael J. Graetz & Alvin C. Warren Jr., *Dividend Taxation in Europe: When the ECJ Makes Tax Policy*, 44 *Common Market Law Review* 1577 (2007).

the latter point, we contended that—in the absence of harmonized income tax bases and rates—the Court had entered a “labyrinth of impossibility.”¹³

Let us restate what we mean by this labyrinth of impossibility.¹⁴ The following three principles cannot hold simultaneously in a consistent and coherent way *in the absence of harmonized tax bases and rates*:

Principle 1—Sovereignty in the Origin Country: The origin country¹⁵ can choose how and at what rates to impose income tax on its citizens or residents. The origin country, for example, may decide to tax all of its residents or citizens (including individuals and resident corporations and other business entities, such as partnerships) at progressive rates based on their ability to pay as measured by their total worldwide income with whatever personal or family allowances it deems appropriate.

Principle 2—Sovereignty in the Destination Country: The destination country¹⁶ can choose how and at what rates to impose tax on income earned within its borders. The destination country, for example, may decide to tax individuals (or corporations) on income earned there regardless of whether the earner is local or a foreigner.

Principle 3—Nondiscrimination: To implement the freedoms of movement, equal treatment of domestic and cross-border income-producing labor, capital, and business activities is required in all member states in their capacity both as countries of origin and destination.¹⁷

A simple example may help to understand the conundrum the ECJ faces. Assume that one country, let us call it Britain, taxes income at a 40% rate, while another country, which we shall call Hungary, taxes income at a 15% rate. As a destination county, Britain

¹³ Graetz & Warren, YLJ at 1243.

¹⁴ See Graetz and Warren, YLJ at 1216-23.

¹⁵ In tax parlance, the origin country is generally referred to as the residence country; sometimes it is called the home country.

¹⁶ In tax parlance, the destination country is generally referred to as the source country; sometimes it is called the host country.

¹⁷ For an important article that extends our “labyrinth of impossibility” beyond taxation to a wide range of regulatory contexts, see Alexandre Sayde, *One Law, Two Competitions: An Enquiry into the Contradictions of Free Movement Law*, 13 *Camb. Yearbook of Eur. Leg. Stud.* --- (forthcoming, 2011). Sayde’s statement of the impossibility result describes the three principles as intra-jurisdictional equity, inter-jurisdictional equity, and the absence of harmonization. *Id.* at 16.

may tax Hungarians (as well as Britons) working there at its 40% rate. But this, of course, means that there is an additional tax burden on Hungarians earning income in Britain, compared to Hungarians earning income at home. Hungarians are taxed differently when they move from Hungary to Britain. Taking a job in Britain is not “free” movement for Hungarians (at least in the sense of costless). There is clearly no obligation for Hungary to reimburse its citizens or residents working in Britain for the 25 additional percentage points of income tax they face in Britain, nor does any country do so. Making either Hungary or Britain compensate Hungarians for the additional 25 percentage points of tax they pay when they work in Britain would violate sovereignty in the origin or destination country, respectively. Now consider a British national who works in Hungary. Forcing Hungary not to tax Britons would violate its destination-based sovereignty, so Hungary will typically impose its 15% tax on income earned by foreigners by foreigners working there.¹⁸ Forbidding Britain from taxing the income earned by a British person in Hungary would violate its origin-based sovereignty (and the ECJ has said that member states have no obligation under European law to prevent international double taxation¹⁹), but if Britain imposes its 40% tax on the income earned in Hungary -- even if it allows a deduction or credit for the Hungarian tax paid -- Britons working in Hungary will be disadvantaged compared to Hungarians working there.

While rate differences are important, it is not only tax rates that

¹⁸ The actual rate may vary if the foreign worker does not stay long enough to become a resident for tax purposes, as the destination country will not have full access to the worker’s financial transactions. In that case, countries typically impose a flat-rate final “withholding” tax on domestic income of foreign workers that is designed to approximate the tax burden on domestic workers. See, e.g., Internal Revenue Code of 1986 (as amended), sections 781, 881 (imposing flat-rate taxes on foreign individuals and corporations)..

¹⁹ See, e.g., Damseaux, Case C-128/08, para. 27 (2009); Block, Case C-67/08, para. 28-31 (2008); Kerchaert and Morres, para. 20-24 (2006).

produce such disparities between cross-border and purely domestic activities. Consider, for example, a charitable organization, organized in one country (the country of origin) that has some activities in a second country (the country of destination) when the two countries have different criteria for favorable income tax treatment, such as eligibility for a charitable deduction or exemption from income taxation.²⁰ Exemption in the destination country might, for example, be based on the premise that the activities of the organization relieve that country from having to provide certain public services to its residents.²¹ From the perspective of the origin country, requiring the organization to qualify with additional requirements in the destination country would burden cross-border activity more than domestic activity. From the perspective of the destination country, there is, however, no extra burden because all charities operating there must satisfy the same criteria. Attempting to eliminate barriers to cross-border activity by requiring nondiscrimination from the perspective of both the origin and destination countries does not therefore provide an answer to the question of whether a guarantee of free movement across borders means that such an organization must or must not meet the requirements of the destination country in order to operate there. Rather, a court presented with that question must choose between the two perspectives.

As a final tax example, consider countries that reduce the burden of double taxation of corporate income by providing shareholders a credit for corporate taxes previously paid

²⁰ Cf. *Centro di Musicologia Walter Stauffer v Finanzamt*, Case C-386/04 (14 September 2006) (denial of tax exemption by one member state for rental income earned in that member state by a charity organized in another member state infringed free of movement of capital); *Hein Persche v Finanzamt*, Case 318/07 (27 January 2009) (denial of tax deduction by one member state for in-kind contribution to a charity organized in another member state infringed free of movement of capital); *Missionswerk Werner Heukelbach v Etat Belge*, Case 25/10 (10 February 2011) (denial of reduced succession duties by one member state for contribution to a charity organized in another member state infringed free of movement of capital).

²¹ *Missionswerk Werner Heukelbach v Etat Belge*, supra note 20 at paragraph 31, holds that this is not an adequate ground for treating a charity organized in another member state differently.

with respect to dividends distributed to the shareholders.²² When the company operates in one country (the destination of capital) and the shareholder resides in another (the origin of the capital), which country should extend the credit? If the first country refuses credits to foreign shareholders, it is arguably discriminating against foreign investors. If the second country refuses credits for shares in a foreign corporation, it is arguably discriminating against foreign investment. On the other hand, if both countries grant credits, cross-border commerce will be favored over domestic commerce. Our point is simply that requiring nondiscrimination in both destination and origin countries is not a satisfactory tool for resolving the conflicts between non-harmonized income taxes and the four freedoms (or, indeed, for resolving other basic issues of international taxation).²³

These kinds of cases are not, of course, limited to taxation. More than thirty years ago, the ECJ famously decided that Germany could not refuse importation of a French liqueur because it did not meet a requirement of minimum alcohol content applicable to *both* domestic and foreign products in Germany.²⁴ To do otherwise, the Court decided, would restrict the free flow of goods produced in another member state, infringing what is sometimes called the principle of mutual recognition.²⁵ More recently, the European Commission, Council, and Parliament have struggled to find an acceptable answer to the question of when certain service providers, such as plumbers, licensed in one member

²² These issues are discussed at length in Graetz & Warren, CMLR (2007), *supra* note 12.

²³ Graetz & Warren, YLJ at 1219.

²⁴ *Rewe-Zentral AG v. Bundesmonopolverwaltung für Branntwein*, Case 120/78, 1979 E.C.R. 649 (commonly referred to as *Cassis de Dijon*). For other non-tax examples, see Sayde, *supra* note 17.

²⁵ Joseph Weiler, *Mutual Recognition, Functional Equivalence and Harmonization in the Evolution of the European Common Market and the WTO*, in F. Kostoris Padoa Schioppa (ed.), *The Principle of Mutual Recognition in the European Integration Process* (2005); K. Nicolaidis, *Kir Forever? The Journey of a Political Scientist in the Landscape of Mutual Recognition*, in *The past and future of EU law: The Classics of EU Law Revisited on the 50th Anniversary of the Rome Treaty* 465 (M. P. Maduro & L. Azoulai, eds. 2010).

state, should be permitted to offer their services in other member states with different licensing standards.²⁶ The list could go on and on.²⁷

This is not to say that there is no way out of the labyrinth we have described. In fact, there are three ways. One might, for example, choose to impose only the requirements of the origin country. Europe does this, for example, with drivers' licenses and certain professional qualifications.²⁸ Alternatively, one might impose only the requirements of the destination country. European value-added taxation does this, ceding the power to tax goods and services to the destination country.²⁹ Finally, one could harmonize the origin and destination countries' tax laws and rates. But, absent harmonization, one simply cannot have both origin and destination income taxation and consistent neutrality or equality between cross-border and domestic activity from the perspective of both origin and destination countries.

Nevertheless, Ruth Mason and Michael Knoll claim that they have discovered a single normative nondiscrimination criterion—which they label “competitive neutrality”—that the ECJ *should* be using to decide income tax cases under the treaties.³⁰ In addition, they contend that this norm in fact best describes the criterion that the Court *is* using to

²⁶ The current resolution is found in Directive 2006/123/EC of the European Parliament and of the Council of 12 December 2006 on Services in the Internal Market. A previous version played a role in the campaign against the EU Constitution, particularly in France, where it was said that foreign service providers, symbolized by a Polish plumber, would work in France without having to comply with French regulations. See K. Nicolaïdis, *Trusting the Poles? Constructing Europe through Mutual Recognition*, 14 *Journal of European Public Policy* 682 (2007).

²⁷ For a more comprehensive discussion of such cases, see Maduro, *supra*, note 8; Sayde, *supra*, note 17.

²⁸ For example, see Council Directive 91/439/EEC, July 29, 1991 (pertaining to drivers' licenses).

