1-1-2012

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THE YALE LAW JOURNAL

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ABSTRACT. Prohibitions of tax discrimination have long appeared in constitutions, tax treaties, trade treaties, and other sources, but despite their ubiquity, little agreement exists as to how such provisions should be interpreted. Some commentators have concluded that tax discrimination is an incoherent concept. In this Article, we argue that in common markets, like the EU and the United States, the best interpretation of the nondiscrimination principle is that it requires what we call "competitive neutrality," which prevents states from putting residents at a tax-induced competitive advantage or disadvantage relative to nonresidents in securing jobs. We show that, contrary to the prevailing view, maintaining a level playing field between resident and nonresident taxpayers requires neither tax rate harmonization nor equal taxation of residents and nonresidents. Our approach produces simple rules of thumb that provide states and courts with clear direction in writing tax laws and evaluating challenges to those laws.

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INTRODUCTION

States may be accused of "tax discrimination" when they tax outsiders differently from insiders, where "insiders" refers to nationals, resident individuals, and resident companies.[1] Stating the tax nondiscrimination principle is deceptively simple: tax likes alike. For example, suppose a resident and a nonresident both earn $100,000 in the same jurisdiction. At first blush, a principle of tax nondiscrimination would seem to require that the resident and nonresident be taxed the same. But differences between insiders and outsiders, such as their usage of government services, may justify differences in their tax treatment. Accordingly, before we can conclude that treating such taxpayers differently is discriminatory, we must first understand what values the nondiscrimination principle promotes.

So far, however, judges, government officials, and scholars have failed to clearly articulate the value or values that legal prohibitions of tax discrimination promote. That failure has provoked commentators to describe the concept of nondiscrimination adopted by the European Court of Justice (ECJ) as "baffling,"[2] "theoretical and arcane,"[3] and "incoherent."[4] Similarly, commentators describe the U.S. tax discrimination cases as "slippery"[5] and in need of a "principled approach."[6] And the Supreme Court has labeled its own tax discrimination jurisprudence a "quagmire"[7] and a "'tangled underbrush.'"[8]

1. Residence for tax purposes is determined by a taxpayer's connections with a jurisdiction. For example, states define tax residence for natural persons with respect to a person's citizenship, domicile, or physical presence. *See* HUGH J. AULT & BRIAN J. ARNOLD, COMPARATIVE INCOME TAXATION: A STRUCTURAL ANALYSIS 347-49 (2d ed. 2004).

2. Mary C. Bennett, *The David R. Tillinghast Lecture: Nondiscrimination in International Tax Law: A Concept in Search of a Principle*, 59 TAX L. REV. 439, 439 (2006) (comparing EU and tax treaty approaches to nondiscrimination).

3. Luc Hinnekens & Philippe Hinnekens, *General Report,* 93a CAHIERS DE DROIT FISCAL INT'L 15, 50 (2008) (surveying enforcement of tax nondiscrimination in domestic law, in EU law, and under tax treaties in two dozen countries).

4. Alvin C. Warren, Jr., *Income Tax Discrimination Against International Commerce*, 54 TAX L. REV. 131, 131 (2001) (discussing trade treaty, tax treaty, EU treaty, and U.S. constitutional conceptions of nondiscrimination).

5. Daniel Shaviro, *An Economic and Political Look at Federalism in Taxation*, 90 MICH. L. REV. 895, 929 (1992) (discussing nondiscrimination under the dormant Commerce Clause).

6. Dan T. Coenen & Walter Hellerstein, *Suspect Linkage: The Interplay of State Taxing and Spending Measures in the Application of Constitutional Antidiscrimination Rules*, 95 MICH. L. REV. 2167, 2173 (1997) (considering the treatment of linked tax-and-subsidy schemes under the dormant Commerce Clause).

7. Nw. States Portland Cement Co. v. Minnesota, 358 U.S. 450, 458 (1959); *see also* Wardair Can., Inc. v. Fla. Dep't of Revenue, 477 U.S. 1, 17 (1986) (Burger, C.J., concurring in part

Lack of a clear definition has not prevented prohibitions of tax discrimination from appearing in (or being read into) statutes, constitutions, and international treaties.[9] For example, the Supreme Court interprets the dormant Commerce Clause to prohibit tax discrimination by U.S. states.[10] Similarly, the ECJ has interpreted the fundamental freedoms of the Treaty on the Functioning of the European Union (TFEU) to prevent tax discrimination by EU member states.[11] Explicit prohibitions of tax discrimination also appear in every U.S. income tax treaty currently in force,[12] and the influential model tax treaties of the Organisation for Economic Cooperation and Development (OECD),[13] the United States,[14] and the United Nations[15] all dedicate an article to tax discrimination. Finally, prohibitions of tax discrimination appear in major multilateral and regional trade agreements.[16]

Although the concept of tax discrimination is ill-defined and poorly understood, its influence seems continually to expand. It has become particularly important in the EU, where tax cases constitute about 10% of the ECJ's caseload.[17] The ECJ has relied upon the nondiscrimination concept to

and concurring in the judgment) (referring to "the cloudy waters of this Court's 'dormant Commerce Clause' doctrine").

8. *Nw. States Portland Cemen Co.*, 358 U.S. at 457 (quoting Wisconsin v. J.C. Penney Co., 311 U.S. 435, 445 (1940)).

9. *See, e.g.*, I.R.C. § 891 (2006) (permitting the U.S. President to double the tax rates of foreigners if their home state subjects U.S. persons to "discriminatory or extraterritorial taxes").

10. *See* JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, STATE TAXATION ¶¶ 4.01-.26 (3d ed. 1999 & Supp. 2009).

11. *See* RUTH MASON, PRIMER ON DIRECT TAXATION IN THE EUROPEAN UNION 37-113 (2011).

12. *See* RICHARD E. ANDERSEN, ANALYSIS OF UNITED STATES INCOME TAX TREATIES ¶ 20.01 (2011).

13. *See* OECD, Model Tax Convention on Income and on Capital, art. 24 (July 22, 2010) [hereinafter OECD Model Tax Treaty], *condensed version available at* http://www.oecd-ilibrary.org/taxation/model-tax-convention-on-income-and-on-capital-condensed-version-2010_mtc_cond-2010-en.

14. *See* United States Model Income Tax Convention of November 15, 2006, 1 Tax Treaties (CCH) ¶ 209.24, art. 24 (2010), *available at* http://www.irs.gov/pub/irs-trty/model006.pdf.

15. U.N. Model Double Taxation Convention Between Developed and Developing Countries, art. 24, U.N. Doc. ST/ESA/PAD/SER.E/21 (U.N. Dep't of Econ. & Soc. Affairs 2001), *available at* http://www.un.org/Docs/journal/asp/ws.asp?m=ST/ESA/PAD/SER.E/21.

16. *See* Warren, *supra* note 4, at 141-46.

17. *See* Ruth Mason, *Made in America for European Tax: The Internal Consistency Test*, 49 B.C. L. REV. 1277, 1281 (2008) (citing annual statistics kept by the ECJ, which aggregate direct and indirect tax cases). Our concern here is only with direct tax cases, but the ECJ does not separate out statistics on direct tax cases.

justify invalidating longstanding tax practices, prompting harsh criticism from scholars and tax officials.[18] For example, the ECJ held that an EU member state could not categorically deny an EU national earning income within its territory but residing in another member state the same deductions for personal and family expenses that it allowed to its own residents.[19] The court held such denials discriminatory notwithstanding the fact that the practice is widespread internationally and expressly permitted under tax treaties.[20] In interpreting the Privileges and Immunities Clause, the U.S. Supreme Court has drawn the same conclusion: a U.S. state cannot categorically deny personal tax benefits to residents of other U.S. states.[21] Spurred by these judicial decisions, tax officials and scholars have begun to scrutinize the nondiscrimination concept intensely.[22] Notwithstanding this scrutiny, a clear definition of tax discrimination has failed to emerge. This continuing lack of guidance leaves government officials to develop tax policies and taxpayers to make business decisions in a highly uncertain legal environment.

Although legal limits on tax discrimination are widely viewed as promoting economic efficiency, there is no consensus regarding what efficiency value they promote. As this Article explains, economists and policymakers traditionally have evaluated cross-border tax policies under two competing efficiency

18. *See, e.g.*, Philip Baker, *Protection of the Taxpayer by the European Court of Justice*, 44 EUR. TAX'N 453, 453-54 (2004) (describing criticism of tax officials); Michael J. Graetz & Alvin C. Warren, Jr., *Income Tax Discrimination and the Political and Economic Integration of Europe*, 115 YALE L.J. 1186, 1219 (2006).

19. *See, e.g.*, Case C-279/93, Finanzamt Köln-Altstadt v. Schumacker, 1995 E.C.R. I-225, discussed *infra* Section I.C.

20. Ruth Mason, *Tax Expenditures and Global Labor Mobility*, 84 N.Y.U. L. REV. 1540, 1608-10 (2009) (discussing *Schumacker*).

21. *See, e.g.*, Lunding v. N.Y. Tax Appeals Tribunal, 522 U.S. 287 (1998) (holding that New York violated the Privileges and Immunities Clause when it denied alimony deductions to a Connecticut resident with New York-taxable income while permitting New York residents to deduct alimony).

22. *See, e.g.*, COMPARATIVE FISCAL FEDERALISM: COMPARING THE EUROPEAN COURT OF JUSTICE AND THE U.S. SUPREME COURT'S TAX JURISPRUDENCE (Reuven S. Avi-Yonah, James R. Hines, Jr. & Michael Lang eds., 2007) (publishing proceedings of a tax discrimination conference at the University of Michigan Law School); Hugh J. Ault & Jacques Sasseville, *Taxation and Non-Discrimination: A Reconsideration,* 2 WORLD TAX J. 101 (2010) [hereinafter OECD Discussion Draft] (introducing published proceedings of an OECD conference at the International Tax Centre, Leiden); Symposium, *Corporate Tax Policy in the European Union*, 62 TAX L. REV. 1 (2009) (publishing proceedings of a tax discrimination conference at N.Y.U. School of Law).

criteria: capital export neutrality and capital import neutrality.[23] A law is capital-export-neutral when it does not distort the allocation of capital across states.[24] In contrast, a law is capital-import-neutral when it does not differently distort the savings-consumption tradeoff across taxpayers residing in different states.[25]

In an influential recent article in this Journal, Professors Michael Graetz and Alvin Warren argued that the ECJ's approach to tax discrimination cases is fundamentally inconsistent.[26] As support for this claim, Graetz and Warren pointed to the fact that the ECJ has imposed nondiscrimination obligations on both states taxing in a source capacity and states taxing in a residence capacity.[27] In international tax parlance, the source state is the state where the taxpayer earns income, while the residence state is the state where the taxpayer resides. But a capital export neutrality construction of nondiscrimination would impose nondiscrimination obligations only on residence states, whereas a capital import neutrality construction of nondiscrimination would impose nondiscrimination obligations only on source states.[28] Graetz and Warren argued that the ECJ's imposition of nondiscrimination obligations at both source and residence did not appear to pursue either neutrality principle. Making matters worse in their view, by imposing nondiscrimination obligations at both source and residence, the ECJ seemed to evince an intention simultaneously to achieve *both* capital export neutrality *and* capital import neutrality. But, as Graetz and Warren correctly point out, it is impossible for states to achieve both kinds of efficiency benchmarks simultaneously unless they harmonize their tax rates and bases.[29] Accordingly, because the ECJ has repeatedly held that EU law does not require tax harmonization on the grounds

23. *See* Michael J. Graetz, *The David R. Tillinghast Lecture: Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 TAX L. REV. 261 (2001) (criticizing the use of these concepts to evaluate U.S. international tax policies because they elevate worldwide welfare over national welfare).

24. *See* discussion *infra* Section II.B.

25. *See* discussion *infra* Section II.C.

26. Graetz & Warren, *supra* note 18, at 1219.

27. *Id*. at 1216-19.

28. For further discussion, see *infra* Sections II.A-E.

29. Graetz & Warren, *supra* note 18, at 1212-23. The inability to establish both neutrality benchmarks in the absence of tax harmonization has been well established. *See, e.g.*, Reuven S. Avi-Yonah, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 HARV. L. REV. 1573, 1606 (2000). For an explanation of this phenomenon, see discussion *infra* notes 135-138 and accompanying text.

that such harmonization would invade the member states' tax autonomy,[30] imposition of nondiscrimination obligations at source and residence seemed not only to serve no clear efficiency goal, but also erected, in Graetz and Warren's terms, a "labyrinth of impossibility."[31] Similarly, although Graetz and Warren did not address the issue, tax discrimination doctrine in the United States is susceptible to the same criticism, since U.S. courts have interpreted the Constitution to place nondiscrimination obligations on states taxing in both source and residence capacities, while at the same time holding that the Constitution does not require states to harmonize their taxes.[32]

In this Article, we provide a way out of this "labyrinth of impossibility" by offering a new efficiency benchmark that is consistent with imposing nondiscrimination obligations on both source and residence states. We draw on recent scholarship by economists Michael Devereux, Mihir Desai, and James Hines to formulate a new version of nondiscrimination, one we call "competitive neutrality."[33] A tax law is competitively neutral when it does not distort the matching of owners with investments (or workers with jobs). Viewed in this way, a tax system is competitively neutral if it maintains a level tax playing field between resident and nonresident taxpayers. As a result, competitive neutrality formalizes the intuition that the nondiscrimination principle is about promoting competition.

Part I provides background on tax discrimination and uses examples from ECJ case law to illustrate the kinds of state tax practices that give rise to discrimination challenges. Part I also shows that a clear conception of the principle of tax nondiscrimination has failed to emerge.

Part II provides three alternative interpretations for tax discrimination. Because we analyze labor taxation, in Part II we translate the traditional tax efficiency benchmarks, which were developed to analyze capital taxes, into the labor tax context. We call the labor analogue of capital export neutrality "locational neutrality," because it obtains when taxes do not distort the allocation of labor across states. We call the labor analogue of capital import neutrality "leisure neutrality," because it obtains when taxes do not differently distort the work-leisure tradeoffs faced by taxpayers residing in different states.

30. *See, e.g.*, Case C-336/96, Gilly v. Directeur des Services Fiscaux du Bas-Rhin, 1998 E.C.R. I-2793, para. 34.

31. Graetz & Warren, *supra* note 18, at 1243.

32. *See* discussion *infra* Part IV.

33. *See* Mihir A. Desai & James R. Hines Jr., *Evaluating International Tax Reform*, 56 NAT'L TAX J. 487, 494 (2003); Michael P. Devereux, Capital Export Neutrality, Capital Import Neutrality, Capital Ownership Neutrality and All That (June 11, 1990) (unpublished manuscript) (on file with the authors).

In Part II, we provide the first formal account of what it would mean to interpret the nondiscrimination principle to require locational neutrality or leisure neutrality. Thus, for courts and scholars that reject our argument that the efficiency component of the tax nondiscrimination principle in common markets best accords with competitive neutrality, we provide clear guidelines for resolving cases under the two traditional tax efficiency benchmarks. In Part II, we also explain why imposing nondiscrimination obligations at *both* source and residence is not compatible with either locational or leisure neutrality. We dedicate the largest portion of Part II to the introduction of competitive neutrality, the new tax neutrality benchmark. We explain its formal requirements, explain how it would work as a nondiscrimination principle using simple examples, and show that competitive neutrality is consistent with imposing nondiscrimination obligations on both source and residence states. Finally, Part II makes our formal discussion of the three neutrality benchmarks concrete by showing how each benchmark would apply to the ECJ labor tax cases discussed in Part I.

While the principal goal of this Article is to elaborate an efficiency benchmark that accords better with the ECJ's tax doctrine than do either of the traditional benchmarks, Part III goes further to argue that competitive neutrality also represents a better interpretation of the TFEU than do either of the other benchmarks. In Part III, we also set forth normative and practical arguments in favor of a competitive neutrality interpretation of nondiscrimination. For example, leveling the playing field between resident and nonresident workers and between foreign and domestic work would promote welfare. This becomes clear when we consider that protectionist sentiments can be strong, especially during tough economic times. We also argue that competitive neutrality aligns better than do the other benchmarks with other non-efficiency goals, such as the promotion of political unity among EU nationals from different member states. On a more practical note, expressly adopting a competitive neutrality interpretation of nondiscrimination would simplify the resolution of tax cases and further integrate the common market. Finally, it would resolve several persistent questions posed in the scholarly literature analyzing tax discrimination. For example, we show that, contrary to widespread assumption, discrimination cannot be identified by a simple comparison of absolute tax rates.

While we use the ECJ tax cases as an example to illustrate our arguments about the meaning of tax discrimination, our arguments have broader applicability due to the pervasiveness of legal prohibitions of tax discrimination. Accordingly, Part IV discusses the implications of our arguments for U.S. constitutional law. Although the U.S. Constitution does not contain an express prohibition of tax discrimination, the Supreme Court has interpreted the Equal

Protection, Commerce, and Privileges and Immunities Clauses to prohibit the states from engaging in tax discrimination. Our guidelines for how to interpret nondiscrimination to require, in the alternative, locational, leisure, or competitive neutrality, also could be used by U.S. courts adjudicating tax discrimination claims brought under the Constitution. Moreover, we argue that, like the ECJ, the Supreme Court regards competitive neutrality as an important component of tax nondiscrimination under the Constitution. As with the ECJ, clear announcement by the Supreme Court that tax nondiscrimination requires competitive neutrality (or either of the other two benchmarks) would bring much-needed clarity and predictability to the Supreme Court's tax discrimination cases.

We conclude by observing that, although we rely heavily on economic analysis in arguing that the principle of nondiscrimination in taxation should be understood as promoting competitive neutrality, the approach we develop does not require courts to engage in extensive economic analysis. Rather, our approach reduces to straightforward directives both for courts to apply when evaluating tax discrimination claims and for legislatures to follow when enacting tax laws.

I. NONDISCRIMINATION IN EU TAXATION

This Part provides background on tax discrimination in common markets, and, in particular, in the EU common market. Section I.A briefly traces the origins of the prohibition of tax discrimination in the EU, and Section I.B illustrates the operation of that principle in two canonical ECJ tax discrimination cases. Together, these Sections illustrate that a clear guiding principle for resolving such cases has failed to emerge, resulting in haphazard and unsatisfying decisions.