²⁹ This is done by taxing imports and exempting exports. Such border adjustments put the sales of goods and services within any particular country on an equal footing regardless of the location of production even when there are variations in tax rates among different member states. Phillip Genschel, *Why No Mutual Recognition of VAT? Regulation, Taxation and the Interpretation of the EU's Internal Market for Goods*, 14 *J. of Eur. Public Policy* 743 (2007).

³⁰ Ruth Mason & Michael Knoll, *What is Tax Discrimination?*, 121 *Yale Law Journal*, ___ (2012) [hereafter Mason and Knoll].

decide such cases. They insist that their competitive neutrality criterion offers the ECJ a way out of the labyrinth of impossibility, and, for good measure, would also enable the Supreme Court of the United States to craft sensible and coherent doctrine implementing the Privileges and Immunities and Interstate Commerce clauses of the U.S. Constitution. For Mason and Knoll, competitive neutrality has become the holy grail of tax discrimination.

The argument of their article can be summarized in eight propositions, which we will consider in turn: (1) The paramount role of the tax nondiscrimination principle in common markets such as the EU or the U.S. is to promote economic efficiency. (2) Three familiar efficiency standards for the taxation of capital income can be translated into efficiency standards for taxing labor income. (3) It is reasonable to analyze tax discrimination on the unrealistic assumption that taxpayers cannot change their state of residence. (4) Given that assumption, one of the three efficiency standards, competitive neutrality, is superior to the other two. (5) Properly understood, competitive neutrality requires a precise set of tax rules that courts have no power or ability to promulgate. (6) Nonetheless, courts should interpret tax nondiscrimination to require a particular partial version of competitive neutrality in common markets. (7) The foundational treaties of the European Union and the Constitution of the United States, as well as the decisions of the European Court of Justice and the U.S. Supreme Court, are best understood as actually imposing that partial requirement of competitive neutrality. (8) Because competitive neutrality would impose obligations on both origin and destination countries, it provides a way out of the labyrinth of impossibility.

Mason and Knoll reach their conclusions about tax discrimination by analyzing decisions in several ECJ labor income cases, decisions that, as they say, are relatively easy

to explain.³¹ The exact scope of their claims is, however, somewhat difficult to pin down. The grand title of their article and its opening pages seem to promise a general examination of tax discrimination in the EU and U.S. However, at some points of the article, capital income seems to be excluded from consideration, and the subject of the article appears to be restricted to labor income.³² But other parts of their article are definitely not restricted to labor income. When, for example, Mason and Knoll say that ten percent of the cases decided by the ECJ are tax cases and imply that their analysis and recommendations apply to all such cases,³³ they certainly are not limiting their claims to labor income cases. Likewise, when they argue that the U.S. Supreme Court should adopt their preferred efficiency norm,³⁴ they discuss business cases and do not limit their conclusions to labor income cases. In order to understand the implications of the analysis, we will therefore treat the article as making both a weak claim (tax discrimination in labor income cases should be interpreted to further a particular efficiency norm in the EU) and a strong claim (tax discrimination in all income tax cases should be interpreted in that way in common markets such as the EU and the U.S.).

1. Efficiency as the Norm

Mason and Knoll view the ECJ as engaged in promoting the internal market within Europe and explicitly adopt economic efficiency as the most important norm for deciding tax discrimination cases.³⁵ (They also urge the same criterion for the U.S. Supreme Court in

³¹ Mason and Knoll TAN 94.

³² Mason and Knoll TAN 97.

³³ Mason and Knoll TAN 19

³⁴ Mason and Knoll TAN 227-254. See also TAN 34-35 (labor cases “illustrate problems of tax discrimination”) TAN 91-92 (the goal of article is to provide ECJ guidelines for interpreting “the tax discrimination principle”) TAN 186 (in the EU single market, nondiscrimination should be interpreted to require competitive neutrality).

³⁵ Mason and Knoll TAN 82-92.

such cases.³⁶) To us, this is much too restrictive a focus for constitutional courts. We obviously agree that efficiency is an important external perspective from which to examine judicial decisions involving economic issues. On the other hand, the ECJ's institutional role cannot be so narrowly cabined, particularly in tax cases, where its decisions can constrain such a fundamental sovereign power and will often result in the assignment of a part of a tax base (and the resulting revenue) to one member state, rather than another.

Nor do we agree with Mason and Knoll that the ECJ has unequivocally declared economic efficiency to be the most important underlying value in resolving these tax cases.³⁷ While we have criticized the Court for its institutional role in democratic decision-making, as well as for not sufficiently taking into account legitimate national fiscal and tax policy considerations beyond discrimination,³⁸ the ECJ has clearly been concerned with more than just efficiency, striking down, for example, barriers to free movement to further greater political union across Europe. Moreover, although the Court continues to insist that it will not consider its decisions' impact in reducing member states' revenues, it has (as we predicted it might³⁹) recently given more weight than previously to member states' defenses grounded in fiscal and administrative concerns, such as preventing taxpayer abuses of domestic tax regimes.⁴⁰

Mason and Knoll's decision to make economic efficiency the paramount consideration for ECJ (or U.S. Supreme Court) decision-making is therefore controversial,

³⁶ Mason and Knoll TAN 227-254.

³⁷ Mason and Knoll TAN 91.

³⁸ Graetz & Warren, YLJ at 1212; Graetz and Warren, CMLR at 1602-1603.

³⁹ Graetz and Warren, YLJ at 1253.

⁴⁰ See Kingson, *supra* note 9, Genschef and Jachtenfuchs, *supra* note 2, and Genschef, et al, *supra* note 5. "In the last five years...the ECJ has been particularly inclined to uphold discriminatory tax provisions based on the rule of reason.... This implies that the principles of free market access...inherent to the internal market concept of the Union will have to be balanced against certain national tax policy preferences."

but, in the interest of understanding their argument, let us for now accept that assertion to see where it leads them.

2. Three Efficiency Standards for International Tax Neutrality

As Mason and Knoll note, understanding the tax nondiscrimination principle as essentially promoting economic efficiency is insufficient to give content to that principle, because there are competing notions of efficiency.⁴¹ Consider a U.K. individual or company operating a manufacturing plant in Germany. Should the plant's income be subject to taxation by Germany, by the U.K., or by both? From the perspective of welfare economics, the argument for taxation by only the U.K., the origin country (or residence country in tax parlance), is that taxation would not distort the owner's decisions about where to locate the plant, achieving what is known as "capital export neutrality." If the destination (or source) country, Germany, also taxed, capital export neutrality could also be achieved if the U.K. granted a tax credit for German taxes, including taxes in excess of the U.K. rate (which no country does).

The parallel argument from the perspective of welfare economics for taxation only by the destination (or source) country, Germany in this case, is that the tax distortion between consumption and saving would not depend on the taxpayer's country of residence, achieving what is known as "capital import neutrality." Source-only taxation would also put domestic and foreign-owned plants on an equal footing in terms of income taxation.

As Mason and Knoll acknowledge, unless countries harmonize their tax systems and rates, capital export neutrality and capital import neutrality cannot be accomplished

⁴¹ Mason and Knoll TAN 104, 186-187

simultaneously.⁴² We obviously agree, as we have used the impossibility of simultaneously implementing capital export and import neutrality as an example of the impossibility of requiring nondiscrimination simultaneously in origin and destination countries.⁴³

In recent years, the economists Mihir Desai and James Hines have argued that ownership is another important economic choice that may be distorted by taxation.⁴⁴ Their analysis emphasizes that the large portion of foreign direct investment occurring through mergers and acquisitions had largely been ignored in the literature and focuses on productivity gains potentially available through multinational firms. Consider, for example, a U.K. and a German company competing to buy a French enterprise. Suppose that, in the absence of taxation, the U.K. company had such superior management attributes and other valuable intellectual property in the relevant sector that it would outbid the German company, because the French enterprise would be most productive under U.K. management. If the U.K. tax system distorts the outcome so that the German bidder prevails, worldwide economic welfare would be diminished. Such a tax system would fail to achieve “capital ownership neutrality,” which would be accomplished by exclusive source-country taxation.⁴⁵

Mason and Knoll import these three familiar ideas from discussions of capital income taxation into the domain of labor income taxation, relabeling them “locational neutrality” (no efficiency gains from “shifting workers across jurisdictions”), “leisure neutrality” (which obtains when “leisure is allocated efficiently across jurisdictions”

⁴² Mason and Knoll TAN 29-30; Michael J. Graetz and Michael O’Hear, The “Original Intent” of U.S. International Taxation, 46 *Duke Law Journal* 1021, 1108 (1997).

⁴³ Graetz & Warren, YLJ at 1216-19.

⁴⁴ E.g., Mihir Desai and James Hines, Evaluating International Tax Reform, 56 *National Tax Journal* 487 (2003).

⁴⁵ *Id.* at 494. Capital ownership neutrality could also be accomplished by source and residence-country taxation as long as the latter granted unlimited foreign tax credits for taxes imposed by the former, but no country that grants foreign tax credits grants unlimited credits. *Id.*

because the relevant choice for a worker is the between work and leisure, rather than between saving and consumption), and “competitive neutrality” (“when it is not possible to increase productivity by shifting jobs among people”).⁴⁶ While the first two of these efficiency norms may translate rather readily from capital to labor, applying capital ownership neutrality to workers is problematic.⁴⁷ Hines and Desai ground their case for this norm on productive synergies that may be achieved by specific multinational companies, especially through economies of scope and scale resulting from their intellectual property ownership. While workers, to be sure, may vary in their productivity—a particular pastry chef, for example, may be more productive than another if hired by a particular pastry shop—it is far from clear that the scope and magnitude of the differences among workers are comparable to those that Hines and Desai postulate for large multinational corporations.⁴⁸ Moreover, the productivity of workers in a particular country depends on the amount and type of capital available to workers there, as well as the efficiency of the firm’s owners. This makes the location of capital important to the productivity of workers.

⁴⁶ Mason and Knoll TAN 103-120.

⁴⁷ European analysts sometimes expressly include labor in their analyses of capital export neutrality (CEN) and capital import neutrality (CIN) by relabeling them CLEN and CLIN, respectively. E.g., Frans Vanistendael, *In Defense of the European Court of Justice*, 62 *Bulletin for International Taxation* 90 (2008). Compare Dennis Weber, *Is the Limitation of Tax Jurisdiction a Restriction of the Freedom of Movement* 112, 118-121 (arguing that the ECJ should adopt CLIN as its guidestar for decisionmaking) with John Avery Jones, *Comments on the Conference Papers* 135, 140-41 (arguing that CLEN would be a better approach), both in *Accounting and Taxation & Assessment of ECJ Case Law, 2007 EATLP Conference, Helsinki (2008)* (Michael Lang and Frans Vanistendael, eds). As we discuss in the text, TAN 47 and 68-75, it is not obvious, however, that one would necessarily want to choose the same efficiency norm for labor as for capital.

⁴⁸ The capital ownership analysis of Desai and Hines is based on very precise (and controversial) conditions, such as the assumption that every dollar of investment that goes abroad will be exactly offset by a dollar of incoming investment from abroad. Although Mason and Knoll are aware of these assumptions of the concept they import (Mason and Knoll footnote 136) they do not indicate whether they are making comparable assumptions about, for example, an exact balance between workers entering and leaving a country.

The three norms discussed do not, of course, exhaust the dimensions along which either capital or labor income taxation can distort decisions. For example, one could imagine a capital or labor “residence neutrality” norm, designed to reduce tax distortions of the decision of where to establish corporate residency or where an individual chooses to reside. Consideration of this particular distortion is simply assumed away by the assumption of Mason and Knoll that taxpayers do not change their country of residence, which we consider below. Despite the foregoing reservations about simply importing capital neutrality norms into the taxation of labor income, we now turn to their analysis based on those norms.

3. The Assumption that Taxpayers Cannot Change Residence

As the economists Peter Diamond and Emmanuel Saez have recently emphasized, moving from either a theoretical mathematical model or from calculated examples, as Mason and Knoll do, to policy recommendations requires that the “result should be reasonably robust to changes in the modeling assumptions.”⁴⁹ Mason and Knoll do not provide any precise model from which they derive their claims. Instead, the mathematical heart of their analysis is a series of two-by-two matrices and examples that explicitly assume taxpayers cannot change their country of residence.⁵⁰ Even as to the weak claim of the paper, limited to labor income in the EU, this key assumption is unrealistic. Although the precise rules vary somewhat among the member states, an individual generally changes residence for tax purposes in the EU if she spends more than 183 days in another member state in any given year. As the European Commission puts it on its web site, “If

⁴⁹ Peter Diamond and Emmanuel Saez, *The Case for a Progressive Tax: From Basic Research to Policy Recommendations*, forthcoming *J. of Econ. Perspective* (manuscript at 2).

⁵⁰ Mason and Knoll, following TAN 98.

you spend more than 6 months in a year in another EU country, you will, in most cases, become a tax resident of that country."⁵¹ Mason and Knoll therefore base their entire analysis on an assumption that EU citizens will not take a job in another country if they have to live in the other country for more than six months. While labor mobility may historically have been more limited in the EU than the U.S.,⁵² the addition of Eastern European member states has increased wage differentials and, as a result, lower-income workers have increasingly crossed borders in recent years.⁵³ In addition, migration of highly educated (including high-tech) workers has long been of concern to many governments, including those in Europe.⁵⁴ As for mobile high-income workers, such as star soccer players, there is ample evidence that Europeans are quite willing to change their residence, specifically in response to lower tax rates.⁵⁵

Whatever one thinks of the assumption that taxpayers cannot change their residence for purposes of the paper's weak claim, that assumption is patently implausible for purposes of any stronger claim. Mason and Knoll do not suggest any reason to suppose

⁵¹ http://ec.europa.eu/youreurope/citizens/work/jobseeker/taxes/index_en.htm (accessed June 10, 2011) (emphasis in the original).

⁵² A European Commission portal aimed at facilitating job mobility indicates that about 2% of EU citizens currently live and work in a member state other than their country of origin (without specifying how long a period is involved). When new member states are admitted to the EU, there is sometimes a transition period that postpones full freedom of movement for a number of years for citizens of the new member state. <http://ec.europa.eu/eures/main.jsp?acro=job&lang=en&catId=52&parentId=0> (accessed June 10, 2010). An important initiative that is expected to improve mobility of university graduates is the standardization of diplomas in the European Higher Education Area begun by the Bologna Process in 1999. See <http://www.ehea.info/article-details.aspx?ArticleId=13> (accessed June 13, 2011)

⁵³ Gordon, Jennifer, Free Movement and Equal Rights for Low-Wage Workers? What the United States Can Learn from the New EU Migration to Britain (May 1, 2011). UC Berkeley Law School, Chief Justice Earl Warren Institute on Law and Social Policy Issue Brief, available at SSRN: <http://ssrn.com/abstract=1864628>

⁵⁴ OECD Observer Policy Brief, International Mobility of the Highly Skilled 1 (July 2002)(finding important intra-regional migration of the highly skilled in Europe).

⁵⁵ Kleven, H., Landais, C., & Saez, E., Migration of Superstars: Evidence from the European Football Market, NBER Working Paper 16545 (2010) (finding that the level of top tax rates has a large impact on the migration decisions of EU soccer players); Camille Landais, LeBronomics: Do Taxes Really Affect Location Decisions of High-Paid Workers, SIEPR Policy Brief, Stanford University, January 2011, available at <http://siepr.stanford.edu/publicationsprofile/2253>, last visited August 31, 2011 (same).

that owners of capital (whether individuals or companies) are not able to change their residences (or place of incorporation). Nor do they offer any reason to believe that American workers do not move their residence from one state to another.⁵⁶

Given its implausibility, why do Mason and Knoll assume that residence is fixed? The justification offered is that cross-border discrimination for workers can come about only when a worker resides in one member state and works in another, because moving across the border would subject a worker to residence taxation in the state of his new home.⁵⁷ While the situation of “cross-border workers” (the authors’ term)⁵⁸ who do not move is undoubtedly a subject worthy of analysis, that subject is remarkably confined when measured against the grand project promised by the article. Of the ECJ tax discrimination cases, only about 20 percent (or two percent of the ECJ’s cases) involve labor income.⁵⁹

Having made the assumption of fixed residence, Mason and Knoll analyze a series of cases using two-by-two matrices in which workers face different tax regimes. The results in each case depend on the assumption of fixed residence.⁶⁰ These matrices do indeed

⁵⁶ Census data suggests that about 15 percent of the population moves every year and that about 40 percent have moved over a five-year period. <http://www.census.gov/hags/migration/data/cps/html>, last visited July 29, 2011.

⁵⁷ Mason and Knoll TAN 99. Mason and Knoll claim that the tax treatment of a French resident who moves to Germany is no longer a concern of EU law Mason and Knoll TAN 99.

⁵⁸ E.g., Mason and Knoll TAN 72.

⁵⁹ For a comprehensive list of the ECJ direct tax cases, see the EU website, http://ec.europa.eu/taxation_customs/common/infringements/case_law/index_en.htm (as of July 7, 2011), last visited July 27, 2011.

⁶⁰ Consider, for example, just two of the cases Mason and Knoll examine in detail. In one instance, they analyze German and French residents who work in both Germany and France, when the only tax is an origin-based income tax on a country’s residents wherever they work (Figure 3, page __). This produces a different tradeoff between labor and leisure for German and French citizens when the applicable tax rates are 20 percent and zero, respectively. This conclusion, however, depends on assuming away the possibility that a German worker would move to France or would remain there for more than six months to benefit from the French tax rate of zero. In another instance, they analyze a German income tax applied only to French residents working in Germany, concluding that the tax will distort only French residents’ decisions about where to work (Figure 4, page __). This conclusion also depends on assuming away any possibility that a

represent the situation of cross-border workers, but we do not see how any *general* implications about tax discrimination can be drawn from them. The assumption of fixed residence obscures the risks of tax-induced distortions to choices of residence, which should be included in any realistic analysis of the economic efficiency consequences of tax discrimination. As Mason and Knoll put it in their discussion of pure residence taxation, their assumption that residence is fixed relieves them from even considering the very real possibility that individuals or corporations shifting their residence across jurisdictions may increase output.⁶¹ It also means that the different residence-based tax rates in their examples are of no relevance for cross-border workers' decisions about where to work, since no one can change their residence to take advantage of lower rates.⁶²

The assumption also obscures the possibility that the location of jobs may change, making it impossible in the absence of a formal model to sort out the effects of such a change from a change in which worker is performing the job.⁶³ The entire analysis of the paper is concerned with enhancing the ability of more productive workers to cross borders to work, but we know that many jobs may move across borders. If one is focused on income tax burdens on labor productivity in Europe, as Mason and Knoll are, one should surely consider cases where production may be relocated. Indeed, in today's global economy, capital moves faster than labor and there may well be only a relatively small

French worker would move to Germany or would remain there for more than six months to benefit from the zero German tax rate. Their entire analysis is grounded in such immobility.

⁶¹ Mason and Knoll TAN 118.

⁶² As Mason and Knoll indicate, TAN 119-127, differences in residence tax rates may, of course, affect choices between saving and consumption or between work and leisure. For further discussion of the limited role that tax-rate differentials play in their analysis, see *infra* TAN 93-98.

⁶³ Mason and Knoll do not explicitly consider the possibility of jobs moving until they reach the possibility of non-uniform taxes, TAN 139-147. On the other hand, the subsequent numerical example of non-uniform taxes (Table 3) seems to depend on workers changing where they work, rather than jobs moving. See also their note 162.

minority of tasks that can be performed only in a specific location. Moreover, the productivity of workers, which is the factor that Mason and Knoll regard as of overriding importance, depends crucially on how much real capital they have to work with.⁶⁴ Clearly, Mason and Knoll do not intend their analysis and conclusions to be limited to migrant workers crossing borders temporarily to immobile jobs, such as the olive pickers who come to the Mediterranean states each fall, but such workers are representative of the cases that they analyze and where their crucial assumptions actually hold.⁶⁵

Although the assumption that residence never changes effectively confines the actual analysis of the article to cross-border workers,⁶⁶ we want to continue considering the article's argument on its own terms, so we now turn to the case for competitive neutrality, keeping in mind that assumption.