A. Goals of the EU

The fundamental economic purpose motivating adoption of the EU treaties was to raise European wages and living standards by uniting the independent nations of Europe into a cohesive economic union that would eliminate barriers to cross-border trade, investment, business, and work.[34] The founders of the

34. *See*, *e.g.*, *Towards a Single Market Act for a Highly Competitive Social Market Economy: 50 Proposals for Improving Our Work, Business, and Exchanges with One Another*, at 2, COM (2010) 608 final (Oct. 27, 2010) ("The construction of one big market is at the heart of the European project envisaged by the founding fathers.").

EU believed that fusing the separate national economies of Europe into a single and substantially larger economy would allow local, European-based companies to assemble capital, labor, and resources on a larger and more efficient scale. The resulting improvement in productivity would be the engine of economic growth and improved living standards.[35]

Since the adoption of the Treaty of Rome in 1957, the member states of what is now the EU have endorsed the notion that they can improve the living and working conditions of their citizens by furthering the integration of the member states' economies.[36] The Single European Act of 1986 and the Maastricht Treaty of 1992 reiterate this position.[37] The entry into force of the Treaty of Lisbon at the end of 2009 preserves and reinforces the primacy of economic integration. Throughout this Article, we refer to both the EU and the United States as "common markets," although the integration of the EU member states' economies has been referred to variously as establishing a common market, a "single market," or an "internal market."[38]

Economic integration among the EU member states is accomplished through both "positive integration" and "negative integration."[39] Positive integration refers to legislative harmonization of member state policies pursuant to EU-level regulations or directives.[40] For example, EU-wide harmonization of value-added taxation was accomplished by a series of council directives.[41]

Negative integration refers to elimination by the ECJ of individual member state policies and practices that, in violation of EU law, impede the integration of the various member states into a single market.[42] Principles of negative integration usually take the form of "thou-shalt-not" dictates directed to the

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35. *See* Rita de la Feria & Clemens Fuest, *Closer to an Internal Market? The Economic Effects of EU Tax Jurisprudence* 3-4 (Oxford Univ. Ctr. for Bus. Taxation, Working Paper No. 11/12, 2011), *available at* http://www.sbs.ox.ac.uk/centres/tax/papers/Documents/WP1112.pdf.

36. *See* Wolfgang Schön, *Tax Competition in Europe—The Legal Perspective*, 9 EC TAX REV. 90, 90 (2000).

37. *Id.*

38. *Id.* The current Treaty on European Union and the TFEU use the term "internal market," although in the past the EU and EC treaties also used the term "common market."

39. ADOLFO J. MARTIN JIMÉNEZ, TOWARDS CORPORATE TAX HARMONIZATION IN THE EUROPEAN COMMUNITY: AN INSTITUTIONAL AND PROCEDURAL ANALYSIS 2-3 (1999).

40. *See* JOSEPHINE STEINER & LORNA WOODS, EU LAW 361-62 (2009).

41. *See, e.g.*, Council Regulation 1777/2005, Laying Down Implementing Measures for Directive 77/388/EEC on the Common System of Value Added Tax, 2005 O.J. (L 288) (EC).

42. BÉLA BALASSA, THE THEORY OF ECONOMIC INTEGRATION (1961); JIMÉNEZ, *supra* note 39, at 3.

member states,[43] but they can also be stated affirmatively, usually as rights. The EU "fundamental freedoms" prominently promote negative integration.[44]

The Treaty on the Functioning of the European Union (TFEU) sets forth four fundamental freedoms—the free movement of goods, workers, capital, and services.[45] Together with the freedom of establishment,[46] these freedoms represent the cornerstones of the EU's internal market, and the principle of tax nondiscrimination derives from them. For example, Article 45 of the TFEU states that the freedom of movement of workers "entail[s] the abolition of any discrimination based on nationality between workers of the Member States as regards employment, remuneration and other conditions of work and employment."[47]

Although Article 45 does not mention taxation, the ECJ has interpreted it to prevent nationality-based tax discrimination. Specifically, a member state may not use its tax system to discriminate against nationals of other member states who enter its territory to work.[48] Nor may a member state use its tax system to discriminate against its own nationals when they earn income in other member states.[49] Moreover, since it regards tax residence as a proxy for nationality, the ECJ also has interpreted the TFEU to forbid residence-based tax discrimination.[50] The ECJ likewise has interpreted the Treaty's other

43. JIMÉNEZ, *supra* note 39, at 3.

44. *See* Servaas van Thiel, *The Direct Income Tax Case Law of the European Court of Justice: Past Trends and Future Developments*, 62 TAX L. REV. 143 (2008).

45. Consolidated Version of the Treaty on the Functioning of the European Union, art. 18, Mar. 30, 2010, 2010 O.J. (C 83) 56 [hereinafter TFEU] ("[A]ny discrimination on grounds of nationality shall be prohibited."); *id*. art. 45, at 66 ("Such freedom of movement shall entail the abolition of any discrimination based on nationality . . . ."); *id*. art. 49, at 67 (business establishment); *id*. art. 56, at 70 (services); *id*. art. 63, at 71 (capital and payments).

46. *Id.* art. 49, at 67.

47. *Id.* art. 45, at 66.

48. In *Bachmann v. Belgium*, for example, the court held that Belgium discriminated in violation of the free movement of workers by allowing deduction of life insurance premiums only when those premiums were paid to Belgian insurance companies. The court reasoned that since nonresident workers were more likely to hold life insurance policies written by non-Belgian insurers than were resident workers, the rule was likely to disadvantage EU nationals from other states who worked in Belgium. *See* Case C-204/90, Bachmann v. Belgium, 1992 E.C.R. I-249 (holding that this treatment constituted discrimination but was nonetheless justified on other grounds).

49. See, for example, the *De Groot* case, discussed *infra* notes 74-79 and accompanying text.

50. *See, e.g.*, Case C-279/93, Finanzamt Köln-Altstadt v. Schumacker, 1995 E.C.R. I-225, paras. 27-29 (concluding that a member state tax provision that denied benefits to nonresidents was liable to operate primarily to the detriment of non-nationals). Most states define tax residence for natural persons by reference to physical presence. For example, some EU

fundamental freedoms to prohibit discrimination in the taxation of business establishments, the provision of services, and investment.[51]

The ECJ interprets the EU's four freedoms, and consequently the tax nondiscrimination principle, to give rise to private rights of action in national courts; in EU parlance, the four freedoms have "direct effect." The ECJ and national courts enforce the four freedoms as individual rights by looking closely at the claims of plaintiffs to standing and in evaluating whether a state's tax laws interfere with EU nationals' exercise of their fundamental freedoms.[52] Thus, in the EU, tax discrimination violates the *personal* rights of private parties, who have standing to sue in a national court for abridgement of those rights.

EU nationals regularly challenge member state tax laws that they believe interfere with their fundamental freedoms. Such suits arise in the first instance in the national court of the offending member state, but under certain circumstances the TFEU permits or requires national courts to refer questions of EU law to the ECJ for binding interpretive rulings.[53] All of the ECJ cases discussed in this Article consist of such references from national courts to the ECJ.

B. ECJ Interpretations of Tax Discrimination

This Section gives background on EU taxation and the ECJ's tax discrimination doctrine. Each member state has its own tax system, and since national income tax law is not harmonized in the EU, tax bases and rates vary significantly across the member states, as do methods of taxing cross-border income. These differences in member state tax systems may create barriers to the exercise by EU nationals of their fundamental freedoms to work, reside, invest, provide services, and establish businesses anywhere in the EU.

member states consider persons spending more than six continuous months in the state to be a tax resident. *See* AULT & ARNOLD, *supra* note 1, at 433.

51. *See* MASON, *supra* note 11, at 37-92.

52. Standing also would seem to be essential to administration, which relies heavily on individuals bringing suit to enforce their rights.

53. TFEU, *supra* note 45, art. 267 (stating that lower national courts may, and courts of last resort must, refer to the ECJ for preliminary ruling any EU question that is vital to the resolution of a case before them). *But see* Case 283/81, CILFIT v. Ministry of Health, 1982 E.C.R. 3415 (holding that national courts have discretion not to refer questions identical to those previously decided by the ECJ or questions where the correct application of EU law is obvious).

Generally, two states have jurisdiction to tax cross-border income. The state where the income was earned (the "source" state) has jurisdiction to tax on a "source" basis, and the state where the taxpayer resides (the "residence" state) has jurisdiction to tax on a "residence" basis. Thus, a musician who resides in the Netherlands but earns income from performances in Germany will be taxable by both states. Under longstanding custom, the tax entitlement of the source state is superior to that of the residence state.[54] As a result, the residence state typically employs one of the following two methods to prevent double taxation.[55] A state implementing "exemption" forgoes its opportunity to tax its residents' foreign-source income. A state implementing "worldwide taxation" taxes such foreign-source income as if it had been earned domestically, but allows a credit for taxes paid to the source jurisdiction.

Source states tax nonresidents differently than residents. For example, source states typically tax nonresidents on their *gross* income at flat tax rates, whereas they tax residents on their *net* income at progressive tax rates. The flat tax rate applicable to nonresidents typically falls somewhere between the top and the bottom progressive rates applicable to residents. At least two reasons justify this difference in treatment. First, taxing nonresidents on a gross, rather than net, basis means that nonresidents do not have to file complete income tax returns in their source state(s), which reduces their compliance burden. Second, states argue that nonresidents would secure an unfair tax advantage if progressive tax rates applied only to the income earned in the source state, since that income usually represents only a portion of the cross-border worker's overall income.[56] In the same vein, source states argue that they lack sufficient information about nonresident taxpayers to confer upon them personal tax benefits. As a result, most states confer personal tax benefits on

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54. This is true as a practical matter because the source state has the first opportunity to tax the income. Source state priority is reinforced by the international tax norm that places the obligation to relieve juridical double taxation entirely on the residence state in the absence of a tax treaty. *See* Warren, *supra* note 4, at 132.

55. A third alternative not currently practiced would involve reducing the tax on residents' foreign income by allowing a deduction from taxable income for source state taxes. However, this method would not fully relieve double taxation.

56. If each state applied its progressive tax rates to only the portion of the cross-border worker's overall income that she earned within its territory, more of her overall income would fall into low tax brackets compared to workers who earned the same overall amount of income from a single state. The simplest design for a progressive tax system in which the brackets depend upon global (not just local) income would proportionately reduce the size of each state's tax brackets to correspond to the share of income the cross-border worker earned in that state. Such systems would require accurate reporting of worldwide income and would be very difficult to police.

resident, but not nonresident, taxpayers. Such tax benefits may include social welfare expenditures (such as wage supplements for low-income taxpayers) or deductions for personal expenses (such as home mortgage interest, childcare, and medical expenses).

When a state administers social benefits through its tax system but limits those benefits to resident taxpayers, the result may be the application of systematically lower tax rates to resident than nonresident taxpayers. Nonetheless, the ECJ has held that under certain circumstances, a source state may deny nonresidents the personal tax benefits it grants to its own residents.[57] Thus, the nondiscrimination principle does not appear to require source states to equalize tax rates for residents and nonresidents.

Likewise, under the ECJ's interpretation, the nondiscrimination principle does not appear to require that states equalize the tax rates that their residents pay on foreign-source and domestic-source income. For example, in *Gilly v. Directeur des Services Fiscaux du Bas-Rhin*, a French resident worked as a teacher in Germany, where her salary was taxable on a source basis. Because German tax rates were higher than French tax rates, Gilly paid more tax on her salary when she worked in Germany than she would have paid on an equivalent amount in France.[58] She argued that the higher taxes she paid for work in Germany violated the freedom of movement of workers, and as a result, that France should be required to credit her German taxes fully. The ECJ rejected this argument, concluding that there was no EU law requirement "to ensure that the tax to which the taxpayer is subject in one state is no higher than that to which he or she would be subject in the other."[59] Thus, the ECJ held that France did not violate the freedom of movement of workers by failing to equalize the rates its residents paid abroad with the rates they would have paid at home.

These examples show that not all tax barriers to European economic integration constitute discrimination within the meaning of the TFEU. Other examples reinforce the point. For instance, tax rate differentials distort the allocation of capital and labor among member states by discouraging residents

57. *See, e.g.*, Case C-234/01, Gerritse v. Finanzamt Neukölln-Nord, 2003 E.C.R. I-5933 (holding that a source state may deny nonresidents the benefit of personal tax exemptions, as long as the nonresident does not earn all or almost all her income in the source state). In contrast, the ECJ held that Greece discriminated when it taxed Greek banks doing business in Greece at only 35%, while taxing banks residing in other member states doing business in Greece at 40%. Case C-311/97, Royal Bank of Scot. plc v. Greece, 1999 E.C.R. I-2651.

58. Case C-336/96, Gilly v. Directeur des Services Fiscaux du Bas-Rhin, 1998 E.C.R. I-2793, paras. 11-12.

59. *Id.* para. 46.

of EU member states from working, investing, or establishing businesses in high-tax states.[60] However, because EU law does not require harmonization of tax rates and bases, the ECJ has expressly held that cross-border tax disadvantages arising from rate differentials do not constitute discrimination, as long as the defendant member state does not single out cross-border taxpayers or cross-border income for higher taxation.[61] Thus, if Germany taxed all income at 50%, while France taxed all income at 25%, neither state would discriminate, even though a French resident might suffer a tax increase if she worked in Germany as compared to if she worked in France.

The challenge for the ECJ is distinguishing permissible from impermissible tax differentials imposed on cross-border economic activity. The ECJ takes the following approach to evaluating member state tax laws for discrimination. First, the ECJ compares the complaining taxpayer—who is a nonresident with income from sources within the defendant member state (or a resident with income sourced in other EU member states)—to a "similarly situated" resident taxpayer with income from only domestic sources. If the nonresident (or resident with foreign-source income) receives worse tax treatment than the similarly situated resident with only domestic income, the court generally concludes that the defendant member state engaged in discrimination. Unless the discrimination can be justified for public policy reasons, such as the need to prevent tax fraud, the court will hold the provision incompatible with EU law.[62] Determining whether taxpayers are similarly situated is therefore crucial for determining whether there is discrimination. But the ECJ has not provided clear guidance on when resident and nonresident taxpayers are similarly

60. *See, e.g.*, PEGGY B. MUSGRAVE, UNITED STATES TAXATION OF FOREIGN INVESTMENT INCOME 74-75 (1969); Thomas Horst, *A Note on the Optimal Taxation of International Investment Income*, 94 Q.J. ECON. 793, 796 (1980).

61. *See, e.g.*, *Gilly*, 1998 E.C.R. I-2793, paras. 49, 53 (holding that a cross-border disadvantage due to differences in national tax rates was not discriminatory); *see also* Case C-294/97, Eurowings Luftverkehrs AG v. Finanzamt Dortmund-Unna, 1999 E.C.R. I-7447 (rejecting as a justification for discriminatory source taxation against nonresidents the fact that such nonresidents may be subject to no or lesser taxation in their residence state).

62. Although the ECJ has held that public policies may justify tax discrimination, it rarely finds the means used by the state proportional to its justifiable goal. For cases in which the ECJ held that tax discrimination was justified and proportionate, see Case C-446/03, Marks & Spencer plc v. Halsey, 2005 E.C.R. I-10837, which holds that discrimination was justified by the need to protect a balanced allocation of tax power among the member states, the need to avoid duplication of tax losses, and the need to prevent tax avoidance; and Case C-204/90, Bachmann v. Belgium, 1992 E.C.R. I-249, which holds that tax discrimination was justified by the member state's need to maintain the fiscal cohesion of its tax system. For justifications in tax cases generally, see MASON, *supra* note 11, at 93-115.

situated, such that they must be taxed the same way, and when they are not.[63] The resulting collection of decisions is a hodgepodge, lacking any clear set of guiding principles. Not surprisingly, the ECJ's tax jurisprudence is highly controversial. Reflecting fundamental uncertainty regarding the meaning of tax discrimination, many of the court's critics argue that it has been overzealous in its interpretation of nondiscrimination,[64] while others argue that the court has not been zealous enough.[65]

C. Two Cases

This Section selects two cross-border labor tax cases—one involving source taxes and the other involving residence taxes—to illustrate the controversies surrounding EU tax discrimination doctrine.

The landmark *Schumacker* case involved source taxes. Schumacker resided in Belgium but earned all his income in Germany. Because he was a nonresident, Germany denied Schumacker several tax benefits available to residents, including marital income splitting, automatic refunds of tax over-withholding, and certain other personal and family deductions.[66] Schumacker argued that by denying him these tax benefits, Germany placed him in "a less advantageous position than residents," thereby discriminating against him in violation of the EU freedom of movement of workers.[67]

The ECJ concluded that a state need not always tax residents and nonresidents the same way because residents and nonresidents ordinarily are not "similarly situated," in part because nonresident workers typically earn only part of their overall income in the source state. As a result, cross-border workers ordinarily should seek personal tax benefits only from their residence state, where the court assumed that they would earn most of their income.[68] Despite its conclusion that resident and nonresident workers ordinarily are not similarly situated, the court held that Schumacker's case was special because he earned all of his income from Germany, and his residence state (Belgium)

63. *See* Ruth Mason, *Flunking the ECJ's Tax Discrimination Test*, 46 COLUM. J. TRANSNAT'L L. 72 (2007) (arguing that the ECJ has not provided clear guidelines on when two taxpayers are similar for tax discrimination purposes).

64. *See, e.g.*, Graetz & Warren, *supra* note 18.

65. *See, e.g.*, Georg W. Kofler & Ruth Mason, *Double Taxation: A European "Switch in Time?,"* 14 COLUM. J. EUR. L. 63, 97-98 (2007) (criticizing the ECJ for ruling that member states' failure to relieve juridical double taxation did not violate EU law).

66. Case C-279/93, Finanzamt Köln-Altstadt v. Schumacker, 1995 E.C.R. I-225.

67. *Id.* para. 52.