4. The Normative Case for Competitive Neutrality

Since Mason and Knoll's norms of locational neutrality, leisure neutrality, and competitive neutrality lead to different income tax design decisions, how should a policy-maker or judge choose among them? Because these norms depend on a welfare economics framework, the choice presumably should depend on how much distortion occurs along each dimension, which, in turn, depends on the underlying supply and demand conditions, including the relevant elasticities. For example, one important long-standing result in

⁶⁴ See, for example, Hans-werner Sinn, *EU Enlargement, Migration, and Lessons from German Unification*, 1 *German Economic Review*, 299 (2000) (lessons from German Unification—emphasizing capital movements—for European policy regarding labor migration); Assaf Razin and Efraim Sadka, *Fiscal and Migration Competition*, NBER Working Paper 16224, July 2010 (modeling productivity differences among workers based on differences in capital/labor ratios).

⁶⁵ The two ECJ decisions chosen “to illustrate the controversies surrounding EU tax discrimination doctrine” both involve cross-border workers, Mason and Knoll TAN 65-79.

⁶⁶ Late in the article, footnote 162 states that even if the assumption of fixed residence were relaxed, uniform taxes would still implement competitive neutrality under certain circumstances. The reasoning in the footnote is so abbreviated that we cannot evaluate its generality, but if the assumption of fixed residence is not necessary to the authors' argument after all, we wonder why the reader has been led through a multitude of matrices and examples in which that assumption is determinative of the outcome.

economists' comparisons of capital export and capital import neutrality is that the former is more apt when the supply of capital in source and residence countries is fixed, while the latter is more apt if the demand for capital is fixed and the supply elastic.⁶⁷ When neither of those extreme conditions is met, countries are often described as compromising between these two efficiency norms.⁶⁸

In any event, a policy decision based on an economic efficiency standard should be grounded in evidence as to the magnitude of the various distortions. Accordingly, economists who prefer capital export neutrality over capital import neutrality generally believe that tax-induced locational distortions are greater than tax-induced savings distortions.⁶⁹ So, for example, in addressing the question whether the U.S. should forgo residence-based taxation in order to achieve capital import neutrality in the interests of reducing economic distortions, the staff of the Joint Committee on Taxation has concluded that a "tax rate on outbound investment lower than the tax rate on domestic investment can only increase economic welfare if the improvement in efficiency from the increase in saving is greater than the reduction in efficiency from the misallocation of savings."⁷⁰ Not surprisingly, when Mihir Desai and James Hines proposed capital ownership neutrality (on which Mason and Knoll's concept of competitive neutrality for labor income rests), they emphasized empirical studies of the behavior of multinational corporations, suggesting, in

⁶⁷ Thomas Horst, A Note of the Optimal Taxation of International Investment Income, 94 Q.J. Economics 793 (1980).

⁶⁸ Michael J. Graetz, Taxing International Income: Inadequate Principles, Outdated Concepts and Unsatisfactory Policies, 54 Tax L. Rev. 261, 269-272 (2001).

⁶⁹ E.g., U.S. Treasury Department, The Deferral of Income Earned Through U.S. Controlled Foreign Corporations: A Policy Study 23-54 (2000); see also U.S. Congress, Joint Committee on Taxation, Factors Affecting the International Competitiveness of the United States 248 (JCS-6-91, May 30, 1991) (noting that a policy that reduces all tax rates (applied to domestic and foreign source income equally) is superior on efficiency grounds to a policy of equal revenue cost that reduces tax rates only on foreign source income).

⁷⁰ U.S. Congress, Joint Committee on Taxation, *supra* note 69, at 247.

that context, that tax-induced ownership distortions are large and important.⁷¹

Surprisingly, Mason and Knoll concede that, of the three neutrality benchmarks they discuss, many economists would view violations of locational neutrality as having the largest negative welfare consequences.⁷²

Peter Diamond and Emmanuel Saez have emphasized that economic analyses are relevant for policy only if the economic mechanism “is empirically relevant and first order to the problem at hand.”⁷³ Importantly, a number of sophisticated economic and legal analysts read the evidence as inconclusive, not pointing in any clear direction as to which version of capital income neutrality is a more important efficiency norm for tax design, whether by a legislature or a court.⁷⁴ In addition, economists have found that the appropriate efficiency norm may vary depending on the extent to which foreign and domestic activities complement or substitute for one another and how capital expenditures are treated.⁷⁵

Mason and Knoll concede that their versions of competitive neutrality would violate locational neutrality or leisure neutrality, giving rise to distortions along those margins.⁷⁶

⁷¹ E.g., Mihir Desai and James Hines, *Evaluating International Tax Reform*, 56 *National Tax Journal*, 487, 491 (2003); but see Mitchell Kane, *Ownership Neutrality, Ownership Distortions, and International Tax Welfare Benchmarks*, 26 *Virginia Tax Review*, 53, 60-66 (2000) (contesting the import of the empirical evidence).

⁷² Mason and Knoll TAN 209.

⁷³ Diamond and Saez, *supra* note 49, at 2.

⁷⁴ E.g., Harry Grubert & Rosanne Altshuler, *Corporate Taxes in the World Economy: Reforming the Taxation of Cross-Border Income*, in *Fundamental Tax Reform: Issues, Choices, and Implications* 319, 320 (John W. Diamond & George R. Zodrow, eds, 2008) (“[None] of these benchmarks is satisfactory because the argument supporting them usually takes place within very simple models.”) American Bar Association Section of Taxation, *Report of the Task Force on International Tax Reform*, 59 *Tax Lawyer* 649, 660-61, 680-89 (2006). See also Kane, *supra* note 71; Stephen E. Shay, *Ownership Neutrality and Practical Complications*, 62 *Tax L. Rev.* 317 (2009).

⁷⁵ Michael P. Devereux, Clemens Fuest and Ben Lockwood, *The Taxation of Foreign Profits (CEN, CON, etc.): A Unified View*, manuscript June 27, 2011, available at http://www.sbs.ox.ac.uk/centres/tax/symposia/Documents/Lockwood_MD_%20CF%20final%20v3.pdf, last visited July 6, 2011.

⁷⁶ Mason and Knoll, footnote 163, text after table 4, and TAN 186.

They nevertheless choose competitive neutrality over locational neutrality and leisure neutrality as the superior efficiency standard for judging tax discrimination. Remarkably, they fail to offer any evidence whatsoever that the distortions that would be prevented by competitive neutrality are greater than the distortions that would be prevented by the other two efficiency benchmarks they analyze and reject, even given their unrealistic assumption of fixed residence. Nor do they offer any theoretical reason to conclude that competitive neutrality is the superior standard for efficiency.

We obviously agree that differences in member states' income taxes may distort decisions as to which worker gets which job (or which company owns which enterprise), but, just as obviously, these taxes may distort locational decisions about both where to work or reside and where to locate capital by both individuals and corporations, as well as the tradeoffs between work and leisure and between saving and consumption. It is not possible on economic efficiency grounds to privilege one potential set of distortions over others without any comparison of their relative magnitudes. For example, if jobs are in fact more mobile than workers, locational neutrality may be much more important to economic efficiency than competitive neutrality. Without such evidence, we simply cannot know whether a norm based on enhancing workers' ability to compete for jobs across borders is more welfare-enhancing than the other efficiency norms.

In discussing normative arguments, Mason and Knoll say at several points that they are not arguing that competitive neutrality would *best* promote EU welfare because more intrusive measures, such as harmonization, might be more welfare-enhancing,⁷⁷ in part because such measures might also promote locational and leisure neutrality. Fair enough;

⁷⁷ Mason and Knoll TAN 34-35, TAN 206-207 (emphasis in the original).

the authors are under no obligation to consider every possible tax policy. On the other hand, having explicitly adopted the economist's notion of welfare⁷⁸ and having defined and extensively analyzed three competing welfare norms, they surely owe the reader an efficiency-related explanation for choosing one of the three as the superior efficiency norm.

The authors sometimes characterize their argument as merely "interpretive,"⁷⁹ but that characterization does not relieve them of the obligation to provide a cogent reason for urging a particular welfare norm. As indicated above, their view is that efficiency is and should be the key focus of the ECJ in deciding tax discrimination cases. Given that view, we cannot understand how they can advocate one of three diverging pathways to greater efficiency without explaining why that pathway is likely to produce superior efficiency results.

Mason and Knoll do suggest five non-efficiency advantages of interpreting nondiscrimination to require competitive neutrality: increased predictability, promotion of representation reinforcement and political unity, avoidance of legislative decisions, resolution of open questions, and, they claim, a way out of the labyrinth. Some of these results, such as increased predictability, greater certainty through resolution of open questions, and avoidance of legislative decisions, would obtain under any of the three efficiency (or other) standards.⁸⁰ And some, such as promotion of representation reinforcement, avoidance of legislative decisions, and greater political unity (again offered without any evidence) depart from their insistence that enhancing economic efficiency in an internal market is and should be the Court's prime focus. Moreover, none of these

⁷⁸ Mason and Knoll TAN 102.

⁷⁹ Mason and Knoll TAN 34-35, 187.

⁸⁰ Mason and Knoll footnotes 210, 215.

asserted advantages addresses the question of why competitive neutrality is the superior benchmark, even if one limits the analysis to the economic efficiency norm they urge.

Despite the foregoing shortcomings of the article's normative claims for the competitive neutrality standard, we shall now examine Mason and Knoll's view of the tax laws that would be required to implement that standard.

5. The Tax Law Requirements of Competitive Neutrality

Mason and Knoll develop the requirements of competitive neutrality by comparing two equally productive workers, Felix and Gunther, who are competing for jobs in France and Germany. The consequences of various tax regimes are displayed in five tables, in which the requirement of fixed residence is maintained.⁸¹ The problem with these tables is that they do not even present the issue of competitive neutrality that is the subject of discussion. Because Mason and Knoll explicitly assume Felix and Gunther to be equally productive, there cannot, by definition, be a welfare gain or loss in competitive neutrality terms from their switching jobs. (There could, of course, be welfare gains or losses from violations of locational or leisure neutrality if taxpayers change jobs due to taxes, but that is not the subject of the tables.) Therefore when the authors conclude that subjecting Felix, but not Gunther, to worldwide taxation violates competitive neutrality,⁸² they are simply wrong, given their definition of competitive neutrality ("it is not possible to increase productivity by shifting jobs among people").⁸³ Although the discussion is complex (to use

⁸¹ Mason and Knoll TAN 148-162.

⁸² Mason and Knoll note 151.

⁸³ Mason and Knoll TAN 132-133.

the authors' characterization),⁸⁴ the examples analyzed in the tables thus fail to elucidate the concept of competitive neutrality, as defined in the paper.⁸⁵

Although the examples and tables used in the paper do not actually illustrate the phenomenon of competitive neutrality, let us nevertheless examine Mason and Knoll's view of what tax laws would be necessary to implement that concept. Competitive neutrality, according to Mason and Knoll, requires either of two income tax systems. One alternative is that *all* residence countries would adopt worldwide taxation with unlimited credits for income taxes paid to source countries.⁸⁶ Whenever the destination-country tax rate is higher than the residence-country rate, this system would require the origin country to refund to its taxpayers the additional amounts they pay abroad. As Mason and Knoll note, under such a system, source-country taxation becomes irrelevant to competition.⁸⁷ However, no country has such a tax system, nor will any country enact such a system, because no country is willing to sacrifice its revenues from taxing domestic activities to refund taxes paid to another country.

⁸⁴ Mason and Knoll TAN 161-62.

⁸⁵ The authors seem to realize this in a footnote following the last relevant table in the text, in which they concede that "strictly speaking" there is no welfare loss due a distortion shown in that table (Mason and Knoll note 159). The footnote then suggests that a different type of example could show a violation of competitive neutrality. The discussion in the footnote is so abbreviated that we cannot evaluate its generality, but even if it is accurate, a careful reader surely wonders why she was asked to work her way through a complex discussion of inapposite examples. Indeed, in spite of footnote 159, the assumption of equal productivity reappears later in the article, Mason and Knoll TAN 179.

⁸⁶ Mason and Knoll TAN 148. The idea of efficiency gains from worldwide taxation with unlimited tax credits was originated by Peggy Musgrave in the 1960s. Peggy B. Musgrave, *Taxation of Foreign Investment Income: An Economic Analysis* (1963); Peggy B. Musgrave, *United States Taxation of Foreign Investment Income* (1969).

⁸⁷ Mason and Knoll TAN 148. Mason and Knoll note in footnote 148 that eliminating source country taxation would also satisfy competitive neutrality but they rule this out as unrealistic because *no* country forgoes source taxation. They do not indicate why they regard unlimited foreign tax credits as realistic even though *no* country has such a credit.

Mason and Knoll's second alternative for achieving competitive neutrality is for *all* countries to tax both residents and nonresidents on a source basis and then to tax residents again on their worldwide income, with a deduction from that income for the source-based tax they paid (at home or abroad). Mason and Knoll call this "the ideal deduction method," which includes the possibility of exempting all foreign income (by setting the residence tax at zero).⁸⁸ These two versions of the ideal deduction method are, however, as unrealistic as the unlimited credit proposal. The proposed mandatory two-tier system does not exist in Europe, the United States, or anywhere else as far as we know.⁸⁹ Although dividing source and residence taxation into two tiers has been discussed in the past, it has generally been rejected by taxing authorities as too complicated for practical administration.⁹⁰ The second possibility, exemption of foreign income coupled with zero residence taxes would be simpler, but is equally unrealistic. Many developed countries exempt foreign-source dividends paid by subsidiary corporations to their parents, but none have complete exemption of foreign source country earnings. Nor have any countries with significant economies been willing to abandon residence taxation.

To achieve Mason and Knoll's preferred norm of competitive neutrality, *all* the member states of Europe (and presumably all the states of the United States) would have to

⁸⁸ Mason and Knoll TAN 151. These deduction and exemption regimes produce, of course, different results.. Compare Table 2(deduction) on page __ with Table B(exemption) in footnote 156. The presentation of these results is particularly confusing. In Table 2, it is assumed that pre-tax wages adjust to differences in source country tax rates, so that wages equalize across countries on an after-source-tax basis, whereas the opposite is assumed in Table B. No explanation is offered for this difference. Moreover, an earlier discussion indicated that taxation in only the source country, which is what is illustrated in Table B, *would* result in a adjustment in pre-tax wages. Mason and Knoll note 128.

⁸⁹ In illustrating such a system, for example, Mason and Knoll describe Germany as a country "where taxes are 50%" but Gunther, who works and lives in Germany, actually pays a 75 percent tax to Germany, which, under the "ideal deduction method," taxes his wages at 50 percent on a source basis and another 50 percent on his after-source tax wages because he is a German resident. See Mason and Knoll TAN 153-154. This is a major departure from the common understanding of what it means to tax residents' income at a 50 percent tax rate.

⁹⁰ See, e.g., Peter A. Harris, *Corporate Shareholder Income Taxation and Allocating Taxing Rights between Countries* 446-500 (1996)(discussing the "composite tax principle")

adopt an income tax system that *none* now has. And all would have to adopt exactly the same system (but each could set its own rates). Of course, as the authors concede, the “choice of how to tax cross-border income is a legislative question.”⁹¹ For any such change to occur legislatively at the European Union level, this would have to be done unanimously.

Neither the European Court of Justice nor the U.S. Supreme Court has the legal authority to require that states adopt *any* of these very specific taxing systems. Implementing either system would require the court to harmonize their methods of taxing cross-border income by imposing the same system on *all* states. Nothing could be more antithetical to the European treaties’ assignment of primary authority over income taxation to the member states, including the unusual requirement of unanimity.

Finally, let us say a word about the limited role of tax-rate differentials in Mason and Knoll’s analysis of competitive neutrality. Earlier we indicated that, in the absence of a formal model, the assumption of fixed residence made it impossible to sort out differences between changes in the location of jobs and changes in the worker performing the job.⁹² When applied to Mason and Knoll’s concept of competitive neutrality, that assumption also obscures the effect of differences in tax rates in any realistic tax system. Under the unlimited credit they postulate, differences in source taxes become irrelevant to foreign investors because of credits and refunds in the residence country. Under their exemption alternative, residence taxes are assumed to be levied at the same (zero) rate. Under the ideal deduction, the assumption of fixed residence assumes away the effect of differences in tax rates on where taxpayers might choose to live or organize their businesses. The diminished role of rate differences under their standard of competitive neutrality is thus a

⁹¹ Mason and Knoll TAN 168-169.

⁹² Supra, TAN 61-64.

function of unrealistic presuppositions (fixed residence, zero rates, unlimited credits and so on). In any more realistic setting, tax-rate differentials play a much more significant role, as many European commentators have observed with respect to both labor and capital income.⁹³ The limited role of rate differences is thus surprising in an article that begins by postulating that taxes are the only thing that matters in workers' decisions about "where to work, how much to work, and which job to work."⁹⁴

Of course, the courts, whose decisions concern Mason and Knoll, have no ability whatsoever to affect tax rates or to redress any economic dislocations or effects on EU welfare that differing tax rates may induce. As they acknowledge, the ECJ "has expressly held that cross-border disadvantages arising from rate differentials do not constitute discrimination."⁹⁵ But, since tax rates (or tax rates net of social insurance and other welfare benefits) may be the most important tax factor in the individual and corporate decisions being analyzed, this creates a conundrum for both the ECJ and Mason and Knoll. For the ECJ (as we and others have shown), it results in confusing, contradictory, and changing patterns of decisions. And, it necessarily plunges Mason and Knoll into a second

⁹³ See, e.g., Commission Staff Working Paper, *Company Taxation in the Internal Market*, SEC (2001) 1681 (Oct. 23, 2001), available at http://europa.eu.int/comm/taxation_customs/resources/documents/company_tax_study_en.pdf (finding rate differences the most important corporate tax distortion within the EU); Kleven, H., Landais, C., & Saez, E., *Migration of Superstars: Evidence from the European Football Market*, NBER Working Paper 16545 (2010), *supra* note 55 (finding that the level of top tax rates has a large impact on the migration decisions of EU football players); Razin and Sadka, *Fiscal and Migration Competition*, *supra* note 64 (considering effects of tax rates net of benefits in home and host countries).

⁹⁴ Mason and Knoll, TAN note 98. They recognize, of course, that many other factors are crucial to these decisions; indeed they list thirteen others, including wage differentials, which are particularly large among Europe's member states. One estimate is that wages in the first group of eastern European countries admitted to the Union ranged from 8 percent to 23 percent of those in western European member states, such as Germany. Sinn, *supra* note 64, at 299. In 2003, hourly wages in the accession countries were only 14 percent, or one-seventh, of those in Germany. Hans-Werner Sinn, *EU Enlargement, Migration and the New Constitution*, 50 *CES of Economic Studies* 685, 686 (2004). Mason and Knoll assert, without any analysis or evidence, that adding these factors would not "dramatically" change their results. *Id.*

⁹⁵ Mason and Knoll, TAN 54.

or third best world in analyzing and evaluating the efficiency of the ECJ's nondiscrimination jurisprudence.