68. *Id.* para. 32.

exempted his foreign-source income. Thus, any claims Schumacker had to personal tax benefits in Belgium were of no use to him because he had no tax liability there. As a result, if Germany did not take his personal expenses into account, they would not be accounted for anywhere.[69] To solve this dilemma, the court held that when a nonresident worker earns "almost all" of his income in a source state, such that his residence state cannot grant him personal tax benefits, the source state must tax him like a resident worker.[70] This so-called Schumacker Rule runs contrary to long-standing tax treaty practice, under which a source state is not obliged to grant nonresident taxpayers personal tax benefits under any circumstances.[71] Thus, in *Schumacker*, the ECJ established a new EU law requirement, namely, that although cross-border workers should not be able to claim duplicative personal tax benefits in more than one EU state,[72] they must be able to claim such benefits in at least one state. We call this the "once somewhere" principle.[73]

In addition to cases like *Schumacker*, in which the ECJ found states taxing in a source capacity to discriminate, the ECJ has also found states taxing in a residence capacity to discriminate when they use their tax systems to discourage their own residents from working in other EU member states. For example, the ECJ case *De Groot* involved a Dutch resident taxpayer who earned income from several other EU member states.[74] To avoid double taxation, the Netherlands exempted De Groot's foreign-source income from tax, but it also reduced his entitlement to personal tax benefits (such as personal deductions and the personal exemption) in proportion to his exempt foreign-source income.[75] De Groot argued that by reducing his residence state tax benefits in

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69. *Id.* para. 36.

70. *Id.* para. 38.

71. *See* OECD Model Tax Treaty, *supra* note 13, art. 24, para. 3; *see also* Mason, *supra* note 20 (arguing that this OECD tax treaty practice is simple, efficient, and fair).

72. In *Schumacker*, as in prior cases, the court based the conclusion that workers should seek personal tax benefits from their residence state in part on the need to avoid situations in which cross-border workers would deduct the same personal expenses both at home and abroad. *Id.* paras. 40-41 (citing Case C-204/90 Bachmann v. Belgium, 1992 E.C.R. I-249, para. 28).

73. *See* Peter J. Wattel, *Judicial Restraint and Three Trends in the ECJ's Direct Tax Case Law*, 62 TAX L. REV. 205, 216 (2008) (referring to the ECJ's "always-somewhere" approach to deductions).

74. Case C-385/00, De Groot v. Staatssecretaris van Financiën, 2002 E.C.R. I-11819.

75. *Id.* para. 18. For example, suppose that if De Groot earned all of his income in the Netherlands, he would be entitled to the full Dutch personal exemption of €10,000 and other personal deductions worth €5000. Under proportionality, if De Groot earned 60% of his income abroad, he would be taxable by the Netherlands only on the 40% he earned in proportion to his foreign-source income, the Netherlands discouraged him from working abroad.[76] The Netherlands responded that a proportionate reduction in residence state tax benefits was a necessary complement to exempting his foreign-source income; since the Netherlands did not tax all of De Groot's income, why should it grant him a full set of personal tax benefits?[77] The Netherlands argued that, instead, the other member states in which De Groot earned income should grant De Groot a fraction of *their* personal tax benefits proportional to the fraction of his worldwide income earned and taxed in each state.[78] Having already ruled in *Schumacker* that the residence state has the primary duty to afford cross-border workers personal tax benefits, however, the ECJ rejected the Dutch proportionality method in *De Groot* because it "discourage[d]" De Groot from "tak[ing] up paid employment" in another member state.[79]

Even these two cases show that tax discrimination cases raise complex questions without ready solutions. For instance, how do tax rate differentials impact the determination of whether there has been discrimination? Does subjecting nonresidents to higher taxation always constitute discrimination? If not—as suggested by the ECJ's conclusion in *Schumacker* that residents and nonresidents ordinarily are not similarly situated (and confirmed in its later rulings)[80]—then under what circumstances does higher taxation constitute discrimination? Such questions generate significant commentary, but neither the judicial opinions themselves nor academic commentary on them provide answers to these fundamental questions. While we discuss the issue at greater

the Netherlands, and the other 60% would be exempt. However, the Netherlands would also reduce by 60% De Groot's personal exemption to €4000 and his personal deductions to €2000.

76. *Id.* para. 33.

77. *Id.* paras. 59-62.

78. *Id.* paras. 57-59.

79. *Id.* para. 84.

80. In *Schumacker*, the ECJ concluded that residents and nonresidents ordinarily are not similarly situated because nonresidents usually earn most of their income outside the source state. Case C-279/93, Finanzamt Köln-Altstadt v. Schumacker, 1995 E.C.R. I-225, para. 31. In another case, where a source state denied its personal exemption to a nonresident who did not earn almost all of his income in the source state, the ECJ found no discrimination even though the denial had the effect of raising the nonresident's tax burden compared to residents who received the benefit of personal exemptions. *See* Case C-234/01, Gerritse v. Finanzamt Neukölln-Nord, 2003 E.C.R. I-5933.

length later, for now we simply note that very similar cases have arisen in the U.S. context.[81]

Despite the lack of clear guidelines on how to resolve specific cases, one thing is clear: the ECJ consistently demonstrates concern for the functioning of the common market and the promotion of the freedom of movement in its tax discrimination cases. The ECJ frequently concludes that tax policies discriminate because they "discourage" or "deter" cross-border economic activity.[82] This interpretation makes sense when we consider that one of the express purposes of the formation of the EU was to integrate the economies of previously independent states by tearing down barriers to cross-border economic activities and by preventing states from enacting new barriers that would prevent taxpayers from operating across borders. The problem with the tax discrimination decisions, however, is that they provide little guidance as to when tax policies "discourage" or "deter" the relevant type of cross-border economic activity. Providing a clear, operational theory of tax discrimination is the principal challenge in this area, and one we undertake in the next Part.

II. TOWARD A COHERENT CONCEPTION OF TAX DISCRIMINATION

In this Part, we introduce three alternative efficiency interpretations for tax nondiscrimination. Two of these alternatives derive from the traditional capital neutrality benchmarks that have been used to analyze international tax laws since the 1960s. They are: locational neutrality, which minimizes distortions of decisions about where to work, and leisure neutrality, which minimizes distortions about how much to work. The third alternative, which we call "competitive neutrality," derives from recent economics literature. Rather than

81. *See, e.g.*, Lunding v. N.Y. Tax Appeals Tribunal, 522 U.S. 287 (1998) (holding that a state violated the Privileges and Immunities Clause when it denied nonresident taxpayers alimony deductions available to resident taxpayers); Travis v. Yale & Towne Mfg. Co., 252 U.S. 60 (1920) (holding that a state violated the Privileges and Immunities Clause when it denied nonresident taxpayers personal exemptions available to resident taxpayers); Wheeler v. State, 249 A.2d 887 (Vt. 1969) (rejecting equal-protection and privileges-and-immunities challenges to a law that applied Vermont's progressive tax rates to both in-state and out-of-state taxpayers).

82. *See, e.g.*, Case C-334/02, Comm'n of the Eur. Cmty. v. France, 2004 E.C.R. I-2229, para. 23; Case C-242/03, Ministre des Finances v. Weidert, 2004 E.C.R. I-7379, paras. 13-14; Case C-364/01, Barbier v. Inspecteur van de Belastingdienst, 2003 E.C.R. I-15013, para. 62; *De Groot*, 2002 E.C.R. I-11819, paras. 84, 91; Case C-436/00, X & Y v. Riksskatteverket, 2002 E.C.R. I-10829, para. 36; Case C-294/97, Eurowings Luftverkehrs AG v. Finanzamt Dortmund-Unna, 1999 E.C.R. I-7447, para. 37; Case C-439/97, Sandoz GmbH v. Finanzlandesdirektion für Wien, 1999 E.C.R. I-7041, para. 19; Case C-118/96, Safir v. Skattemyndigheten i Dalarnas Län, 1998 E.C.R. I-1897, para. 29.

seeking to ensure that every worker in a particular jurisdiction faces the same tax rate, or that any given worker who resides in a particular jurisdiction faces the same tax rate regardless of where she works, competitive neutrality seeks to ensure that tax-rate differences do not differentially affect each worker's choice of job. That is to say, competitive neutrality requires that tax rate differences not affect comparative advantage.[83] More precisely, if the tax system causes Worker 1, who is relatively more productive than Worker 2 in State *X* as compared to State *Y*, to work in State *Y*, *and* causes Worker 2, who is relatively more productive than Worker 1 in State *Y* as compared to State *X*, to work in State *X*, then the tax system violates competitive neutrality. Expressed more colloquially, a competitively neutral tax system does not interfere with the matching of workers to jobs, whereas a system that violates this neutrality is one in which workers sort into jobs not only on the basis of comparative advantage, but also residence. In addition to explaining the benchmarks, this Part provides, for the first time in the scholarly literature, clear guidelines for interpreting the tax nondiscrimination principle to require each kind of neutrality. Later, in Part III, we will argue that, of the three benchmarks, competitive neutrality best reflects EU goals and the ECJ's nondiscrimination doctrine.

A. Some Caveats

Before presenting our three alternatives for interpreting nondiscrimination, we set out a few caveats and assumptions in this Section.

1. Economic Efficiency

This Subsection discusses our decision to focus on the economic efficiency rationale for the tax nondiscrimination principle. Commentators recognize three "standard" values promoted by prohibitions on discrimination by states in a common market: economic efficiency, representation reinforcement, and

83. The use of the principle of comparative advantage in this context might seem unfamiliar or misplaced to some readers because the principle, which was first described by David Ricardo in the context of trade in goods between states, is the foundation for the economic argument in favor of free trade between states. The principle, however, applies more broadly, including to individuals, and is as much about the benefits of specialization as it is about the benefits of exchange. *See, e.g.*, PAUL A. SAMUELSON & WILLIAM D. NORDHAUS, ECONOMICS 679-81 (15th ed. 1995) (illustrating the principle of comparative advantage using the example of the best lawyer in town who is also the best typist and arguing that the lawyer should practice law and her secretary should type, even though her secretary is not as good a typist as is she).

promoting political unity.[84] Despite its modest origins after World War II as a coal and steel customs union among six European nations, over the last half-century the EU has evolved into considerably more.[85] With 450 million people living in twenty-seven member states, today the EU is the largest common market in the world. In addition to a well-integrated economy, the EU continues to make strides towards political unity, in part by guaranteeing EU nationals the freedom of movement for reasons other than work or business and by expanding the role of the European Parliament.

Despite these transformative developments, and our acknowledgement that the EU tax nondiscrimination principle also promotes representation reinforcement and political unity, we nevertheless focus primarily on the economic efficiency component of tax nondiscrimination. We make this choice for several reasons. First, the rhetoric of "ever closer union" does not seem to play a prominent role in discussions of direct taxation.[86] For example, direct taxation remains one of a shrinking number of policy areas that require member state unanimity for the passage of legislation.[87] In the negotiations for the EU Constitution, member state representatives even discussed limiting the ECJ's jurisdiction in tax matters.[88] Furthermore, the ECJ's reasoning in tax

84. Lisa Heinzerling, *The Commercial Constitution*, 1995 SUP. CT. REV. 217, 220.

85. *See, e.g.*, *Single Market Act: Twelve Levers To Boost Growth and Strengthen Confidence: Working Together To Create New Growth*, at 3, COM (2011) 206 final (Apr. 13, 2011) ("At the heart of the European project since its inception, the common market . . . has for over 50 years woven strands of solidarity between the men and women of Europe, whilst opening up new opportunities for growth for more than 21 million European businesses.").

86. TFEU, *supra* note 45, pmbl. (citing as one of the motivations for the Treaty the desire for "an ever closer union among the peoples of Europe"). Although political unity has not played a role in tax discrimination cases, it is considered by the European Economic and Social Committee (EESC) to be an important element of the movement of workers. *See, e.g.*, *Opinion of the Economic and Social Committee on 'Freedom of Movement for Workers in the Single Market (Single Market Observatory)*,' 2001 O.J. (C 155) 47, ¶ 1.1.2 ("Freedom of movement of workers is, in the [EESC's] view, a key factor in the achievement of an ever closer Union. It is also one of the most concrete expressions of the concept of Union citizenship."). The EESC provides a forum for EU interest groups to express views on EU issues, and the TFEU obliges the Council to consult with both the European Parliament and the EESC before undertaking tax and other kinds of legislation. *See* TFEU, *supra* note 45, art. 115.

87. TFEU, *supra* note 45, art. 115 ("[T]he Council shall, acting unanimously in accordance with a special legislative procedure and after consulting the European Parliament and the Economic and Social Committee, issue directives for the approximation of such laws, regulations or administrative provisions of the Member States as directly affect the establishment or functioning of the internal market.").

88. *See* Frans Vanistendael, *The ECJ at the Crossroads: Balancing Tax Sovereignty Against the Imperatives of the Single Market*, 46 EUR. TAX'N 413, 413 (2006).

discrimination cases continues to hew closely to the economic justifications for the formation of the EU, even as the court increasingly stresses the importance of noneconomic EU values, such as political unity and equality, in other areas of law.[89] Specifically, the ECJ has never invoked the representation reinforcement or political unity rationales in its tax discrimination cases. Indeed, to our knowledge, the ECJ has never invoked values other than economic efficiency in deciding whether a state used its tax system to discriminate.

The ECJ's bifurcated approach to deciding tax cases also reinforces the primacy of economic efficiency concepts in deciding tax nondiscrimination cases. The court's decisions generally proceed in two stages.[90] In the first stage, the court considers whether the state discriminated by looking to whether the challenged tax law "discourages" or "deters" cross-border economic activity.[91] It is not until the second stage of the court's ruling, the justification stage, that the court even considers other values. Yet, even here, the ECJ has only accepted a limited number of justifications, such as the need to prevent fraud or tax evasion, all of which directly relate to economic efficiency.[92]

Because our goal in this Article is to try to get a clearer understanding of what the tax nondiscrimination principle requires, it seems prudent to discuss what the ECJ itself has identified as tax nondiscrimination's most important underlying value. Thus, in focusing on efficiency, we take our cue from the ECJ. Later, however, we discuss the implications of our interpretation of nondiscrimination for representation reinforcement and political unity.[93]

2. Labor, Not Capital

All three of the economic efficiency benchmarks we discuss in this Article were developed for the analysis of capital taxation, not labor taxation.

89. The ECJ has declared its expectation that Union citizenship will continue to take on greater importance as a source of legal rights for EU nationals. *See, e.g.*, Case C-184/99, Grzelczyk v. Centre Public d'Aide Sociale d'Ottignies-Louvain-la-Neuve, 2001 E.C.R. I-6193, para. 31 ("Union citizenship is destined to be the fundamental status of nationals of the Member States, enabling those who find themselves in the same situation to enjoy the same treatment in law irrespective of their nationality, subject to such exceptions as are expressly provided for.").

90. *See* MASON, *supra* note 11, at 93-114 (discussing justifications for tax discrimination).

91. *See* sources cited *supra* note 82.

92. *See* MASON, *supra* note 11, at 93-114 (reviewing the limited justifications the ECJ has accepted in tax cases, such as the need to prevent tax fraud and the need for fiscal supervision).

93. *See* discussion *infra* Subsection III.B.3.

Nevertheless, we focus on labor taxation for several reasons. First, labor tax cases affect many people because many people work outside their residence state or have labor income from more than one state.[94] Second, because the facts, law, and institutional setting of labor tax cases are relatively straightforward, they are much easier to explain and understand than are the capital tax cases.[95] Third, illustrating our arguments using labor, rather than capital, allows the reader to more readily connect our conception of tax nondiscrimination with more intuitive notions of nondiscrimination that implicate political equality, such as discrimination on the basis of race or national origin. Thus, the labor tax cases remind us that the desire to avoid nationality discrimination animates the fundamental freedoms, as does the desire to forge political unity among the peoples of Europe, even though the ECJ has not specifically acknowledged that value in its tax discrimination doctrine. Finally, the freedom of capital movement has a different scope than do the other fundamental freedoms. Specifically, while the other fundamental freedoms, including the free movement of goods, workers, services, and business establishments, only apply to EU situations, the freedom of capital movement also applies to capital moving into or out of the EU.[96] The application of the freedom of capital movement to so-called third countries and the consequent protection of non-EU nationals under that freedom has

94. Although we could not find statistics on the number of people working outside their state of tax residence, statistics on related cross-border worker mobility issues provide some insight into the size of that population. *See Reaffirming the Free Movement of Workers: Rights and Major Developments*, at 2, COM (2010) 373 final at 2 (July 13, 2010) (noting that "10% of persons polled in EU-27 replied that they had lived and worked in another country at some point in the past, while 17% intended to take advantage of free movement in the future"); *cf. Posting of Workers in the Framework of the Provision of Services: Maximizing Its Benefits and Potential While Guaranteeing the Protection of Workers*, at 3, COM (2007) 304 final at 3 (June 13, 2007) (noting that the number of workers employed in one member state, but temporarily posted by their employer in another member state was "just under 1 million, or about 0.4% of the EU working age population in 2005").

95. Members of the court have remarked on the complexities in these cases. *See, e.g.*, Case C-374/04, Test Claimants in Class IV of the ACT Grp. Litig. v. Comm'rs of Inland Revenue, 2006 E.C.R. I-11673, para.3 (opinion of Advocate General Geelhoed) ("This is an area in which the Court, faced with increasingly complicated factual and legislative contexts and arguments seeking to test the limits of the Treaty, has developed a substantial body of rather complex case-law."). Scholars agree. *See, e.g.*, Walter Hellerstein et al., *Constitutional Restraints on Corporate Tax Integration,* 62 TAX L. REV. 1, 18, 65 (2008) (describing the corporate tax integration jurisprudence in the ECJ as "woefully complex").

96. TFEU, *supra* note 45, art. 63, para. 2 ("[A]ll restrictions on payments between Member States and between Member States and third countries shall be prohibited.").

complicated its interpretation.[97] Because our goal in this Article is to address the meaning of tax discrimination within a common market, we do not expressly consider the freedom of capital movement, which has third-party effects. Although our arguments have implications for capital taxation, we do not consider those implications here.