The required departure from the political understanding enshrined in the treaties and the unrealistic assumptions of competitive neutrality confirm our view that constitutional courts should not be making tax policy based on abstract and contradictory principles of nondiscrimination. Mason and Knoll's view is different. After conceding that courts cannot implement the neutrality concept they prefer, they then go on to suggest that judges may nevertheless promote that concept by interpreting prohibitions against discrimination in a certain way, to which we now turn.

6. Proposed Constitutional Version of Competitive Neutrality

Despite admitting that courts are incapable of fully implementing a requirement of competitive neutrality, Mason and Knoll still argue that both the ECJ and the Supreme Court should strike down legislation by interpreting nondiscrimination requirements *as if* competitive neutrality were a constitutional requirement. Specifically, they urge that income tax laws should be struck down whenever they involve nonuniform source or residence taxes.⁹⁶ There is no indication that this advice is limited to labor income cases involving cross-border workers. To avoid confusion between the actual requirements of competitive neutrality advanced by Mason and Knoll and the related constitutional standard that they urge be applied by courts, we will call the latter "partial competitive neutrality." For readers who are unwilling to embrace competitive neutrality, Mason and Knoll also identify partial versions of locational neutrality (uniform residence taxes) and

⁹⁶ Mason and Knoll TAN 169-71 . Mason and Knoll define uniform source taxes as a tax applied by the source country "to all workers with income from its territory, regardless of the workers' residence." Id. TAN 112-113 A uniform residence tax is at tax applied by a country "on the same basis to all residents, regardless of the source of their income." Id. TAN 118-119.

leisure neutrality (uniform source taxes with no residence taxes) that they say constitutional courts could apply.

At this point, we are mystified by what theory of constitutional interpretation Mason and Knoll have in mind. Having chosen efficiency as the paramount norm for constitutional interpretation in this area, they have urged one efficiency concept—competitive neutrality—over competing formulations, albeit without providing any empirical (or theoretical) basis for the choice. Then, after conceding that courts do not have the legal or institutional competence to implement the requirements of the concept they favor, they nonetheless urge courts to elevate competitive neutrality to constitutional status. They ask courts, to the extent of their ability, to invalidate legislation that fails to conform in a particular, partial way to their competitive neutrality concept. For us, the institutional and conceptual gaps between the assumed constitutional norm (efficiency) and the proposed interpretative standard (uniformity) alone are simply too great to make the connection compelling as a matter of constitutional law.

Is it even clear that using *partial* competitive neutrality as a constitutional standard will necessarily reduce distortions and advance competitive neutrality? Formulation of this partial concept endorses certain attributes of competitive neutrality (uniformity) and suppresses others (for example, their two-level tax with an “ideal” deduction). Why then should we conclude that the former necessarily advances the overall goal of improving efficiency, even though the latter cannot be required? Without more analysis, we are not convinced that partial competitive neutrality will always advance competitive neutrality. Indeed, the theory of the second best shows that in the presence of other distortions, it cannot be assumed that reduction any one economic distortion will always increase overall

welfare.⁹⁷ Consider, for example, a residence country, let us say Poland, that adopts a limited foreign tax credit. Due to the foreign tax credit limitation (which is not consistent with competitive neutrality, but which is both universal in credit countries and beyond the scope of judicial invalidation in Europe and in Mason and Knoll's framework), Polish individuals and companies may decide not to compete for projects in a higher-tax source country for which they have a comparative advantage, distorting ownership of those projects. In order to induce Polish and other foreign individuals or companies to bid on projects within its borders, the source country might respond by lowering its income tax only for foreigners (or in a bilateral tax treaty only for Polish individuals and companies). As we understand Mason and Knoll, the ECJ (and the U.S. Supreme Court) should strike down the nonuniform favorable source tax as a violation of partial competitive neutrality, even if the nonuniformity simply offset another distortion, thereby promoting competitive neutrality overall.⁹⁸

7. The Positive Claim for Competitive Neutrality

Mason and Knoll argue not only that competitive neutrality *should* be adopted as the judicial standard of tax nondiscrimination in common markets, they argue also that the European treaties' four freedoms and the decisions of the ECJ *are* consistent with competitive neutrality, *but not* with locational or leisure neutrality.⁹⁹ They claim that this

⁹⁷ R.G. Lipsey & Kelvin Lancaster, *The General Theory of Second Best*, 24 *Review of Economic Studies* 11 (1956). In note 208, Mason and Knoll recognize the difficulty of making definitive statements about welfare in the presence of other distortions, but do not indicate how that affects their analysis.

⁹⁸ The ECJ case law is confusing and has changed over time regarding when discriminatory taxation of a cross-border transaction in one member state will be upheld if offset by tax advantages in the other member state. Joachim Englisch, *Coordination between Member States in the EU: Role of the ECJ*, manuscript at 10 (2011). at 16-17. The ECJ has made it clear, however, that it will not impose a most-favored nation requirement in bilateral tax treaties within Europe. See the *D* case, *supra* note 3.

⁹⁹ Mason and Knoll TAN 186-204.

convergence with their preferred norm can be discovered in both the text of the freedoms and the ECJ's jurisprudence, including in the Court's overall approach to tax cases.

Needless to say, imputing a particular economic concept, such as competitive neutrality, to constitutional documents, such as the EU treaties, and to an extensive set of constitutional decisions striking down national laws would be a daunting task. To be convincing, the exercise would presumably include examination of preparatory documents, analysis of a multitude of tax cases, comparison with non-tax cases decided on comparable grounds, and so on. Mason and Knoll do not undertake that massive task, nor will we. Instead, we restrict our comments here to why we do not find convincing their arguments that the text of the freedoms and the ECJ's approach to tax cases accord with competitive neutrality, but not with locational or leisure neutrality.¹⁰⁰

¹⁰⁰ Mason and Knoll make two other arguments that the ECJ's jurisprudence is consistent with competitive neutrality, but not locational or leisure neutrality. First, they argue, TAN 193, that the idea that discriminatory taxes harm particular parties aligns only with the first of those three standards. They say that violations of locational neutrality do not create winners and losers (even relative winners and losers), but harm everyone. They apparently have in mind the idea that high taxation of capital in one country could be shifted to workers there (resulting in lower wages) and cause capital to flow to lower-rate countries (reducing the marginal pre-tax rate of return for capital in those countries). While we agree that the incidence of any tax must take into account taxpayer reactions, there is no reason to believe that those reactions would mean that all taxpayers are harmed to the same extent by violations of locational neutrality. Suppose residence country R decides to tax foreign income significantly more heavily than domestic income. We think that an R company that engages primarily in foreign commerce will be disadvantaged more than an R company that engages primarily in domestic commerce. It is certainly true that the ensuing taxpayer adjustments (e.g., more capital remains at home in R, perhaps reducing the marginal rate of return to all R companies) may affect all taxpayers. But the same is true of taxpayer adjustments in response to violations of competitive neutrality. Suppose higher taxes in R cause an R company to lose a bidding contest to acquire a company in source country S (where there is no local tax) to a competing company from low-tax country L, when the R company would have outbid the L company in the absence of taxation due to the R company's greater expertise in the S company business. We agree that the R company is disadvantaged, but that is not the end of the story. As in the previous case, there will also be taxpayer adjustments here that need to be taken into account. Workers at the S company may have lower wages because L management is less efficient than the R company management would have been. All investors in R may earn a lower rate of return on their investment, because the R company capital remains at home, increasing the supply of capital. Without a fully specified model of the relevant relationships, there is simply no logical basis for claiming that *only* competitive non-neutralities harm particular parties.

Second, Mason and Knoll argue, at TAN 194-195, that the two labor income decisions analysed in their article provide "anecdotal evidence that the ECJ does not regard the nondiscrimination principle to require locational or leisure neutrality," whereas those decisions *could* be reconciled with competitive

To begin with, there are simply too many counter-examples that come immediately to mind. To take but one example, neither the ECJ nor the U.S. Supreme Court invalidates legislation that *advantages* foreigners over residents or cross-border transactions over domestic ones. Such “reverse discrimination” is very controversial in the literature,¹⁰¹ but the ECJ has “consistently refused” to strike down such provisions,¹⁰² even though they are clearly nonuniform under Mason and Knoll’s definition. As Miguel Maduro has observed, accepting the home-country principle (residence-only regulation or taxation such as by mutual recognition) reflects the “acceptance of reverse discriminations.”¹⁰³ In income taxation, the so-called “Beckham rule” in Spain, which provides favorable income tax rates for foreign professional soccer players, may be the most famous example of reverse discrimination.¹⁰⁴ Non-uniform “patent boxes” are also common in Europe.¹⁰⁵

The U.S. Supreme Court has likewise sustained discrimination in favor of nonresidents corporations over resident corporations, while invalidating discrimination in favor of resident over nonresident corporations,¹⁰⁶ inducing one leading commentator to observe that the constitutional guarantee of equality “was not designed to protect the

neutrality. The authors do not put much weight on this argument, a judgment we share, particularly since the holdings of the two decisions are strongly criticized elsewhere in the paper. See Mason and Knoll TAN 180 (where they criticize the holding of *Finanzamt Köln-Altstadt v. Schumacker*, Case C-279/93, 1995 E.C.R. I-225 that personal benefits must be available at least “once somewhere” as inconsistent with competitive neutrality); id. TAN 185-86 (where they characterize the facts in *De Groot v. Staatssecretaris van Financiën*, Case C-385/00, 2002 E.C.R. I-11819, as not violating competitive neutrality).

¹⁰¹ See, e.g., Sayde, *supra* note 17, at 24-26, and the sources cited there in his note 130.

¹⁰² Sayde, *supra* note 17 at notes 131 and 132 and the cases cited therein.

¹⁰³ Maduro, *We the Court*, *supra* note 8, at 131.

¹⁰⁴ See Kleven, H., Landais, C., & Saez, E., *Migration of Superstars: Evidence from the European Football Market*, *supra*, note 55 .

¹⁰⁵ See, e.g., Shanahan, *Is it Time for Your Country to Consider the "Patent Box?," PricewaterhouseCoopers Global R&D Tax Symposium*, May 23, 2011 (countries that have implemented a patent box regime include Belgium, China, France, Hungary, Ireland, Luxembourg, the Netherlands, and Spain; the UK has announced its intention to adopt a patent box regime effective in 2013) .