3. *Assumptions*

As part of our analysis, we present a simple two-state model of how taxation distorts labor markets. In developing that model, we make two assumptions, namely, that only taxes matter and that tax residence is fixed. The more important assumption is that only taxes matter. Of course, taxes are not the only factor that workers consider when answering important questions, such as where to work, how much to work, and which job to work. A whole variety of other factors—both economic and noneconomic—influence such decisions. These varied factors include everything from wage rates to climate, from religion to love of unpasteurized cheese. People's work decisions depend not only on taxation but also on geography, working conditions, family and community support and expectations, cultural factors, standards and costs of living, labor and immigration regulations, moving costs, transportation costs, and other frictions. Many of these factors weigh more heavily than taxation in decisions about work. However, in order to isolate the effect of taxation on work decisions, we assume that the only factor that influences work decisions is taxation and that there are no nontax costs of moving.[98]

Second, in order to explore the impact of taxes on decisions about where to work, how much to work, and which job to work, we hold taxpayers' residence fixed. This means that we assume that taxes will not cause workers to change their state of tax residence, even though taxes may cause people to commute to other jurisdictions or to work there for long periods. Although this assumption is contrary to fact, it is justified given the limited applicability of the legal prohibition of tax discrimination under EU law. Specifically, EU law only covers cross-border situations. For example, EU nondiscrimination law protects an EU national who is a French tax resident when she earns income from Germany. However, should the French resident move her residence to

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97. *See, e.g.*, Case C-452/04, Fidium Finanz AG v. Bundesanstalt für Finanzdienstleistungsaufsicht, 2006 E.C.R. I-9521 (struggling to determine whether cross-border lending involves the freedom to provide services, the freedom of capital movement, or both).

98. We do not believe that introducing these complications would dramatically change our results, although doing so would dramatically complicate our examples, exposition, and analysis.

Germany and continue to work in Germany, her tax treatment would no longer be a concern of EU law, since she would be a resident of Germany earning only domestic income. EU nondiscrimination law generally does not concern member states' tax treatment of their own residents' purely domestic income.[99] If the taxpayer became a German tax resident, Germany would treat her like other German tax residents (most of whom are German nationals). Because tax law applies on the basis of residence, rather than nationality, once a taxpayer establishes tax residency in a member state, that state generally will treat her the same as other tax residents.[100] Thus, the application of the tax nondiscrimination principle generally concerns cases in which an EU national resides in one state, but earns income in another state. Of course, should the taxpayer in our example, who now resides in Germany, begin to earn income from work in Belgium, EU law would protect her from tax discrimination by Germany or Belgium. And in our analysis, we now would assume that her residence is fixed in Germany.[101]

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99. That is not to say that the ECJ never looks at member states' tax treatments of their own residents with only domestic income. It regularly does so in comparison with residents of other member states earning income in that country or with its own residents earning income abroad. The purpose of such assessments, however, is to determine whether the state is discriminating against foreign residents working or seeking to work in that country or domestic residents seeking to work abroad. *See, e.g.*, Case C-385/00, De Groot v. Staatssecretaris van Financiën, 2002 E.C.R. I-11819 (comparing the Netherlands' treatment of it residents' foreign-source income with the Netherlands' treatment of its residents' Dutch-source income); Case C-279/93, Finanzamt Köln-Altstadt v. Schumacker, 1995 E.C.R. I-225 (comparing Germany's treatment of its own residents' German-source income with Germany's treatment of nonresidents' German-source income).

100. *Cf.* Case C-112/91, Werner v. Finanzamt Aachen-Innenstadt, 1993 E.C.R. I-429 (holding that the freedom of establishment did not apply to a German national establishing a business in Germany). We could imagine scenarios involving discrimination against new residents, which would be a concern for EU law, but we are aware of no such cases in the EU.

Similarly, in the U.S. state tax context, the assumption of fixed residence allows us to focus on the most constitutionally relevant set of circumstances: specifically, occasions when a taxpayer resides in one state, but has income from another. While it is not impossible for a state to discriminate against its own residents with only in-state income (or only in-state activities), such cases have proven exceptional in comparison to the bulk of cases, which involve state tax discrimination against nonresidents or against residents with out-of-state income. *Cf.* Nordlinger v. Hahn, 505 U.S. 1, 12 (1992) (ruling that California's Proposition 13A, which based property taxes on assessments made in 1975-76, did not discriminate against new residents in violation of the Equal Protection Clause because the rule was rationally related to the state's goal to encourage "neighborhood preservation, continuity, and stability").

101. Moreover, the assumption of fixed residence, although designed to make our models tractable, is not necessary for our results, as we show later. *See infra* note 170.

4. *What We Mean by Welfare*

Throughout this Article, we use the traditional economist's concept of welfare. We derive welfare from individual preferences. We also generally ignore the possibility of externalities and so generally assume that an unregulated environment would yield an efficient equilibrium. At the same time, we recognize that governments raise revenue through taxes for a variety of purposes, some of which are because of market imperfections, such as externalities. Such taxes, however, distort behavior along a number of different dimensions. In our view, a tax distorts behavior if it would in theory be possible for a central planner to adjust behavior, compensate the losers, and have a surplus remaining. Thus, when we talk about welfare we are using the criterion of Kaldor-Hicks efficiency.[102]

5. *Why These Benchmarks?*

Finally, given the many possible margins upon which tax-induced distortions can occur, one might question our choice to consider whether the tax nondiscrimination principle can best be understood as requiring only locational neutrality, leisure neutrality, or competitive neutrality. We chose these benchmarks because they dominate cross-border tax debates.[103] In addition the ECJ has made clear that the nondiscrimination principle does not govern certain margins, such as residence-based discrimination by a member state against its own nationals with only domestic income,[104] although the freedom of EU nationals to choose their state of residence is protected by other parts of the TFEU.[105]

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102. *See generally* BALASSA, *supra* note 42, at 10-14 (discussing how integration of the economies of different states can impact economic welfare).

103. *See, e.g.*, STAFF OF JOINT COMM. ON TAXATION, 102D CONG., FACTORS AFFECTING THE INTERNATIONAL COMPETITIVENESS OF THE UNITED STATES 5 (Comm. Print 1991) (discussing locational neutrality and savings neutrality); *see also* Desai & Hines, *supra* note 33 (discussing all three benchmarks); Graetz, *supra* note 23 (discussing locational and savings neutrality and arguing that U.S. international tax policy should focus more on promoting national welfare).

104. *Werner*, 1993 E.C.R. I-429, para. 17 (holding that EU law "does not preclude a Member State from imposing on its nationals who carry on their professional activities within its territory and who earn all or almost all of their income there or possess all or almost all of their assets there a heavier tax burden if they do not reside in that State than if they do").

105. TFEU, *supra* note 45, art. 21 ("Every citizen of the Union shall have the right to move and reside freely within the territory of the Member States, subject to the limitations and

The first of the benchmarks we consider is locational neutrality, and it obtains when taxes do not distort the location of workers. In the capital tax context, this benchmark is known as "capital export neutrality," and it obtains when taxes do not distort the location in which capital is employed. Capital export neutrality, which requires an investor to pay the same tax regardless of where an investment is located, was described by economist Peggy Musgrave in the 1960s.[106] It has become one of the standard tools for evaluating the impact of national tax measures upon the efficiency of global capital markets. Reflecting its importance, explicit appeals to locational neutrality appear in foundational policy documents written by domestic tax authorities[107] and major international tax policymaking bodies, such as the OECD.[108]

The second benchmark, savings neutrality, obtains when the supply of savings is allocated efficiently across jurisdictions. Savings neutrality was explained most clearly by economist Thomas Horst in the 1980s under the term "capital import neutrality." Capital import neutrality requires residents of different states to face the same consumption-saving tradeoff. In the form described by Horst, capital import neutrality does not have many advocates among policymakers or economists.[109] Nevertheless, capital export neutrality and capital import neutrality together represent the standard efficiency benchmarks for analyzing cross-border tax issues, and so our analysis would be incomplete without them.[110]

We also consider what we call competitive neutrality. We derive competitive neutrality from recent scholarship by economists Michael Devereux, Mihir Desai, and James Hines emphasizing "capital ownership neutrality," which obtains when taxes do not distort the ownership of assets.[111] Although economists have only recently formalized the requirements of capital ownership neutrality, the notion of competitive or ownership neutrality is older. Discussions of the role that internal, firm-specific factors play in understanding the pattern of foreign direct investment first appeared in the

conditions laid down in the Treaties and by the measures adopted to give them effect."). Article 21 of the TFEU was not in force at the time of the *Werner* decision.

106. PEGGY BREWER RICHMAN, TAXATION OF FOREIGN INVESTMENT INCOME 8 (1963).

107. *See* Graetz, *supra* note 23, at 270-77.

108. *See, e.g.*, OECD Discussion Draft, *supra* note 22, at 102-03.

109. Horst, *supra* note 60.

110. *See* Graetz, *supra* note 23, at 270-77 (criticizing the overreliance by the U.S. Treasury Department on the concept of locational neutrality, and citing many government publications referencing the neutrality benchmarks).

111. Desai & Hines, *supra* note 33; Devereux, *supra* note 33.

economics literature in the 1950s.[112] References to competitive or ownership neutrality first appeared in academic scholarship in the 1990s.[113] In the U.S. legal literature, we believe the term "ownership neutrality" was first used in 1994.[114] But even before the introduction of the term "ownership neutrality," international tax analysts and policymakers had long emphasized the importance of maintaining a level playing field among taxpayers resident in different states who compete for jobs, investments, or customers in the same markets. Given the sustained importance assigned to competitiveness by policymakers and experts, and given the new emphasis on the formal requirements of ownership neutrality in economics scholarship, we add analysis of competitive neutrality to the usual approach to international tax questions, which limits discussion to capital export neutrality and capital import neutrality. As we will show, competitive neutrality turns out to be a better fit than locational neutrality or leisure neutrality for the nondiscrimination principle, given the text of the TFEU, the goals of the EU, and the ECJ's tax nondiscrimination doctrine.

Our last caveat involves the acknowledgement that international tax scholarship and policy documents reflect confusion over the meaning of the term capital import neutrality. Noneconomist international tax experts have long used the term to refer to something akin to competitive or ownership neutrality, while economists have used the term to refer to savings neutrality. This divergence in usage between economists and others has created significant confusion.[115] To avoid this confusion, we do not use the term capital import neutrality. Instead, we use the term "savings neutrality" to refer to what economists call capital import neutrality, and we use the term "leisure neutrality" to refer to the labor analogue of savings neutrality. Finally, we use the term "competitive neutrality" to refer to both what economists call capital ownership neutrality as well as to its labor analogue.

112. EDWARD M. GRAHAM & PAUL R. KRUGMAN, FOREIGN DIRECT INVESTMENT IN THE UNITED STATES 191-93 (3d ed. 1995) (surveying economic explanations for foreign direct investment).

113. Devereux, *supra* note 33.

114. *See* Robert A. Green, *The Troubled Rule of Nondiscrimination in Taxing Foreign Direct Investment*, 26 LAW & POL'Y INT'L BUS. 113, 138 (1994) ("Ownership neutrality prevails if the international tax system is neutral with respect to the identity of the firm that owns and controls capital in a given country.").

115. Michael S. Knoll, *Reconsidering International Tax Neutrality*, 64 TAX L. REV. 99, 101-18 (2011) (arguing that Musgrave's original description of capital import neutrality was a type of competitive neutrality and that many noneconomists continued to use the term capital import neutrality to refer to competitive neutrality long after economists following Horst switched to using the term to refer to savings neutrality).

B. Locational Neutrality

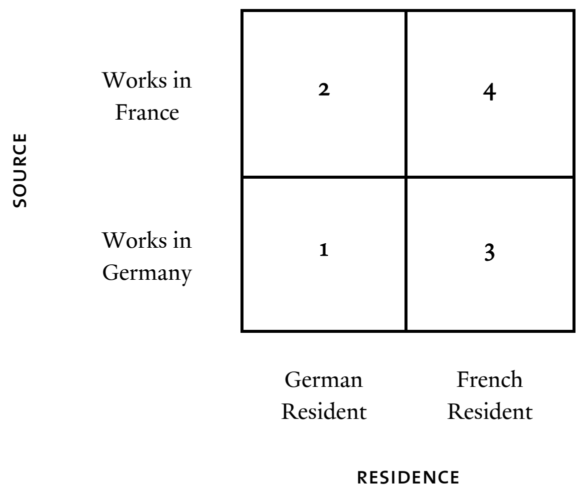
Capital export neutrality is the first traditional tax neutrality benchmark. A tax system achieves capital export neutrality when it does not distort the location of capital. If the tax system achieves capital export neutrality, then shifting capital across borders does not increase global output.[116] We label both capital export neutrality and its labor analogue "locational neutrality." A tax system is locationally neutral when it does not distort the location where individuals work. If the tax system achieves locational neutrality, then shifting workers across jurisdictions does not increase global welfare.

As with taxing capital income, taxing labor income may create distortions. We demonstrate the notion that taxes can distort the location of labor with a simple example. If the world consisted only of two states, France and Germany, Figure 1 would describe the four possible categories of workers based on where they work and where they reside.[117] The bottom left quadrant (Quadrant 1) represents German residents working in Germany. The top left quadrant (Quadrant 2) represents German residents working in France. The bottom right quadrant (Quadrant 3) represents French residents working in Germany. The top right quadrant (Quadrant 4) represents French residents working in France.

116. For concise explanations of capital export neutrality and capital import neutrality, see DANIEL N. SHAVIRO, DECODING THE U.S. CORPORATE TAX 122-25 (2009); and Richard A. Musgrave & Peggy B. Musgrave, *Inter-Nation Equity*, *in* MODERN FISCAL ISSUES: ESSAYS IN HONOR OF CARL S. SHOUP 63 (Richard M. Bird & John G. Head eds., 1972).

117. Figure 1 is similar to the figure developed by Professor Alvin Warren to describe discrimination against foreign production and foreign producers. *See* Warren, *supra* note 4, at 149. Our analysis differs from his, however, because we emphasize labor mobility and competitive neutrality.

Figure 1.
FOUR TYPES OF WORKERS



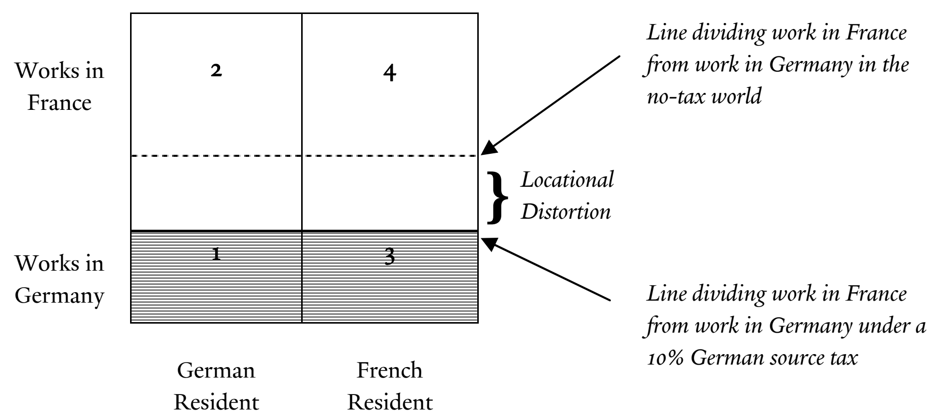
The solid vertical line separating Quadrants 1 and 2 from Quadrants 3 and 4 separates the work done by German residents from that done by French residents. Similarly, the solid horizontal line separating Quadrants 1 and 3 from Quadrants 2 and 4 separates the work done in Germany from that done in France. Figure 1 assumes an environment without taxes (or with harmonized taxes).[118]

118. The solid horizontal line separating Quadrants 1 and 3 from Quadrants 2 and 4 separates work that is efficiently performed in Germany (below that line) from work that is efficiently performed in France (above that line). Accordingly, the area just below that line represents tasks performed in Germany that could be performed almost (but not quite) as efficiently if those tasks were shifted to France. Similarly, the solid vertical line separating Quadrants 1 and 2 from Quadrants 3 and 4 separates work that is most efficiently performed by German residents (left of that line) from work that is most efficiently performed by French residents (right of that line). Accordingly, the area just to the left of that line represents tasks performed by German residents that could be performed almost (but not quite) as efficiently by French residents. Thus, the area in the lower left corner of Quadrant 1 represents tasks that can be performed much more efficiently by German residents working in Germany than by French residents working in either Germany or France or by German residents working in France (for example, designing and testing German grammar books for German primary school students). In contrast, the area in the lower right corner of Quadrant 3 represents tasks that can be performed much more efficiently by French residents working in Germany than by German residents working anywhere or French residents working in France (for example, baking soufflés for customers in Berlin).

Throughout this Article, we assume Germany is considering imposing a tax. In contrast, France, which represents the rest of the world or at least the rest of the EU, will not change its tax policies regardless of what Germany does. Because France represents the rest of the world, Germany is (counterfactually) a small state relative to France. That implies that prices and wages in France are given and will not be affected by German tax policies. German prices and wages, however, will change in response to the tax.

Suppose, for example, Germany imposes a uniform 10% source tax. By a "uniform" source tax we mean that the state applies the tax to all workers with income from its territory, regardless of the workers' residence. Thus, to be uniform, Germany would have to apply the tax to both German residents and French residents working in Germany. We represent the work performed in Germany that is subject to the uniform source tax with light shading in Figure 2. Because all workers in Quadrants 1 and 3 are subject to the German source tax, we shade all of Quadrant 1 and all of Quadrant 3.

Figure 2.
SOURCE-TAX-INDUCED DISTORTION OF LOCATION



As compared to Figure 1, which represented the no-tax world, in Figure 2 Quadrants 1 and 3 are smaller and Quadrants 2 and 4 are larger. The shift in the size of the quadrants represents the locational distortion caused by the German source tax; the German source tax drives labor out of Germany and into France. Specifically, a taxpayer will choose to work in Germany only if she earns at least 111% of what she can earn in France.[119] Thus, the effect of the tax would be to shift workers from Germany to France, as represented by the downward shift in the solid horizontal line separating work in France from work in Germany. This locational distortion reduces welfare by reducing work and therefore production in Germany.[120]

Any source tax, including a uniform source tax that applies to both residents and nonresidents like the one described here, distorts locational neutrality. To raise tax revenue without distorting the location of labor, states must ensure that their residents face the same tax burden on their work, no matter whether they earn their income at home or abroad.[121] If where they earn their income has no effect on how much tax they pay, workers will choose where to work based on where they earn the highest pre-tax wages. There are two tax systems that can achieve this effect without requiring global harmonization of tax rates and bases: residence-only taxation and worldwide taxation with unlimited credits for source taxes.[122]

Under residence-only taxation, states would tax all their residents' income, whether earned domestically or abroad, and source taxation would be forbidden. Similarly, under worldwide taxation with unlimited credits

119. Viewing France as a proxy for the rest of the world and assuming that Germany is not such a large state in labor markets that its policies affect wages elsewhere, it follows that the productivity of workers in France will remain unchanged.

120. To see why, consider a worker who could earn €111 in Germany, but who works in France where she earns only €100. She is indifferent between working in France where she earns €100, which is not subject to tax, and working in Germany, where she would earn €111, but pay €11 in tax. Shifting her work to Germany will allow her to produce €111. Of that amount, €100 would be enough to compensate the worker for her lost French wages. We need not compensate the French government, which does not tax, nor the German government, because before the shift the French resident worked in France and so the German government collected no tax from her. Thus, the shift leaves a surplus of €11, which is proof of the locational distortion.

121. Let

$$R_{r(D)}^{w(F)}$$

represent the after-all-taxes retention rate on work performed by an individual who resides in jurisdiction *D* on work performed in jurisdiction *F*. The retention rate is the portion of the worker's before-tax salary that she retains after paying all source and all residence taxes. Thus, locational neutrality requires that

$$R_{r(D)}^{w(F)} = R_{r(D)}^{w(D)} \quad .$$

In our two-state example, this means that for all German residents, the retention rate on Quadrant 2 must equal the retention rate on Quadrant 1. Likewise, for all French residents, the retention rate on Quadrant 3 must equal the retention rate on Quadrant 4.

122. States also could maintain locational neutrality by agreeing to assess taxes at the same rate.

("worldwide taxation"), states also would tax all their residents' income, no matter where earned. But source taxation would be permitted. To maintain locational neutrality, states would fully credit any taxes their residents paid to source states. In this way, residents of a particular state would always face the same tax burden on their income, no matter where they earned it, so the presence of higher or lower tax rates in other states would not influence residents' decisions about where to work.[123] Because we assume residence is fixed, worldwide taxation tends to push before-tax wages into equality across borders so that shifting labor across jurisdictions will not increase output. Worldwide taxation is an example of what we call a "uniform residence tax" because it applies on the same basis to all residents, regardless of the source of their income.

C. Leisure Neutrality

The second traditional tax neutrality benchmark is "capital import neutrality," or "savings neutrality," which obtains when savings are allocated efficiently across jurisdictions.[124] We call capital import neutrality "savings neutrality," and we call the labor analogue to savings neutrality "leisure neutrality." Leisure neutrality obtains when leisure is allocated efficiently across jurisdictions. In other words, leisure-neutral taxes do not create different distortions of the labor/leisure tradeoff for workers residing in different states.

In the absence of taxes, people would decide how much time to devote to work and how much to leisure based purely on their preferences regarding those activities. However, because income from work is taxed, whereas leisure is not taxed, all income tax systems favor leisure over work. This distortion between work and leisure arises under any system that taxes income, and would exist even if the world consisted of a single taxing jurisdiction. But the existence of multiple jurisdictions that impose taxes at different rates creates an additional distortion. For example, if Germany is a high-tax jurisdiction, and France is a low-tax jurisdiction, French residents will receive higher after-tax wages from their work than will German residents. As a result, French residents may work too much compared to German residents, who work too

123. *See* Musgrave & Musgrave, *supra* note 116, at 69. Notice that, to maintain locational neutrality, states would have to refund foreign taxes that exceeded their own. The United States relieves double taxation via the credit method, but it limits the credit to the tax that would have been due on domestic income. Thus, if a U.S. resident earns $100 of foreign source income and if the U.S. tax rate is 35%, then the maximum credit for foreign taxes it will allow is $35, even if a U.S. resident pays a higher rate abroad. *See* I.R.C. § 901 (2006).

124. Horst, *supra* note 60, at 794-96; *see also* Knoll, *supra* note 115 (discussing terminology).

little.[125] Thus, shifting units of work from French residents to German residents could improve global welfare.[126]

A tax system violates leisure neutrality when residents of different states face different work-leisure tradeoffs. A tax system satisfies leisure neutrality when residents from different states face the same work-leisure tradeoff. That will occur only if everyone working in a jurisdiction faces the same marginal tax rate. Of course, even if everyone faced the same marginal tax rate, there would still be a work-leisure distortion as long as the tax rate was not zero. However, there would not be a differential distortion across residents of different states. As we use the term here, "leisure neutrality" refers to the elimination of *differential* work-leisure distortions across residents of different states.

We demonstrate that residence taxation distorts leisure neutrality using our two-state example. Suppose that the only tax is a uniform 20% German residence tax. Recall that a uniform residence tax is one that a state applies to all its residents' income, regardless of where earned. Thus, Germany would tax the income of all German residents at 20%, regardless of whether they earn that income in Germany or abroad in France. When Germany taxes its residents, it makes work less attractive for them than it is for French residents because German residents keep only 80% of what they earn after taxes, whereas French residents keep 100%. As a result, whether they work in Germany or France, German residents face a different work-leisure tradeoff than do French residents. This difference is a violation of leisure neutrality.

The effect of the German tax on the total hours worked by Germans is theoretically indeterminate: it could go either up or down. If the substitution effect predominates,[127] such that taxpayers prefer to spend more time at leisure than to work more to earn after-tax wages, then by lowering the after-tax wages of German residents relative to French residents, the German residence tax reduces the amount worked by German residents compared to French residents. For no special reason, we drew Figure 3 using the assumption that the substitution effect would predominate.

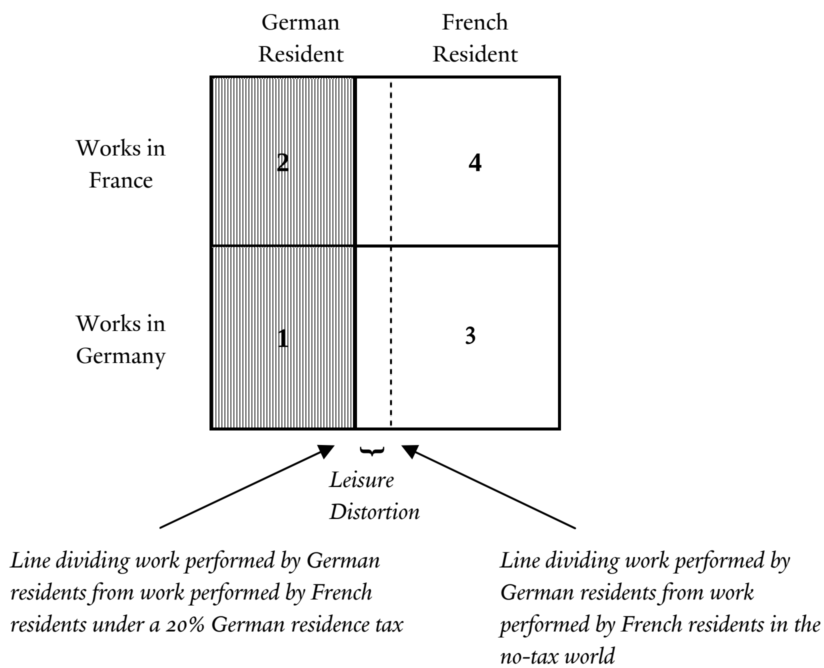
125. *Cf.* Rosanne Altshuler, *Recent Developments in the Debate on Deferral*, 20 TAX NOTES INT'L 1579, 1581-82 (2000) (discussing capital taxation, and therefore couching her discussion in terms of savings and consumption, rather than work and leisure).

126. *Cf.* SHAVIRO, *supra* note 116, at 122-26 (analyzing capital taxes); Altshuler, *supra* note 125 (analyzing capital taxes).

127. The substitution effect states that when the price of a good (such as ice cream or leisure) rises, consumers tend to consume less of that good, and vice versa. SAMUELSON & NORDHAUS, *supra* note 83, at 78.

As in the last figure, we use light shading to represent the work that is subject to the German tax. In this case, however, because we posit a uniform German residence tax, all workers in Quadrants 1 and 2 are subject to the tax so we shade all of Quadrant 1 and all of Quadrant 2:

Figure 3.
RESIDENCE-TAX-INDUCED DISTORTION OF LEISURE



Under our assumption that the substitution effect predominates, the German residence tax shifts units of work from German residents to French residents, and it therefore shifts to the left the solid line separating Quadrants 1 and 2 from Quadrants 3 and 4, as compared to its position in a no-tax world. Unlike in Figure 2, in Figure 3, the change in the size of the quadrants does not represent a physical shift of workers across state borders. Instead, in Figure 3, the change in the size of the quadrants represents a shift in the amount of work done by the workers in each quadrant relative to the no-tax world. Uniform residence taxation does not cause anyone to change *where* they work;[128] instead,

128. In the previous Section, we explained that uniform residence taxation does not create locational distortions.

it causes people to change the *amount* they work. That distortion reduces welfare.[129]

In Figure 3, we assumed that the substitution effect would dominate, but it is possible that the income effect may dominate instead,[130] such that earning lower after-tax wages encourages German residents to work more in order to increase these wages. In that case, there would still be a distortion: the solid vertical line separating Quadrants 1 and 2 from Quadrants 3 and 4 would shift to the right as compared to its position in a no-tax world. Now welfare could be improved by having German residents work less and French residents work more. No matter whether the substitution or income effect dominates, in the absence of global tax rate harmonization, *all* residence taxation distorts leisure

129. The German residence tax creates a distortion by shifting units of work from German residents to French residents. We demonstrate this distortion by showing that it is possible to increase aggregate welfare by rearranging work and leisure between French and German residents. Assume an additional unit of work by either a French or German resident is just enough to generate €100 before tax. At the margin, because the German residence tax does not apply to residents of France, a French resident is indifferent between working the additional unit (thereby earning €100) and not working. Similarly, at the margin, a German resident, who must pay residence tax at 20%, is indifferent between working the additional unit (thereby earning €80 after the German residence tax) and not working. Recall that in our example in the text, we assumed that the substitution effect would dominate, so that the German residence tax would reduce work by German residents. Now consider the possibility of partially offsetting that change by reducing the work of a French resident and increasing the work of a German resident. Because the French resident is indifferent at the margin between working and earning €100 and not working, reducing the French resident's work by one unit will reduce her income by €100 without reducing her welfare. The German resident has to be paid only €80 for the additional work to compensate for his lost leisure. We need not compensate the French government for any loss of tax, since, no matter who performs the work, France will not tax it. Nor need we compensate the German government, since, if the French resident had performed the work instead of the German resident, Germany would not have collected any tax on it. Thus, as compared to the scenario where the French worker performs the work and demands €100 to compensate her for her lost leisure, if the German resident performs the work he demands only €80 to compensate him for his lost leisure, leaving €20 to be shared among the German worker and his employer. This is proof of the work-leisure distortion across residents of different states.

130. The income effect is the effect of a change in income on the quantity of a good (such as ice cream or leisure) consumed. SAMUELSON & NORDHAUS, *supra* note 83, at 79. For most goods, the quantity consumed increases with income, but for some goods (economists called these inferior goods) the quantity decreases as income rises (e.g., packaged ramen noodles). *See id.* at 754 (defining inferior goods). When the price of a good rises, there is both a substitution effect, which is away from the good, and an income effect, which can be away from or towards the good. An income tax lowers the price of leisure, which encourages consumption of leisure, but it also lowers income, which would lower such consumption (assuming leisure is a normal, not an inferior, good). Thus, with an income tax, the substitution and income effects on leisure are in the opposite direction. *See id.* at 79.

neutrality, although *uniform* residence taxes do not also distort locational neutrality.[131]

To achieve leisure neutrality in the absence of global tax rate harmonization, taxpayers must earn the same after-tax wage, no matter where they reside.[132] This means that states may not assess taxes on a residence basis. Instead, they must practice exemption. Additionally, states that tax on a source basis must use uniform source taxes—those that apply on the same basis to resident and nonresident workers.[133] Under this system, after-tax wages converge across jurisdictions, so shifting leisure among residents of different states would not raise welfare.

Many common tax policies violate leisure neutrality. For example, some states tax resident workers on a net basis but nonresident workers on a gross basis. Applying different tax bases to residents and nonresidents working in the same jurisdiction distorts their labor/leisure decisions because members of the group that faces the higher effective tax rate will either work fewer hours (if the substitution effect predominates) or more hours (if the income effect predominates) than the other group. Both cases violate leisure neutrality. Likewise, in the absence of tax rate harmonization, all residence taxation violates leisure neutrality because taxpayers pay different rates depending upon where they reside.

D. Competitive Neutrality

As we have shown, to achieve locational neutrality, all taxpayers residing in the same state must face the same tax burden on their foreign and domestic earned income, namely, the residence state's tax rate. Thus, the burden to maintain locational neutrality falls on residence states, which must tax residents' foreign and domestic income the same way, including by granting unlimited credits for source taxes if necessary. In contrast, to achieve leisure

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131. *See supra* Section II.B.

132. Using the notation *supra* in note 121, leisure neutrality requires that $R^{w(D)}_{r(F)}$ equal $R^{w(D)}_{r(D)}$. In our two-state example, this means that the retention rate for all taxpayers who work in Germany must be the same no matter where those workers reside (i.e., the retention rate for Quadrant 1 must equal the retention rate for Quadrant 3). Likewise, the retention rate for all taxpayers who work in France must be the same no matter where those workers reside (i.e., the retention rate for Quadrant 2 must equal the retention rate for Quadrant 4).

133. In the terminology of international law, states must grant nonresidents national treatment with respect to source taxes. Since states must extend national treatment to all nonresidents regardless of where they reside, leisure neutrality effectively also encompasses a most-favored-nation treatment requirement for source taxation. Leisure neutrality forbids residence taxation in the absence of rate harmonization.

neutrality, all taxpayers must face the same tax burden on income earned in a jurisdiction no matter where they reside, namely, the source state's tax rate. This means that residence states must not tax at all and source states must tax nonresidents the same way that they tax residents.[134] Thus, the burden to maintain leisure neutrality falls primarily on source states, because only source states tax under leisure neutrality.

Notwithstanding that the burden to maintain locational neutrality would fall on residence states and the burden to maintain leisure neutrality would fall on source states, the ECJ has imposed nondiscrimination obligations on states taxing in *both* a source capacity and a residence capacity. Professors Graetz and Warren have argued that imposition of nondiscrimination at both source and residence shows that the ECJ's approach to nondiscrimination is incoherent.[135] Crucial to their argument is the fact that, unless all states harmonize their tax rates, locational neutrality is incompatible with leisure neutrality.[136] This is a simple matter of logic: if locational neutrality requires cross-border workers to be taxed at their residence state's rate, and leisure neutrality requires cross-border workers to be taxed at their source state's rate, then those two requirements can only hold simultaneously if the source and residence states have the same tax rate.

But the ECJ repeatedly has held that EU law does not require tax rate harmonization, because rate harmonization would invade the member states' retained tax autonomy.[137] Thus, the ECJ's imposition of nondiscrimination burdens at both source and residence cannot logically be understood as an

134. Leisure neutrality is not distorted by source states taxing at different rates from each other. Assuming each state has a single tax rate, wages across states will adjust so that after-tax wages are the same everywhere. Thus, workers will face the same labor/leisure tradeoff regardless of where they work or where they reside. The lower wage paid in a low-tax state is called an implicit tax. Thus, the total tax—the sum of implicit and explicit tax—is equal across states.

135. Graetz & Warren, *supra* note 18, at 1219.

136. *Id.* at 1212-23 (couching their discussion in terms of capital export neutrality and capital import neutrality rather than locational neutrality and leisure neutrality); *see also* Michael J. Graetz & Alvin C. Warren, Jr., *Dividend Taxation in Europe: When the ECJ Makes Tax Policy*, 44 COMMON MKT. L. REV. 1577, 1577 (2007) ("[T]he Court's general approach to income tax issues is incoherent because it seeks to eliminate discrimination based on both the origin and destination of economic activity—an impossible quest in the absence of harmonized income tax bases and rates . . . ."). The inability to achieve locational neutrality and savings (leisure) neutrality simultaneously in the absence of rate harmonization is well-established. *See* Graetz & Warren, *supra* note 18, at 1217 (framing their discussion in terms of capital import and export neutrality).

137. *See, e.g.*, Case C-336/96, Gilly v. Directeur des Services Fiscaux du Bas-Rhin, 1998 E.C.R. I-2793, para. 34.

attempt by the court to impose *both* locational and leisure neutrality. Or, at least, if the court were trying to impose both neutrality benchmarks simultaneously, it would be entering, in Graetz and Warren's terms, a "labyrinth of impossibility."[138]

The competitive neutrality construction of nondiscrimination offers a way out of this labyrinth. From a competitive neutrality perspective, there is nothing fundamentally incoherent about imposing nondiscrimination obligations at both source and residence.

A tax system is competitively neutral when it is not possible to increase productivity by shifting jobs among people. In contrast with locational neutrality, which concerns the global allocation of workers across all jurisdictions, competitive neutrality concerns the matching of workers with jobs. States violate competitive neutrality when their tax systems distort which people occupy particular jobs. If the tax system causes one worker who is more productive in State *X* to work in State *Y* instead and causes another worker who is more productive in State *Y* to work in State *X* instead, the tax system violates competitive neutrality.[139]

The principal insight of competitive neutrality for capital is that if productivity differs across capital owners, then removing tax distortions to ownership can increase welfare. Whereas outmoded theories conceived of foreign direct investment and the firms that engaged in it as mere conduits for net transfers of savings between states, modern economic theory emphasizes that multinational firms exist to exploit the advantages of common ownership of proprietary assets across different jurisdictions. For example, by investing in a jurisdiction directly through a controlled subsidiary, rather than dealing at arm's length with local firms, multinational firms can exploit unique intangibles (such as patents, production processes, brands, and know-how) in the local jurisdiction without having to license or otherwise share the intangibles with local firms.[140] That significant foreign direct investment by multinationals takes the form of acquisitions of local firms and assets (rather

138. Graetz & Warren, *supra* note 18, at 1243.

139. For example, if the effective tax rate on French residents working in France relative to the effective tax rate of French residents working in Germany is lower than the effective tax rate on German residents working in France relative to the effective tax rate of German residents working in Germany (taking into consideration both source and residence taxes), then taxes might allow a French resident to underbid a German resident for the job in France, even if the German resident is the better candidate.