¹⁰⁶ Compare *Allied Stores, Inc. of Ohio v. Bowers*, 358 U.S. 522 (1959) (sustaining exemption for nonresident but not resident corporations from state’s property tax for merchandise stored in a local warehouse) with *Wheeling Steel Corp. v. Glander*, 337 U.S. 562 (1949) (invalidating tax on accounts receivable owned by nonresident corporations while exempting similar accounts receiveable owned by foreign corporations).

wolves from the sheep.”¹⁰⁷ Although the U.S. Supreme Court has occasionally struck down provisions providing incentives for local investments and jobs,¹⁰⁸ the Court has also made it clear that the Constitution “does not prevent the States from structuring their tax systems to encourage the growth and development of intrastate commerce and industry.”¹⁰⁹

In addition, Mason and Knoll assume that the free movement of *portfolio* investment (by shareholders) is fully sufficient to achieve locational neutrality for *direct* investments (of corporate capital). On that assumption, they conclude that application of the freedom of movement to both portfolio and direct investment in the treaties *must* mean that capital ownership neutrality is being protected, because freedom of movement for direct investment is unnecessary for locational neutrality.¹¹⁰ On the same assumption, they also argue that freedom of movement for workers would be superfluous if nondiscrimination were aimed at locational neutrality, because free movement of portfolio capital would achieve equality of capital-labor ratios across borders. Mason and Knoll provide, however, no support from the economics literature for their extraordinary assumption. Nor do they

¹⁰⁷ 1 Jerome R. Hellerstein & Walter Hellerstein, *State Taxation* ¶ 3.05[2][a] at 3-34 (3rd ed. 2011 rev.).

¹⁰⁸ See generally Walter Hellerstein & Dan T. Coenen, *Commerce Clause Restraints on State Business Development Incentives*, 81 *Cornell L. Rev.* 789 (1996).

¹⁰⁹ *Boston Stock Exchange v. State Tax Commission*, 429 U.S. 318, 336 (1977). The Court’s most recent encounter with state tax incentives designed to encourage local economic development involved review of the controversial decision of the U.S. Court of Appeals for the Sixth Circuit in *Cuno v. DaimlerChrysler, Inc.*, 386 F.3d 738 (6th Cir. 2004), which struck down Ohio’s income tax credit for new in-state investment on the ground that it discriminated against interstate commerce in violation of the Commerce Clause but at the same time sustained the state’s personal property tax exemption for new in-state investment over Commerce Clause objections. The U.S. Supreme Court vacated the portion of the decision striking down the income tax credit on the ground that the plaintiff, a taxpayer who objected to the “corporate welfare” the state was providing to DaimlerChrysler, lacked standing to pursue her claim in federal court. *Daimler Chrysler Corp. v. Cuno*, 547 U.S. 332 (2006). At the same time, the Court denied the taxpayer’s petition for certiorari from the portion of the opinion that sustained the tax exemption. *Cuno v. DaimlerChrysler, Inc.*, 386 F.3d 738 (6th Cir. 2004), *cert. denied in part*, 547 U.S. 1147 (2006). While the Court did not reach the merits of either claim, its disposition of the issues at a minimum reflects the continuing incoherence of the law in this area.

¹¹⁰ Mason and Knoll TAN 188.

identify the market conditions necessary to reach the conclusion that freedom of movement for portfolio investment (by shareholders) would efficiently eliminate *all* capital locational distortions by companies, so that freedom of movement for direct investors would not be necessary to achieve locational neutrality. Those conditions are likely to be wildly unrealistic. As Mason and Knoll indicate, many economists are likely to view violations of locational neutrality as having greater negative welfare consequences than violation of leisure or competitive neutrality.¹¹¹ On efficiency grounds alone, a more plausible reading of the freedom of movement is therefore that the goal of locational neutrality for corporate investment cannot be simply ruled out as superfluous.

Mason and Knoll also say that interpreting the nondiscrimination requirement to require locational neutrality would preclude the exemption method of taxing international income, because locational neutrality requires solely origin-based taxation or residence-based worldwide taxation with unlimited tax credits.¹¹² Similarly, they observe that interpreting nondiscrimination as leisure neutrality requires only destination-based taxation and would preclude residence taxation.¹¹³ Since the ECJ decisions clearly permit both the exemption method and residence taxation without unlimited credits, they conclude that the decisions cannot be regarded as implementing either principle. In the traditional language of international tax policy, the Court's decisions are not fully compatible with limiting nondiscrimination to either capital export or capital import neutrality. As indicated above, we obviously agree, as one of the points in our original

¹¹¹ Mason and Knoll TAN 206-207.

¹¹² Mason and Knoll TAN 196-197.

¹¹³ Mason and Knoll TAN 199-200.

article was that some cases point in one of these directions and others in the opposite direction, leading to incoherent and inconsistent results.¹¹⁴

However, it seems equally obvious that the ECJ cases cannot be read as implementing competitive neutrality, because the Court has never indicated that an unlimited foreign tax credit or “ideal deduction” is required by the nondiscrimination standard. In considering locational and leisure neutrality, Mason and Knoll test the ECJ jurisprudence against the actual analytical requirements of those concepts, not against the partial standards they have proposed for judicial interpretation. When considering competitive neutrality, however, they use a different, much more lenient test, focusing on certain language in the ECJ decisions to conclude that they are compatible with the logic behind their partial version of competitive neutrality.¹¹⁵ If, however, a similar test were applied to all three concepts, the ECJ decisions would be regarded as just as incompatible with competitive neutrality as with locational and leisure neutrality.

Having insisted that their preferred norm of competitive neutrality can be found in the EU treaties and cases, Mason and Knoll also assert that dormant Commerce Clause and the Privileges and Immunities Clause of the U.S. Constitution, as interpreted by the U.S. Supreme Court, promote that standard as well.¹¹⁶ As with the European Court, this conclusion is both normative and positive, and the discussion goes far beyond cases involving cross-border workers. We have already indicated why we think the normative case for competitive neutrality is inadequate, even given the authors’ efficiency norm. As for the positive claim that competitive neutrality explains the hitherto confounding U.S.

¹¹⁴ Graetz & Warren at YLJ at 1216-19.

¹¹⁵ Mason and Knoll TAN 202.

¹¹⁶ Mason and Knoll TAN 225-254.

decisions, Mason and Knoll's analysis is remarkably limited, spanning only a few pages and discussing only a couple of cases. Indeed, their discussion of tax nondiscrimination in the United States focuses almost exclusively on the Privileges and Immunities Clause, which they recognize does not even apply to corporations, the principal litigants in interstate tax discrimination cases. Moreover, although there may be Commerce Clause cases involving discrimination that could, with the benefit of hindsight, be cast in a competitive neutrality mode, the overwhelming proportion of interstate tax discrimination decisions cannot be fairly be read as saying anything about residence or source. Rather, they reflect the view that Commerce Clause discrimination "simply means differential treatment of in-state and out-of-state economic interests that benefits the former and burdens the latter,"¹¹⁷ for whatever that is worth. Finally, even Mason and Knoll appear to acknowledge that, unless and until the Supreme Court adopts their competitive neutrality analysis, its jurisprudence may fairly be characterized as "a series of confused and incoherent tax discrimination decisions."¹¹⁸

A convincing showing that competitive neutrality is the key to understanding the Supreme Court's extensive nondiscrimination jurisprudence would thus require a much fuller analysis of the very large number of relevant decisions. In sum, Mason and Knoll's claims that their norm of competitive neutrality follows from the text of the ECJ treaties and the U.S. Constitution and can be found in the ECJ and Supreme Court cases interpreting these founding documents are simply not convincing.

8. Competitive Neutrality As a Way out of the Labyrinth of Impossibility

¹¹⁷ *Oregon Waste Systems, Inc. v. Department of Environmental Quality*, 511 U.S. 93, 99 (1994); see generally 1 Hellerstein & Hellerstein, *supra* note 107, at ¶ 4.14 (discussing case law).

¹¹⁸ Mason and Knoll TAN 243.

Finally, Mason and Knoll insist that competitive neutrality, unlike locational or leisure neutrality, offers a way out of the labyrinth of impossibility. As our article was about the European Court of Justice's jurisprudence, we presume that it is the partial version of competitive neutrality that they formulate for courts that is relevant here.¹¹⁹ It is, however, worth our stating why their full version of competitive neutrality does not resolve the impossibility of applying a nondiscrimination principle in both origin and destination countries in the absence of harmonization of tax systems and rates, which is the proposition we reiterated at the beginning this paper.¹²⁰ The full version of competitive neutrality contemplates harmonization of all tax systems, but not rates, into one of two unrealistic systems: (a) worldwide taxation with unlimited foreign tax credits or (b) two-part taxation of source and residence income, accompanied by either (i) a deduction for source taxes (paid at home or abroad) or (ii) an exemption for foreign income (when residence taxation is set at zero).¹²¹ Such harmonization obviously undermines the sovereignty in the origin and destination countries that we postulated above. Moreover, as Mason and Knoll recognize,¹²² their harmonized version (a) eliminates any role for taxation of cross-border income in the destination country, as the country of origin must credit or reimburse all foreign taxes. Version (b)(ii), on the other hand, eliminates any role for taxation of cross-border income in the origin country, which must exempt foreign income. Only version (b)(i) maintains a role for taxes in both countries, but it creates a locational incentive to invest or work at home or abroad, depending on relative tax rates, thereby

¹¹⁹ Cf Mason and Knoll TAN 33-34, 132 with id. TAN 224-225.

¹²⁰ *Supra*, TAN 14-18.

¹²¹ These requirements are summarized by Mason and Knoll in Table 4 (TAN 166), as clarified by notes 166-167.