140. For developments in the literature on foreign direct investment, see Desai & Hines, *supra* note 33, at 488-91. Other advantages of multinational firms include the opportunity to integrate local production into preexisting global production processes. *Id.* at 489.

than new investments) suggests that multinationals sometimes possess productivity advantages over local firms.[141] If differences in ownership result in differences in productivity, then taxes that distort ownership reduce welfare.[142]

The easiest way to conceive of competitive neutrality for capital is as a competition between taxpayers residing in different states to acquire a target asset. We adopt Professor Mitchell Kane's formulation of competitive neutrality for capital, which states that competitive neutrality obtains when "the potential acquirer with the greatest productivity advantage will be able to offer the highest bid for the target."[143] This requires that an investor not face tax advantages or disadvantages in the acquisition of assets in a jurisdiction relative to competing investors in that jurisdiction. This logic carries over to labor because workers compete for jobs similarly to how investors compete for assets: investors bid up prices and down rates of return, whereas workers bid down wages.

Both types of competition can be distorted by taxation. Just as competitive neutrality for capital obtains when it is not possible to increase productivity by shifting assets among owners, competitive neutrality for labor obtains when it is not possible to increase productivity by shifting jobs among people. Violations of competitive neutrality occur when states assess nonuniform source taxes or nonuniform residence taxes.[144] Source taxes are nonuniform if

141. *Id.* at 490 (noting that the evidence on acquisitions also tends to negate the view that foreign direct investment represents merely transfers of net savings across jurisdictions).

142. The welfare gains from achieving competitive neutrality have not been estimated. In developing the capital ownership neutrality framework, Desai and Hines begin with the "extreme case in which the total stock of physical capital in each country is unaffected by international tax rules." *Id.* at 494. They acknowledge that "[t]he welfare implications of [capital ownership neutrality] are less decisive in settings in which the location of plant, equipment, and other productive factors is mobile between countries in response to tax rate differences." *Id.* at 495. Moreover, if achieved via source-only taxation, capital ownership neutrality would violate locational neutrality, "encourag[ing] excessive investment in low-tax countries" resulting in potentially "substantial" welfare impacts. *Id.* at 495-96. Mitchell Kane challenges the notion that ownership distortions caused by methods of double tax relief justify adopting ownership neutrality as a normative benchmark. *See* Mitchell A. Kane, *Ownership Neutrality, Ownership Distortions, and International Tax Welfare Benchmarks*, 26 VA. TAX REV. 53, 60-66 (2006).

143. Kane, *supra* note 142, at 59.

144. As explained *supra* Section II.C, residence taxes always violate leisure neutrality unless they are harmonized across all the states. In addition to violating competitive neutrality, nonuniform source taxes also violate locational neutrality, unless all states have adopted worldwide taxation with unlimited credits for source taxes. Nonuniform source taxes do not violate locational neutrality under such a system because the availability of unlimited foreign tax credits means that taxation at source has no impact on the cross-border worker's overall tax burden.

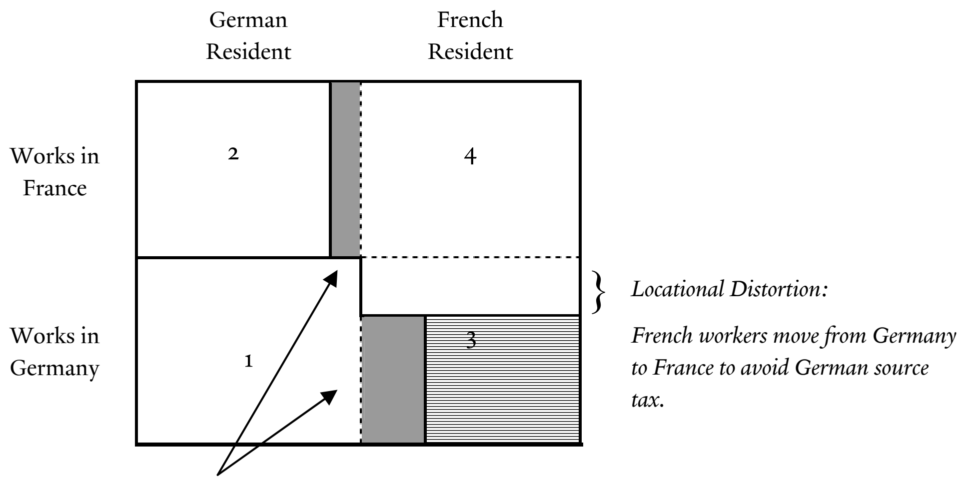
they do not apply on the same basis to all workers in the jurisdiction, both residents and nonresidents. Residence taxes are nonuniform if they do not apply on the same basis to all residents, no matter where they earn their income.

1. Source Taxes

Consider nonuniform source taxes first. Suppose that in our hypothetical world consisting only of Germany and France, Germany assesses a 10% source tax only on French residents working in Germany. French residents working in Germany pay the tax, but no one else does, including German residents working in Germany. In Figure 4, we represent with light shading of Quadrant 3 the work that is subject to German tax. Notice that, unlike in our prior examples, because this tax is nonuniform, it applies to only *one* quadrant, namely Quadrant 3. While this tax is highly stylized, real world examples of nonuniform source taxes abound. For example, when a state taxes nonresidents on their gross income while taxing residents on their net income, the state assesses nonuniform source taxes.[145]

145. Since tax benefits are economically equivalent to negative taxes, a state could also be said to apply nonuniform source taxes when it grants a tax holiday to nonresident taxpayers but fails to make that holiday available to residents. This would be equivalent to a German source tax only on Quadrant 1.

Figure 4.
SOURCE-TAX-INDUCED DISTORTION OF COMPETITION



Competitive Distortions:

Upper dark shaded region: French residents can underbid equally and (certain) more productive German residents for work in France. Since in our example, France is large compared to Germany, the distortion is smaller in France than in Germany.

Lower dark shaded region: German residents can underbid equally and (certain) more productive French residents for work in Germany.

The nonuniform German source tax in our example causes a locational distortion. It causes some French residents to work in France, even if they could earn more in Germany before taxes. Specifically, under the 10% German source tax that applies only to French residents, unless a French resident can earn more than 111% in Germany of what she could earn in France, she will work in France to avoid the tax. Thus, some work done by French workers in Germany that can easily be shifted to France will move to France (e.g., the baking of croissants in German border towns). In Figure 4, we represent this distortion by enlarging Quadrant 4 relative to Quadrant 3; compared to the no-tax world, fewer French residents work in Germany when they face German source taxation.

But there is an additional distortion. Since German residents are not taxed, they will work wherever they earn the most. Thus, taxes distort French, *but not*

German, residents' decisions about where to work, thereby distorting competition between French and German residents for jobs.[146] Accordingly, some jobs previously performed by French residents in Germany will remain in Germany, but those jobs now will be performed by German residents rather than by French residents (e.g., waiting tables at French restaurants in German border towns). This impact is different from the locational distortion because instead of affecting the aggregate number of workers in Germany, it affects the *composition* of the workforce in Germany, skewing it in favor of German residents. We represent this distortion with the lower, dark-shaded region in Figure 4. In addition to giving German residents a competitive advantage over French residents in Germany, the nonuniform German source tax, which applies only to French residents working in France, also gives French residents a competitive advantage over German residents for work in France. Thus, in addition to skewing the workforce in Germany towards Germans, the nonuniform source tax also skews the workforce in France towards French residents. We represent this distortion with the upper dark-shaded region of Figure 4. This (two-directional) distortion of competitive neutrality means that the vertical line separating work performed by French and German residents is not continuous because workers with the same earning potential will work in different jurisdictions based on where they reside.

2. *Residence Taxes*

Now consider nonuniform residence taxes, which also distort competition for jobs. There are many real-world examples of nonuniform residence taxes. Such taxes may create a preference for foreign work. For example, for U.S. residents meeting certain statutory requirements, the United States exempts

146. Nonuniform source taxes also violate locational neutrality, unless the residence state implements worldwide taxation with unlimited foreign tax credits. For a numerical example, see *supra* note 120.

Nonuniform source taxes also violate leisure neutrality. This can be seen in the current example because French residents face a different tradeoff between work and leisure than do German residents. German residents always retain 100% of their productivity-determined wage. In contrast, French residents working in Germany retain less than their productivity-determined wage due to the source tax. This includes French residents who are between 100% and 111% as productive in Germany as France and therefore work in France to avoid German source taxes. They earn €100 in France, but France does not tax. It also includes French residents whose productivity in Germany is more than 110% of their productivity in France. This latter group works in Germany but receives only 90% of their productivity-determined wage due to German source taxes. Thus, whereas French residents face variable work-leisure tradeoffs, Germans always face the same tradeoff. This violates leisure neutrality.

nearly $100,000 of their foreign-earned income.[147] Other nonuniform residence taxes create a preference for domestic work.[148] For example, the United States limits the foreign tax credit to the amount of tax that the United States would have assessed on the relevant income, and it restricts the credit in various other ways.

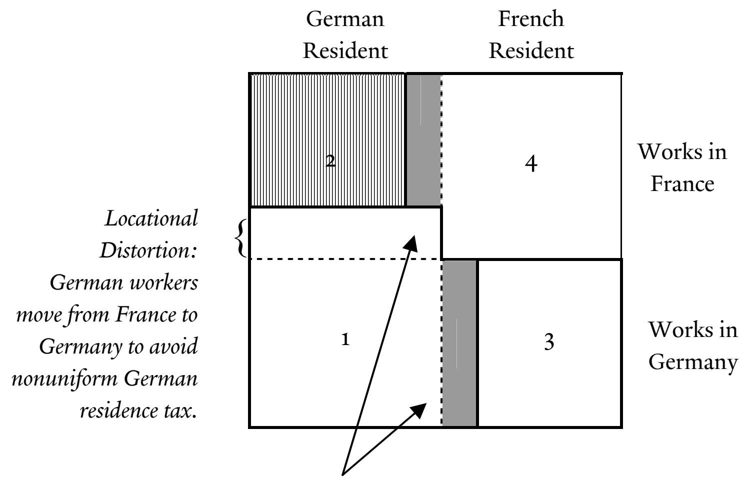
We use another example to illustrate that nonuniform residence taxes violate competitive neutrality. Suppose Germany applies a 20% tax to German residents' foreign-source income (but not to German residents' domestic income). The only people who pay taxes in this system are German residents who work in France.[149] This tax is nonuniform; Germany applies the tax to only one quadrant, namely Quadrant 2. In Figure 5, we represent the work performed by German residents in France that is subject to the tax with light shading.

147. I.R.C. §§ 911(a)(1) and (b)(2) allow for the exclusion of foreign income up to a statutorily established cap, which is indexed for inflation. A maximum of $92,900 was excludable in 2011. *See Foreign Earned Income Exclusion—Requirements*, INTERNAL REVENUE SERV., http://www.irs.gov/businesses/small/international/article/0,,id=96817,00.html (last updated Dec. 6, 2011).

148. For example, when enacted by low-tax states, exemption systems may preference residents' domestic work over their foreign work.

149. Thus, nonuniform residence taxation violates leisure neutrality because German residents working in France keep 80% of what they earn whereas French residents working in France keep 100%.

Figure 5.
RESIDENCE-TAX-INDUCED DISTORTION OF COMPETITION



Competitive Distortions:

Upper dark shaded region: French residents can underbid equally (and certain more) productive German residents for jobs in France.

Lower dark shaded region: German residents can underbid equally (and certain more) productive French residents for jobs in Germany.

As in the last example, the nonunifom tax causes both a locational and a competitive distortion. It causes a locational distortion by discouraging some German residents from taking jobs in France, even if they would earn more there on a pre-tax basis. Specifically, German residents will choose to work in Germany as long as they can earn at least 80% in Germany of what they can earn in France before taxes. To the extent that it shifts jobs from France to Germany, the nonuniform residence tax causes a locational distortion. We represent this distortion in Figure 5 by enlarging Quadrant 1 relative to Quadrant 2.

But the tax also causes a competitive distortion. Specifically, it causes some jobs in Germany to be occupied by Germans instead of French residents.[150] In

150. The tax has another effect: German residents working in Germany will earn less after taxes than French residents earning the same before-tax wage. Whether German wages decline or

addition, the tax causes French residents to occupy some of the jobs in France vacated by departing Germans. We represent that two-directional distortion with the two dark shaded rectangles in Figure 5. In the current example, where German residents face a nonuniform 20% residence tax that applies only to income they earn in France, some German residents who have a comparative advantage for working in France will nevertheless work in Germany to avoid the tax.[151] Because these German residents are willing to lower the wage they seek in Germany to avoid the nonuniform residence tax (which applies only to wages they earn in France), they may win jobs from French residents seeking to work in Germany, even in cases where the French residents have a comparative advantage for working in Germany over France. Thus, the result of the tax is that some German residents with a comparative advantage for working in France will work in Germany and some French residents with a comparative advantage for working in Germany will work in France. Thus, nonuniform residence taxation distorts the matching of workers to jobs because workers sort into jobs not solely according to productivity or earnings potential, but also according to *residence*.

3. Maintaining Competitive Neutrality

Taxes would not distort competition for jobs if all states had exactly the same tax base and rates. In the absence of global tax harmonization, however, there are two principal ways to prevent competitive distortions.[152] First, all states could adopt worldwide taxation with unlimited credits for source taxes. Under worldwide taxation, each state sets its own tax rates. Source taxes become irrelevant to competition because they are effectively refunded by the residence state through the unlimited credit. Thus, only residence taxes matter, and states must apply their residence taxes uniformly to all their residents, no matter where those residents earn their income. Because competitive neutrality does not require tax rate harmonization, taxpayers residing in different states will earn different after-all-tax wages.[153] Specifically, residents of high-tax

French wages rise depends on the demand and supply of labor. Assuming Germany is a small state relative to France, German wages are likely to decline more than French wages rise.

151. Specifically, German residents whose productivity in Germany is between 80% and 100% of their productivity in France will work in Germany.

152. Forbidding source taxation entirely would also satisfy competitive neutrality, but since all states tax on a source basis, we do not consider this option.

153. Non-harmonized residence taxes distort leisure neutrality, since taxpayers residing in different states face different labor/leisure tradeoffs.

states will tend to earn less (after all taxes) than residents of low-tax states. However, such taxes will not distort competitive neutrality.[154]

A concrete example will help illustrate this point and drive home the notion that it is *comparative*, not absolute, tax rates that matter for competitive neutrality. Suppose Françoise resides in France and Günther resides in Germany, and that they both compete for a job in each jurisdiction. Assume further that Françoise and Günther are equally productive working in France, but that Françoise is substantially more productive than Günther when working in Germany. Putting some numbers to these assumptions, let us say that Françoise and Günther both would produce €100 of output in France, that Günther would produce €100 in Germany, and that Françoise would produce €150 in Germany. Table 1 illustrates this.

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154. Using the notation *supra* note 121, competitive neutrality requires that

$$\frac{R_{r(D)}^{w(D)}}{R_{r(D)}^{w(F)}} = \frac{R_{r(F)}^{w(D)}}{R_{r(F)}^{w(F)}} \quad .$$

In a world with only two states, France and Germany, to prevent competitive tax distortions between two equally competitive German and French workers, the ratio of the French worker's retention rate on work in France compared to her retention rate on work in Germany must be the same as the ratio of the German worker's retention rate in France compared to his retention rate in Germany, i.e.,

$$\frac{R_{r(Fr)}^{w(Fr)}}{R_{r(Fr)}^{w(Ger)}} = \frac{R_{r(Ger)}^{w(Fr)}}{R_{r(Ger)}^{w(Ger)}} \quad .$$

In terms of Figure 4, this means that

$$\frac{\text{Retention rate on Quadrant 4}}{\text{Retention rate on Quadrant 3}} = \frac{\text{Retention rate on Quadrant 2}}{\text{Retention rate on Quadrant 1}} \quad .$$

Notice that the equality of these ratios does not require that French and German workers pay the same effective marginal tax rate on work in France or Germany (i.e., the tax rate on Quadrant 2 need not equal the tax rate on Quadrant 4, and the tax rate on Quadrant 1 need not equal the tax rate on Quadrant 3). Instead, what is required is that the ratios of the taxes they pay on work in those jurisdictions must be the same. *See infra* note 156 for a demonstration that worldwide taxation does not distort competitive neutrality.

Table 1.
COMPETITIVE NEUTRALITY IN A NO-TAX WORLD

	JOB IN FRANCE		JOB IN GERMANY	
	Françoise	*Günther*	*Françoise*	*Günther*
Gross Income and Take-home Pay	100	100	150	100

Under these circumstances, productive efficiency requires Françoise to work in Germany and Günther to work in France. Françoise should work in France because the ratio (1½) of her productivity in Germany (€150) to her productivity in France (€100) exceeds the ratio (1) of Günther's productivity in Germany (€100) to his productivity in France (€100). Conversely, Günther should work in France because the ratio (1) of his productivity in France (€100) to his productivity in Germany (€100) exceeds the ratio (2/3) of Françoise's productivity in France (€100) as compared to her productivity in Germany (€150).

That the market will reach the productively efficient matching of workers to jobs can be seen by assuming that Françoise and Günther compete for jobs by offering to take less than the full value that they produce. When considering how much to bid for a job in Germany, both Françoise and Günther consider their alternative job opportunities in France. Since Günther can earn €100 if he takes a job in France, which is the full value of his output there, he will not be willing to accept less than €100 in Germany, which is the full value of his output in Germany. In contrast, because Françoise is more productive in Germany than in France, she can lower the wage she demands in Germany (relative to her productivity) and still come out ahead compared to if she works in France, where the maximum she can earn is €100 (the full value of her output in France). Specifically, Françoise will be willing to work for as little as €100 in Germany, even though she produces €150 there. Assuming that there are many Françoises and Günthers and that employers are not restricted to hiring a fixed number of employees, but rather are trying to produce a given output at least cost, then employers will select employees with the greatest relative difference between their wage and their output. Thus, because Françoise would be willing to accept as little as 2/3 of her total output in Germany as payment for her services for working there, Françoise will outcompete Günther for the job in Germany. In contrast, Günther, who requires payment equal to his full productivity in either state, will work in France. Because it results in Françoise working in Germany and Günther working in France, the no-tax world maintains competitive neutrality.

Now we show that the introduction of residence taxes with unlimited credits for foreign taxes likewise maintains competitive neutrality. Assume that both France and Germany implement worldwide taxation with unlimited foreign tax credits. Assume further that France taxes at 20% and Germany taxes at 50%. The following chart compares how much each worker would take home after taxes if each earned his or her productivity-determined wage in each state:

Table 2.

COMPETITIVE NEUTRALITY UNDER WORLDWIDE TAXATION

		JOB IN FRANCE Uniform 20% worldwide taxation		JOB IN GERMANY Uniform 50% worldwide taxation	
		Françoise	*Günther*	*Françoise*	*Günther*
a.	Gross Income	100	100	150	100
b.	Source Tax	(20)	(20)	(75)	(50)
c.	Net Residence Tax/Refund[155]	0	(30)	45	0
d.	Take-home Pay	80	50	120	50

As residents of different states that have different tax rates, Françoise and Günther take home different amounts after payment of all taxes. However, because the ratio of their after-tax wages *relative to each other* are unchanged from the world without taxes, taxation has not distorted the competition between Françoise and Günther for jobs. Even after taxes, Françoise still earns 50% more when she works in Germany than when she works in France, whereas Günther still earns the same amount no matter where he works. Although Françoise is taxed at a total tax rate of 20% whereas Günther is taxed at a total tax rate of 50%, the difference in tax liability does not translate into a change in the ratio of Françoise's earnings in Germany relative to her earnings in France; nor does it translate into a change in the ratio of Günther's earnings in Germany relative to his earnings in France. (Hence, it does not result in a change in the ratio of these two ratios.) Thus, in order to have a job in Germany rather than in France, Françoise still would be willing to accept a salary equal to only two-thirds of what she produces in Germany. In contrast, Günther still would require payment for all he produces in Germany (or

155. Taxes paid and cash outflows are negative numbers and are in parentheses; refunds and cash inflows are positive numbers and are not in parentheses. Our examples assume that the residence state provides unlimited credits for source taxes under worldwide taxation.

France). Thus, implementation of worldwide taxation with unlimited foreign tax credits maintains competitive neutrality even in the presence of national tax rate diversity.

Expressed in the language of comparative advantage, although Françoise and Günther are taxed at different rates, the tax system does not affect comparative advantage because comparative advantage is based on the ratio of two ratios. Since universal adoption of worldwide taxation with unlimited foreign tax credits does not affect either ratio, it does not affect comparative advantage. It therefore follows that such a system maintains competitive neutrality.[156]

The second way to achieve competitive neutrality would be for all states to enact what we call "ideal deduction" or the "ideal deduction method" of double tax relief, one instantiation of which is exemption. Under this method, taxes on cross-border income would consist of two stages. The first stage would consist of uniform source taxes. That is, each state would apply its source tax regime on the same basis to both nonresidents *and residents* who work in its territory. In the second stage, states would tax the worldwide income of their residents, but first-stage taxes (i.e., source taxes, including domestic source taxes) would be deductible from income taxable at residence. Thus, under the ideal deduction method, states would tax their own residents on two jurisdictional predicates: source and residence.[157] Under ideal deduction, states need not

156. In the absence of taxes, Françoise has a comparative advantage in Germany because her productivity-determined wage in Germany (€150) relative to France (€100) as compared to Günther's productivity-determined wage in Germany (€100) relative to France (€100) is 3/2. Conversely, Günther has a comparative advantage in France because Günther's productivity-determined wage in France (€100) relative to Germany (€100) as compared to Françoise's productivity-determined wage in France (€100) relative to Germany (€150) is 3/2. Introduce uniform worldwide taxation at 20% in France and at 50% in Germany. Françoise still has a comparative advantage in Germany because her productivity-determined wage in Germany (€120) relative to France (€80) as compared to Günther's productivity-determined wage in Germany (€50) relative to France (€50) is 3/2 as in the example without taxes. Conversely, Günther's productivity-determined wage in France (€50) relative to Germany (€50) as compared to Françoise's productivity-determined wage in France (€80) relative to Germany (€120) is 3/2 again, as in the example without taxes. It, therefore, follows that uniform taxation does not distort competitive neutrality because none of the ratios expressing comparative advantage (3/2) changes upon the introduction of the tax.

157. Although the tax method contemplated here might seem unfamiliar, it resembles the way corporate profits are generally taxed. Many states tax active (corporate) income on a source basis and also tax passive (personal investment) income on a residence basis. It also resembles the way states provide personal tax benefits in the context of an income tax. States often tax income on a source basis and grant tax benefits on a residence basis.

adopt the same tax rates as each other; that is, they need not harmonize their tax rates. However, each state must apply its own taxes uniformly.

A small adjustment in the example will show that ideal deduction does not distort competition.[158] Again assume Françoise resides in France where both source taxes and residence taxes are 20%, and Günther resides in Germany where both source and residence taxes are 50%. Because German-source income is taxed at 50%, whereas French-source income is taxed at only 20%, in equilibrium jobs in Germany will pay more than jobs in France so that, regardless of their residence, workers will earn the same amount after payment of source taxes. For example, if a French job pays €100, then the equivalent job in Germany will pay €160.[159] Thus, in equilibrium, the after-source-tax wage in each jurisdiction will be the same, namely €80.

For this example, we maintain our assumption that Françoise and Günther are equally productive when they work in France, and we assume that they would both earn €100 (before tax) for work there. When they work in Germany, however, since in equilibrium wages are 60% higher in Germany than in France to compensate for higher German source taxes, both Françoise and Günther will earn more in Germany than in France.[160] Since we continue to assume for this example that Françoise is 50% more productive than Günther when they both work in Germany, Günther will earn €160 if he works in Germany and Françoise will earn €240 if she works in Germany. If both states implement ideal deduction, which requires residence states to allow deductions for source state taxes, the following chart shows that competitive neutrality is maintained. [161]

158. Under this system, because each state assesses the same source taxes against resident and nonresident workers, before-tax wages will differ across states by the difference in source taxes. And because states assess different residence taxes, after-tax wages also will differ for residents of different states by the difference in residence taxes. Thus, taxpayers from high-tax states will tend to earn less (after all taxes) than residents from low-tax states. However, as long as each state assesses residence taxes at the same rate on all its residents (whether they have foreign or domestic income), then such taxes will not violate competitive neutrality.

159. Given the salary in France (€100), the salary in Germany is calculated as follows:

€160 = €100 x (1-20%) / (1-50%).

160. The higher German taxes will drive jobs to France. Only those positions in which workers are productive enough to cover the additional German source taxes will remain in Germany.

161. The simplest version of ideal deduction is an exemption system. If the example in the text were changed so that France and Germany employed exemption, the tax rate in the second stage would be zero, which effectively eliminates the second stage. The taxpayers' take-home pay would be as follows:

Table 3.
COMPETITIVE NEUTRALITY UNDER IDEAL DEDUCTION

		JOB IN FRANCE Uniform 20% source and residence taxes		JOB IN GERMANY Uniform 50% source and residence taxes	
		Françoise	*Günther*	*Françoise*	*Günther*
a.	Gross Income	100	100	240	160
b.	Source Tax	(20)	(20)	(120)	(80)
c.	Residence Income	80	80	120	80
d.	Residence Tax[162]	(16)	(40)	(24)	(40)
e.	Take-home Pay	64	40	96	40

As in the example with worldwide taxation, Françoise and Günther earn different after-all-tax wages and pay taxes at different total rates. Even so, taxation will not affect the matching of workers with jobs. Günther will continue to work in France, and Françoise will continue to work in Germany. As in the prior examples, Günther is not willing to accept less than the full value of what he produces in order to take a job in Germany, whereas Françoise is willing to take a one-third discount. Thus, as with worldwide taxation,

Table A.
COMPETITIVE NEUTRALITY UNDER EXEMPTION

		JOB IN FRANCE Uniform 20% source tax, no residence tax		JOB IN GERMANY Uniform 50% source tax, no residence tax	
		Françoise	*Günther*	*Françoise*	*Günther*
a.	Gross Income	100	100	240	160
b.	Source Tax	(20)	(20)	(120)	(80)
c.	Residence Tax	N/A	N/A	N/A	N/A
d.	Take-home Pay	80	80	120	80

When all the states employ exemption, no worker has a tax-induced advantage or disadvantage compared to any other for work in any particular jurisdiction. Thus, exemption maintains competitive neutrality.

162. Under ideal deduction, workers are subject to tax on their worldwide income at their residence state's rate, but source taxes (including domestic source taxes) are deductible from taxable income.

implementation of the ideal deduction method maintains competitive neutrality even in the presence of national tax rate diversity.[163]

163. Using a numerical example, we argued in the text that universal adoption of either worldwide taxation or the ideal deduction method will not compromise competitive neutrality. In this footnote, we provide a more general example for the two-worker and two-state example. Denote the productivity of a worker in any quadrant by P with a subscript to indicate the quadrant. Thus, P_1 represents the productivity of a German worker in Germany, P_2 represents the productivity of a German worker in France, P_3 represents the productivity of a French worker in Germany, and P_4 represents the productivity of a French worker in France.

If $(P_2/P_1) / (P_4/P_3) > 1$, then the German resident has a *comparative* advantage in France (and the French resident has a comparative advantage in Germany), but if $(P_4/P_3)/ (P_2/P_1) > 1$, then the French resident has a *comparative* advantage in France (and the German resident has a comparative advantage in Germany). Note that it is not possible to have a comparative advantage in both states.

Denote the total tax rate in any quadrant by t with a subscript for the quadrant number. It follows that the tax system does not affect comparative advantage and so does not compromise competitive neutrality if:

Equation (1)

$$\frac{\dfrac{(1-t_2)P_2}{(1-t_1)P_1}}{\dfrac{(1-t_4)P_4}{(1-t_3)P_3}} = \frac{\dfrac{P_2}{P_1}}{\dfrac{P_4}{P_3}}$$

Because the fraction for comparative advantage is on both sides of the equation, it can be eliminated from both sides of the equation. After rearranging terms, this yields:

Equation (2)

$$\frac{1-t_2}{1-t_1} = \frac{1-t_4}{1-t_3} ,$$

which is the requirement for a tax system not to distort competitive neutrality.

If all states adopt worldwide taxation with unlimited foreign tax credits, then a taxpayer pays the same tax rate wherever that taxpayer works, although taxpayers resident in different states might pay tax at different rates. This implies that the left and right sides of equation 2 both equal 1. Since worldwide taxation with unlimited foreign tax credits satisfies equation 2 (i.e., the two sides of the equation are equal), it thus follows that worldwide taxation does not distort competitive neutrality.

The derivation is slightly more complicated when all states use the ideal deduction method. More notation is needed because both source and residence taxation affects the

We offer one final numerical example to show that adoption by all states of the same method for taxing cross-border income (i.e., all states enact worldwide taxation or all states enact ideal deduction) is not enough to achieve competitive neutrality. Rather, competitive neutrality also requires states to implement uniform taxes. For example, assume that both France and Germany still implement ideal deduction and that France assesses uniform source and residence taxes. Specifically, France assesses uniform 20% source taxes on all workers in France, no matter where they reside. France also assesses uniform 20% residence taxes on French residents' income, no matter where earned.[164] Although Germany assesses uniform 20% source taxes, its residence taxes are nonuniform. Germany imposes a 10% tax on the income earned by German residents working in Germany, but it taxes income earned by Germans abroad at 50%. Table 4 shows that even though both states adopt ideal deduction,

taxpayer's final liability. Let subscripts and superscripts G denote Germany and F denote France. Let a subscript denote a residence tax and a superscript denote a source tax. Thus, for example, with the ideal deduction method, the after-tax income of a French resident who earns €1 in Germany (Quadrant 3) is €1$(1-t_F)(1-t^G)$. Thus, substituting the French and German taxes into the condition for competitive neutrality given by Equation (2), that condition can be rewritten as:

Equation (3)

$$\frac{(1-t_G)(1-t^F)}{(1-t_G)(1-t^G)} = \frac{(1-t_F)(1-t^F)}{(1-t_F)(1-t^G)}$$

Simplifying Equation (3) by dropping the expression $(1-t_G)$ from the left side of the equation because it appears in both the numerator and the denominator and by dropping the expression $(1-t_F)$ from the right side of the equation for the same reason, we are left with just the source taxes, which is equivalent to universal adoption of the exemption method:

Equation (4)

$$(1-t^F)/(1-t^G) = (1-t^F)/(1-t^G)$$

Equation (4) is obviously true. Thus, the ideal deduction method achieves competitive neutrality because it also does not distort comparative advantage.

164. Note that although for the sake of simplicity we set the German and French source tax rates to be the same, that assumption is not necessary for the results. Likewise, although we set the French source tax rate to be the same as the French residence tax rate in this example (as well as in other examples in this Section), "uniformity," as we use the term throughout this Article, does not require a state to adopt the same tax rate for source and residence taxes. Rather, uniformity for source taxation means that source taxes are imposed at the same rate and upon the same base for both resident and nonresident workers. Uniformity for residence taxes means that both foreign and domestic income is taxed at the same rate and upon the same base.

competitive neutrality nevertheless is lost when the German tax system is not uniform.[165]

Table 4.

NONUNIFORM RESIDENCE TAXATION VIOLATES COMPETITIVE NEUTRALITY

		JOB IN FRANCE Uniform 20% source and residence taxes		JOB IN GERMANY Uniform 20% source tax, nonuniform (10%, 50%) residence tax	
		Françoise	*Günther*	*Françoise*	*Günther*
a.	Gross Income	100	100	150	100
b.	Source Tax	(20)	(20)	(30)	(20)
c.	Residence Income	80	80	120	80
d.	Residence Tax	(16)	(40)	(24)	(8)
e.	Take-home Pay	64	40	96	72

As Table 4 illustrates, although Françoise earns more after all taxes than does Günther regardless of where they work, Günther now has an advantage in the competition to secure a job *in Germany*. As in the prior examples, Françoise is willing to accept as little as 67% (i.e., €64/€96) of her productivity-determined wage in Germany to secure a job in Germany rather than a job in France at which she would be less productive.[166] However, because Günther faces a much lower residence tax when he works in Germany than when he works in France, Günther is willing to accept as little as 56% (i.e., €40/€72) of his productivity-determined wage in Germany in order to secure the job in Germany rather than the job in France that would subject him to high German residence taxation. Because employers will hire the worker with the largest relative difference between productivity and wage, employers in Germany will prefer to hire Günther, who demands in wages only 56% of what his productivity-determined wage would be, than to hire Françoise, who demands

165. That competitive neutrality requires uniform source taxation is an important point that has been missed in the literature on capital ownership neutrality. *See, e.g.*, Desai & Hines, *supra* note 33, at 494-99 (describing global adoption of exemption as achieving competitive neutrality for capital without noting that source taxes also must be uniform). Although states may assess source taxes that differ from the source taxes applied by other states, to maintain competitive neutrality, each state must apply its own source taxes uniformly to all workers within its jurisdiction, regardless of workers' residence.

166. By "productivity-determined wage" we mean the value of marginal product (i.e., the value of the marginal output of the factor at issue (labor)). *See* N. GREGORY MANKIW, PRINCIPLES OF ECONOMICS 380 (6th ed. 2008) (explaining that a profit-maximizing firm will hire workers up to the point where the value of marginal product equals the wage).

in wages 67% of what her productivity-determined wage would be. In spite of Günther's lower absolute productivity in Germany (compared to Françoise) and his lower relative productivity in Germany than in France (compared to Françoise's relative productivity), nonuniform taxation results in Günther being able to outbid Françoise for the job in Germany.

At the same time, Germany's nonuniform residence taxation gives Françoise a competitive advantage over Günther for the job in France, even though she is no more productive than Günther there. Compared with working in Germany, Françoise will demand in France a smaller portion of her productivity-determined wage (i.e., €96/€64), than will Günther (i.e., €72/€40).[167] Thus, Françoise will outbid Günther for the job in France. As the example illustrates, the reason why the nonuniform tax distorts competitive neutrality is because it affects comparative advantage—the ratio of Françoise's earnings in France to her earnings in Germany as compared to the ratio of Günther's earnings in France to his earnings in Germany. In the example, the nonuniform German residence tax raises the ratio of Günther's earnings in Germany to his earnings in France, thereby tilting Günther's comparative advantage towards Germany and hence Françoise's towards France. Similar analysis would show that nonuniform source taxation also violates competitive neutrality. These results are consistent with the ECJ's case law, in which the court has held that the nondiscrimination principle neither requires residents and nonresidents to be taxed at the same tax rate,[168] nor requires foreign-source income to be taxed at the same rate as domestic income.[169]

We take the opportunity here to clarify a difference between locational neutrality and competitive neutrality. In contrast to competitive neutrality, locational neutrality represents a distortion that encourages movement in only one direction. In a world with two states and no taxes, if State *X* violates locational neutrality by imposing a source tax, then the source tax will encourage workers in State *X* to give up work in State *X* for work in State *Y*. However, the tax does not encourage other workers to give up work in State *Y* for work in State *X*. More generally, the source tax in State *X* does not create a

167. For example, assume that Günther outbids Françoise for the job in Germany by accepting a shade under 2/3 of his productivity-determined wage. Thus, Günther will earn €66.67, pay €13.33 in source tax to Germany, and pay €5.33 in residence tax to Germany, leaving him with €48. To match these after-tax earnings in France, Günther would require 120% of his productivity-determined wage (€48/€40) in France. In contrast, Françoise requires only 100% of her productivity-determined wage (€64/€64) to work in France. As a result, Françoise can outcompete Günther in France.

168. *See supra* note 57.

169. *See supra* notes 58-59.

situation where welfare can be improved by shifting a worker in State *Y* to State *X and* vice versa. Unlike locational neutrality, which concerns movements of workers in only one direction (away from the state assessing the tax), competitive neutrality concerns distortions that encourage movement in two directions—both into and out of the taxing state. The example we just gave of the nonuniform German residence tax caused distortions in two directions: it enabled Günther to outbid Françoise for work in Germany (despite Françoise's higher productivity than Günther in Germany) *and* it also enabled Françoise to outbid Günther for work in France (despite the two workers' equal productivity there, and despite the fact that Françoise would be less productive in France than in Germany). Stated more generally, if in a world without taxes State *X* imposes a tax that violates competitive neutrality, then the tax will induce some workers to shift from State *X* to State *Y* and other workers to move in the opposite direction, from State *Y* to State *X*. If the tax violates competitive neutrality, then it is possible to increase welfare by shifting a worker from State *X* to State *Y* and another worker from State *Y* to State *X*.