¹²² Mason and Knoll TAN 148-149.

discriminating for or against cross-border movement of capital or labor.¹²³ This distortion could, of course, be eliminated by harmonizing tax rates as well as tax systems, but, as we have said, harmonization of both income tax bases and rates would avoid the impossibility result. Without such harmonization, however, different tax rates distort people's choices about where to live and work and companies' decisions about where to locate their subsidiaries and their plant and equipment. And, as Mason and Knoll acknowledge, neither the ECJ nor the U.S. Supreme Court has the power to compel such harmonization.

Turning now to the partial version of competitive neutrality that Mason and Knoll propose for judicial decision-making, their claim seems to be that it provides a way out of the labyrinth because there is nothing fundamentally incoherent about imposing requirements of uniform taxation on both source and residence countries from the perspective of partial competitive neutrality.¹²⁴ Note, however, that they also assert that uniform residence taxes maintain locational neutrality and that uniform source taxes with no residence taxes maintain leisure neutrality,¹²⁵ while they also admit the impossibility of having locational and leisure neutrality simultaneously.¹²⁶ So, as they concede, their approach crucially requires a court to restrict its analysis to the laws of a single country when considering cross-border transactions involving two or more countries.¹²⁷

As we indicated in our original article, our analysis, like the ECJ's, is not so restricted because we view the nondiscrimination interpretation of the four freedoms as protecting

¹²³ That discrimination is shown in Mason and Knoll's Tables 2 and 3 by the higher pre-tax wage in Germany (Mason and Knoll TAN 154). As the authors indicate, enough workers have shifted their place of employment to lower-taxed France in response to the tax differential to achieve the equality of after-source-tax wages shown in the table. Mason and Knoll note 154; see also their note 128.

¹²⁴ Mason and Knoll TAN 224-226.

¹²⁵ Mason and Knoll, note 163.

¹²⁶ Mason and Knoll, TAN 30-33.

¹²⁷ Mason and Knoll TAN 224-225.

taxpayers against a higher tax burden for cross-border income than for domestic income.¹²⁸ We also discussed there an alternative, more limited view that was not subject to our impossibility result. Under this alternative view, which has a long intellectual history in the EU,¹²⁹ nondiscrimination would preclude a member state only from taxing more heavily income that crosses its borders than income that does not. As with Mason and Knoll's recommendation, such limited alternatives would look only at one member state's laws and would not take into account the tax situation in the other member state. As one example of this approach, we cited the argument of Wolfgang Schön that nondiscrimination should only require (a) source countries to adopt capital import neutrality and (b) residence countries not to unreasonably hinder the export of capital, whether human or monetary.¹³⁰ This prescription is essentially similar to (if not identical with) Mason and Knoll's partial version of competitive neutrality, which would require (a) source countries to adopt uniform source taxation and (b) residence countries to adopt uniform residence taxation.¹³¹

As in our original article, we agree that these approaches avoid our impossibility result. The rub is that they require the ECJ to restrict its analysis of nondiscrimination to a single country, ignoring the tax system in any other country implicated in cross-border commerce, a restriction that Mason and Knoll regard as salutary.¹³² Our own view is that any serious attempt to identify the tax advantages or disadvantages for cross-border income should take account of the tax consequences in both countries. In any event, as

¹²⁸ Graetz & Warren, YLJ, at 1220.

¹²⁹ Graetz & Warren, YLJ, notes 116-118.

¹³⁰ Graetz & Warren, YLJ, note 116, citing, inter alia, Wolfgang Schön, Tax Competition in Europe—the Legal Perspective, 9 EC Tax Rev. 90, 97-99 (2000).

¹³¹ The definition used by Mason and Knoll for uniform source and residence taxes is set forth in note 96, *supra*.

¹³² Mason and Knoll TAN 221-223.

Mason and Knoll concede,¹³³ it is clear that the Court does not consider itself subject to any such restriction, as many of its nondiscrimination decisions require evaluation of the taxing systems in *both* source and residence countries.¹³⁴ As Joachim Englisch has put it, the “ECJ has repeatedly held that discriminatory taxation of cross-border transactions in one member state can be offset by tax privileges in the other state with links to the transaction at issue.”¹³⁵ The limited approach that Mason and Knoll recommend is thus not a way out of the ECJ’s labyrinth any more now than when we wrote our original article.

Moreover, even if the Court, contrary to its longstanding practice, were to decide to restrict its requirement of income tax nondiscrimination to a single country, we are skeptical that Mason and Knoll’s partial competitive neutrality would, as they claim, always provide “clear direction”¹³⁶ in difficult cases. Reconsider two of the tax examples with which we began this article: Would an EU member state (the destination country) be permitted to deny deductions for contributions to a charity organized in a second member state if the first state treated all charities the same by requiring them to meet its own requirements? That would seem to be the result under the requirement of uniform destination-country taxation, but it would also be inconsistent with many ECJ decisions and EU practices privileging origin country laws by requiring mutual recognition.¹³⁷ Would a

¹³³ Mason and Knoll TAN 221.

¹³⁴ E.g., *Marks & Spencer plc v. Halsey*, Case C-446/03, (Apr. 7, 2005) (deductibility by parent company of losses of subsidiary located in another member state depends on treatment in other state); *In re Manninen*, Case C-319/02, (2004) (dividend credit in country of a shareholder depends on treatment in country of the dividend-paying corporation); “N”, Case C-470/04, (September 7, 2006) (exit taxes). For other examples, see Graetz & Warren, YLJ, note 120.

¹³⁵ Englisch, *supra* note 98, at 16. Once both countries are considered, it becomes clear that Mason and Knoll’s approach would not create the “level tax playing field” between domestic and cross-border transactions they claim to supply, Mason and Knoll TAN 33, 200, because, as they admit, that there would still be a “drag” on cross-border transactions. Mason and Knoll TAN 254-255.

¹³⁶ Mason and Knoll abstract and TAN 254-255.

¹³⁷ See notes 25 and 27, *supra*. Although Mason and Knoll argue, TAN 189, that their concept of competitive neutrality is consistent with the landmark decision in *Cassis de Dijon*, *supra* note 22, we think just the

country from which an investment in corporate stock originated be required to grant tax credits to the shareholders for corporate taxes paid to another country if it granted such credits for purely domestic dividends? That would seem to be the result under origin-country uniformity, but it would also result in favoring cross-border transactions over domestic transactions if the country from which the dividends were paid also granted a credit.

Consider, finally, a same-sex couple who marry in a member state permitting such marriages and then move (for more than six months) to take new jobs in a member state that does not permit such marriages. Would it be permissible for the destination state to deny the newly arrived residents income tax benefits accorded married couples on the grounds that all same-sex couples are treated the same in that country? If not, the new residents would be better off than same-sex couples that had always lived in the destination country. On the other hand, the denial of benefits could create a disincentive for a single-sex couple to move to another member state to take jobs for which they have a comparative advantage. Mason and Knoll simply avoid such cases by their assumption that taxpayers cannot change their country of residence. We, however, do not see how a standard of competitive neutrality provides “clear direction” and an obvious answer to this important, realistic question.¹³⁸

opposite. In that case, the country of destination, Germany, had a uniform law that prohibited sale of liqueurs that did not meet a minimum alcohol content, whether produced domestically or imported from another member state. In spite of that uniformity, the ECJ struck down the German law, on the grounds that it restricted the free movement of goods.

¹³⁸ Cf. *Romer v. Freund Hansestadt Hamburg*, Case 147/08 (May 10, 2011) (extension of public employee benefits to (different-sex) married couples but not to (same-sex) registered partners violates an EU directive prohibiting discrimination on the basis of sexual orientation). Regarding a same-sex marriage recognized in one member state, the European Commission’s website contains the following statement: “In principle, your marriage is guaranteed to be recognised in all other EU countries - but this does not fully apply to same-sex

9. Conclusions

Let us summarize our differences with Mason and Knoll in a half-dozen points: (1) Their article adopts economic efficiency as the paramount criterion for interpreting tax discrimination, but this is too restrictive a focus for constitutional courts, because it would preclude member states from adequately considering important political, fiscal, distributional, or other tax policy norms. For those member states that have relinquished control over their currency by adopting the Euro, for example, retaining flexibility over fiscal matters through income tax legislation may be especially important. (2) The unrealistic assumption of fixed residence confines the article's actual analysis to discrimination against cross-border workers, so any broader claims about tax discrimination are not grounded in the paper's analytics. (3) Mason and Knoll never make an adequate case for competitive neutrality as the preferred economic efficiency criterion because the distortions that would be eliminated by competitive neutrality are never compared with those that would be eliminated by other efficiency standards, such as leisure neutrality or locational neutrality. On its own logic, the article therefore provides no reason to favor competitive neutrality over the competing economic efficiency concepts it discusses. (4) Given the actual requirements of competitive neutrality developed in the paper, the partial version they urge courts to use is simply too attenuated to serve as a compelling constitutional principle. (5) Mason and Knoll's positive case that the European Court of Justice and the U.S. Supreme Court are, and have been, actually engaged in promoting competitive neutrality is not convincing in light of their limited analysis and the many counter-examples available. (6) Competitive neutrality fails to provide a way out of

marriages."(without the emphasis found in the original).

http://ec.europa.eu/youreurope/citizens/family/couple/marriage/index_en.htm (accessed June 21, 2011).

the labyrinth because it entails either harmonization, locational distortions, or effective elimination of either source or residence country taxation. Partial competitive neutrality fails to provide a way out because it assumes, contrary to the ECJ's decisions (and, indeed, to our original description of the labyrinth itself), that the law of only a single country is relevant to questions of tax discrimination in cross-border transactions. Finally, even on the assumption that the Court would and should restrict its consideration to the law of only one country, neither version of competitive neutrality provides clear and acceptable answers in many difficult cases.

For us, then, competitive neutrality turns out not to be the holy grail of tax discrimination. With respect to tax jurisprudence, the ECJ remains stuck in a labyrinth of impossibility because the logical implications of requiring nondiscrimination in both origin and destination member states remain contradictory and incoherent.