Furthermore, as the above examples with Françoise and Günther demonstrate, in order to attain competitive neutrality it is not necessary for a state to tax its own residents and foreign residents earning income in its territory at the same total tax rate. For example, in Table 3 above, France taxed French residents working in France at 36%, while it taxed German residents working in France at only 20%. As we showed, this scheme did not violate competitive neutrality. Nor is it necessary for a state to tax residents earning income at home at the same total tax rate as residents earning income abroad. In Table A above, when Françoise worked in France, her effective tax rate was 20%, whereas when she worked in Germany, her effective tax rate was 50%. We showed that these differences did not affect the competition between Françoise and Günther for jobs, and they did not compromise competitive neutrality.

While the foregoing discussion of competitive neutrality has been complex, it reduces to straightforward guidelines for identifying taxes that violate competitive neutrality. Simply put, uniform taxes promote competitive neutrality,[170] whereas nonuniform taxes distort competitive neutrality.[171] That

170. We developed our argument that uniform source taxes do not violate competitive neutrality under the assumption that residence is fixed. If we were to relax that assumption by assuming that some people could freely change their residence, it would still be the case that uniform source and residence taxes would not distort competitive neutrality. In terms of the example, if residents could freely elect their residence, they would choose France over Germany because of its lower residence taxes. Taxes would affect choice of residence, but once residence was selected they would not affect job choice. Alternatively, if we assumed that residence followed where one worked, then higher residence taxes in Germany would means that any tax that does not fall equally on two adjacent quadrants of Figure 1 distorts competitive neutrality. For example, a tax only on German workers in Germany (Germany taxes only Quadrant 1)[172] distorts competition because it encourages German workers to work in France and French workers to work in Germany.[173]

E. Simple Guidelines for Tax Neutrality

Interpreting the tax nondiscrimination principle to require any of locational, leisure, or competitive neutrality would produce simple guidelines for resolving cases. In this Section, we briefly summarize those guidelines under the assumptions that states will not harmonize their tax rates and bases, and that states will not forego source taxation.

We begin with the guidelines for implementing locational neutrality. Although each state may set its own tax rates, all states must enact worldwide taxation with unlimited credits for source taxes. Such worldwide taxation constitutes what we have been calling a "uniform residence tax" because it applies on the same basis to all of a state's residents, no matter where they earn their income. Locational neutrality permits the assessment of source taxes in addition to residence taxes, and because any locational distortions introduced at source will be effectively negated at residence by the availability of unlimited

make Germany a less desirable state in which to work and so German wages would have to rise relative to French wages. However, as long as states had uniform source and residence taxes, competitive neutrality would not be compromised. Under uniform source and residence taxes, the only way there could be a distortion to competitive neutrality is if there were a threshold amount of work above which a nonresident worker would be considered to be a resident of the source state (and, presumably, not of the former residence state). In such circumstances, nonresidents might avoid exceeding the work threshold in high-tax jurisdictions in order to avoid becoming residents there. As far as we know, no jurisdiction imposes such an explicit threshold rule. However, physical presence rules, which are common, will have the same effect for many workers who need to live close to their jobs.

171. Uniform residence taxes maintain both competitive neutrality and locational neutrality. Uniform source taxes maintain both competitive neutrality and leisure neutrality. Although nonuniform source taxes violate competitive neutrality, the violation can be cured via global adoption of worldwide taxation with unlimited foreign tax credits. Thus, whether a nonuniform source tax violates competitive neutrality depends on the method of double tax relief adopted by the states.

172. Such a tax could be enacted by Germany as either a nonuniform source tax or a nonuniform residence tax.

173. In cases, such as user fees, where the "tax" is not a tax, but rather a payment for services received where the tax (cost) equals the value received, there is no distortion.

foreign tax credits, locational neutrality contains no tax proscriptions for source states. In other words, locational neutrality permits all manner of source taxes.

The second benchmark is leisure neutrality. Under leisure neutrality, no state may tax on a residence basis (assuming residence taxes are not harmonized). In addition to forbidding residence taxation, leisure neutrality requires all states to assess only what we have been calling "uniform source taxes," meaning that although each state can choose its source tax rates and base, those rates and base must apply on the same basis to all workers within the source jurisdiction, no matter where those workers reside.

Finally, to maintain competitive neutrality, states may assess taxes on either a residence-basis, a source-basis, or on both bases. Whether competitive neutrality requires source uniformity depends on how states achieve competitive neutrality. If states achieve competitive neutrality via ideal deduction, then source taxation must be uniform. In contrast, if states achieve competitive neutrality by adopting worldwide taxation with unlimited credits for source taxes, then any manner of source taxation would be permitted, since the unlimited foreign tax credit at residence would make source taxes irrelevant to competition. In either case, if states assess residence taxes, then such taxes must be uniform, meaning that, although states are free to set their own residence tax rates, each state must apply its residence taxes the same way to all its residents, no matter where they earn their income. The following table summarizes these prescriptions for tax neutrality:

Table 5.
PRESCRIPTIONS FOR TAX NEUTRALITY

	LOCATIONAL NEUTRALITY	LEISURE NEUTRALITY	COMPETITIVE NEUTRALITY VIA WORLDWIDE TAXATION	COMPETITIVE NEUTRALITY VIA IDEAL DEDUCTION
SOURCE TAXES	Permitted without restriction	Permits only uniform source taxes	Permitted without restriction	Permits only uniform source taxes
RESIDENCE TAXES	Permits only uniform residence taxation, specifically worldwide taxation with unlimited foreign tax credits	Not Permitted	Permits only uniform residence taxation, specifically worldwide taxation with unlimited foreign tax credits	Permits only uniform residence taxation with deductions for source taxes[174]

Note that although the prescriptions of locational neutrality are incompatible with those of leisure neutrality, competitive neutrality can be achieved simultaneously with either locational neutrality or leisure neutrality, but not both (unless tax rates and bases are harmonized). Adoption by all states of worldwide taxation with unlimited foreign tax credits would achieve both locational and competitive neutrality. In contrast, adoption by all states of one particular form of the ideal deduction method, namely exemption, would achieve both leisure neutrality and competitive neutrality.

F. Limits on Judicial Authority To Impose Tax Neutrality

This Section explains that although courts generally lack the authority to do all that would be necessary to fully achieve any of the tax neutrality benchmarks, they can, without exceeding their institutional competence, help advance any of the alternative benchmarks by interpreting the nondiscrimination principle to require uniform taxation.

As is clear from our discussion so far and from Table 5 above, achieving any of the neutrality benchmarks requires significant international coordination in the selection of a method for alleviating the double tax on foreign income.

174. The deduction method includes exemption systems, in which there is no residence taxation (i.e., the second stage, or residence, tax rate is zero), and therefore deductions for source taxes have no effect. It also includes tax systems in which the residence tax rate is effectively negative because, for example, the residence state grants refundable tax benefits on a residence basis.

Specifically, locational neutrality requires all states to adopt uniform worldwide taxation with unlimited foreign tax credits. Conversely, leisure neutrality requires all states to exempt foreign-source income and impose only uniform source taxation. Although competitive neutrality is consistent with both methods of alleviating double taxation, all states must agree on one or the other method. That is to say, the tax system will not be competitively neutral if some states enact worldwide taxation (with unlimited foreign tax credits) while other states enact exemption. Instead, to achieve competitive neutrality, all states must either converge on worldwide taxation with an unlimited foreign tax credit or converge on the ideal deduction method, which includes exemption. Thus, full achievement of any of the benchmarks by the EU member states requires all states to adopt the same method for taxing cross-border income.

But, as the ECJ itself has acknowledged, the ECJ lacks the institutional competence to impose upon the member states a specific method for taxing cross-border income.[175] That is, the ECJ cannot require states to implement worldwide taxation, or any particular form of the ideal deduction method, including exemption. Likewise, it is unlikely that any national court in an EU member state possesses the authority to choose its state's method for taxing cross-border income. Instead, the choice of how to tax cross-border income is a legislative question.

Since full achievement of any of the neutrality benchmarks requires states to coordinate their methods for taxing cross-border income, full implementation of any of the tax neutrality benchmarks we have discussed requires legislative harmonization. This could be done at the national level by coordinated efforts of the individual EU member states or at the EU level under the authority of Article 115 of the TFEU.[176] Thus, one of the policy recommendations that arises from our analysis is that if states desire to fully achieve any of the conceptions of tax neutrality advanced in this Article, they do not have to harmonize their tax rates, but they must harmonize their

175. *See, e.g.*, Case C-513/04, Kerckhaert & Morres v. Belgium, 2006 E.C.R. I-10967, para. 22 (noting that EU law "does not lay down any general criteria for the attribution of areas of competence between the Member States in relation to the elimination of double taxation within the Community"); Case C-336/96, Gilly v. Directeur des Services Fiscaux du Bas-Rhin, 1998 E.C.R. I-2793, para. 24 ("The Member States are competent to determine the criteria for taxation on income and wealth with a view to eliminating double taxation . . . .").

176. *See* TFEU, *supra* note 45, art. 115 ("[T]he Council shall, acting unanimously in accordance with a special legislative procedure and after consulting the European Parliament and the Economic and Social Committee, issue directives for the approximation of such laws, regulations or administrative provisions of the Member States as directly affect the establishment or functioning of the internal market.").

methods of taxing cross-border income. Since most of the EU member states already employ exemption systems, EU-wide adoption of the ideal deduction method (of which exemption is one instantiation) probably represents the easiest path to harmonization.

In light of the need for legislative harmonization to fully achieve any of the neutrality benchmarks, it is reasonable to ask what courts can do to advance tax neutrality without exceeding their institutional authority. Our answer is that courts can advance tax neutrality goals by interpreting the nondiscrimination principle to require fidelity to the uniformity requirement specified by the relevant neutrality benchmark. Later, we will show that this approach finds a striking analogy in the tax discrimination jurisprudence of the U.S. Supreme Court under the dormant Commerce Clause.[177]

Thus, to promote locational neutrality, courts would interpret the nondiscrimination principle to require uniform residence taxes. This would mean that courts would strike down a state law that, for example, taxed foreign-source income more harshly than domestic income. In contrast, to promote leisure neutrality, courts would interpret the nondiscrimination principle to require uniform source taxes. This would mean that courts would strike down a state law that, for example, taxed nonresidents more harshly than residents for work performed in its jurisdiction. Finally, to promote competitive neutrality, courts would interpret the nondiscrimination principle to require both uniform residence taxes and uniform source taxes. It bears emphasizing that the uniformity requirements do not amount to rate harmonization requirements. Each state may set its own tax rates. Source uniformity requires only that the state apply the same source tax regime to all workers within its jurisdiction (no matter where they reside), and residence uniformity requires only that the state apply the same residence tax regime to all its residents (no matter where they earn their income). As we show in the next Section, any of these alternative standards would be easy for courts to apply.

G. Resolving Cases Using the Benchmarks

This Section applies each of the three neutrality benchmarks to the ECJ labor tax cases we presented in Part I to show that interpreting the

177. See *infra* Part IV for a discussion of the internal consistency test applied by the U.S. Supreme Court to evaluate whether state apportionment formulas violate the nondiscrimination principle of the dormant Commerce Clause.

nondiscrimination principle to require any of locational, leisure, or competitive neutrality would provide simple rules for resolving even such difficult cases.

We first revisit *Schumacker*, the case brought against a source state. Recall that Schumacker was a Belgian resident working in Germany who argued that Germany discriminated against him by denying him the personal tax benefits that it granted to German residents, including marital income splitting and deductions for family expenses.

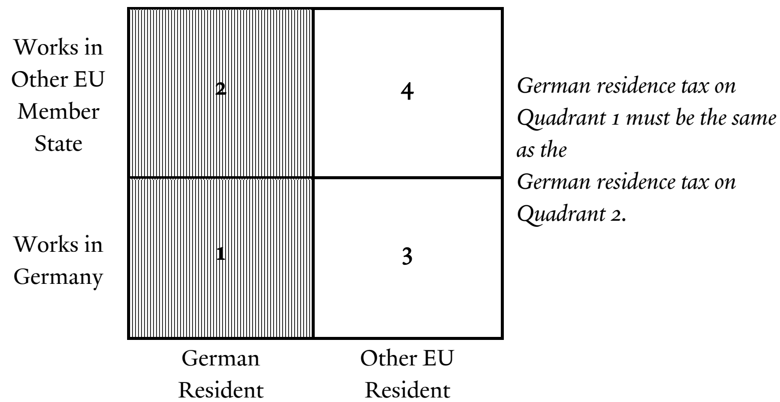
Germany's decision to exclude nonresident workers from tax benefits it granted to resident workers did not violate locational neutrality, simply because locational neutrality is not concerned with how source states tax. This point bears emphasizing: under locational neutrality, states impose worldwide taxation with unlimited foreign tax credits to ensure that residents pay the same taxes on their worldwide income, no matter where it is earned.[178] With unlimited foreign tax credits, taxation by the source state has no impact on locational neutrality, so there would be no obligations concerning how source states may tax.[179]

In terms of Figure 6 below, locational neutrality requires Germany to assess uniform *residence* taxes on Quadrants 1 and 2, but it says nothing about how Germany should tax Quadrant 3.

178. Worldwide taxation with unlimited foreign tax credits is the only way to achieve locational neutrality while allowing both source taxation and unharmonized tax rates.

179. *Cf.* Green, *supra* note 114, at 128 (noting that as long as the residence state makes the taxpayer whole by fully crediting source taxes, there should be no locational distortions from differentially applying source taxes); Warren, *supra* note 4, at 160 (same). Obliging source states to tax nonresidents the same as residents, however, likely would make maintenance of locational neutrality cheaper for residence states that must credit source taxes without limitation.

Figure 6.
REQUIREMENTS TO MAINTAIN LOCATIONAL NEUTRALITY



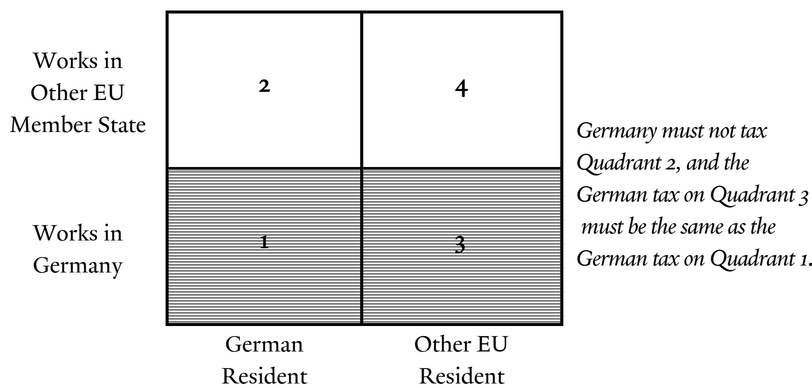
Interpreting nondiscrimination to require locational neutrality would greatly simplify resolution of tax cases: all cases against source states would be dismissed because they all concern how states tax Quadrant 3 compared to how they tax Quadrant 1.

Since *Schumacker* involved German source taxes on other EU residents (i.e., German taxes on workers in Quadrant 3), it would be dismissed under a locational neutrality interpretation of nondiscrimination. Instead, under locational neutrality the focus of nondiscrimination cases would be on residence taxes, and residence taxes would have to be uniform. Thus, under a locational neutrality interpretation of nondiscrimination, we would conclude that Schumacker sued the wrong member state. Instead of suing Germany for failing to treat him the same as competing resident workers, he should have sued his own residence state, Belgium, for failing to provide him the same personal tax benefits (in refundable form, if necessary) provided to residents with only domestic income.[180] Consistent with locational neutrality, the provision of personal tax benefits—including family deductions, personal exemptions, and progressive taxation—at residence would prevent national differences in tax benefits and tax rates from distorting workers' decisions about whether to work at home or abroad.

180. In other words, the violation of locational neutrality in *Schumacker* stemmed from the failure of Belgium to apply the same residence taxes to Quadrants 1 and 2. If it instead had a locationally neutral tax system characterized by worldwide taxation with unlimited credits for foreign taxes, then Schumacker would have been able to collect personal tax benefits at home on the same basis as fellow residents with only domestic income.

Resolution of tax discrimination cases under leisure neutrality would be equally straightforward. Under leisure neutrality, residence taxes are forbidden, and a state's source taxes must be uniform—they must apply the same way to residents and nonresidents working in the same jurisdiction. In terms of Figure 7 below, Germany would be prohibited from taxing Quadrant 2, and it would be required to tax Quadrants 1 and 3 the same.

Figure 7.
REQUIREMENTS TO MAINTAIN LEISURE NEUTRALITY

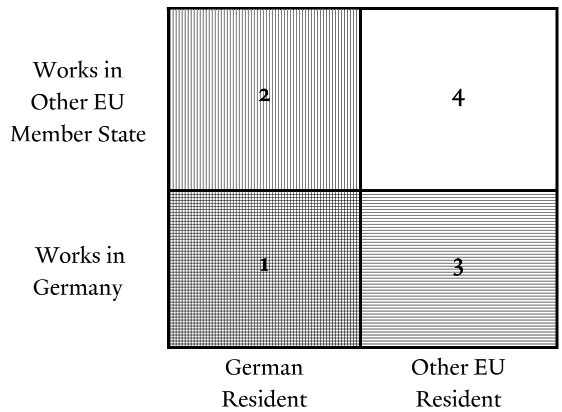


In *Schumacker*, by denying nonresidents the same personal tax benefits that it granted to residents, Germany violated the source tax uniformity requirement. In other words, it assessed different taxes on Quadrants 1 and 3. As a result, Germany violated leisure neutrality.

To resolve *Schumacker* under a competitive neutrality construction of nondiscrimination, we need more information about the German tax system. Recall that Germany can, without violating competitive neutrality, assess uniform source taxes or uniform residence taxes or both.[181] In terms of Figure 8 below, any German source taxes must treat Quadrants 1 and 3 the same, and any German residence taxes must treat Quadrants 1 and 2 the same.

181. To be consistent with competitive neutrality, imposition of both source and residence taxes would require the state to use either the ideal deduction method (in which source taxes apply uniformly to both residents and nonresidents and are deductible from the worldwide income of residents) or worldwide taxation (in which source taxes apply uniformly and the residence state grants unlimited foreign tax credits). For a numerical example, see *infra* note 249.

Figure 8.
REQUIREMENTS TO MAINTAIN COMPETITIVE NEUTRALITY



The German residence tax on Quadrant 1 must be the same as the German residence tax on Quadrant 2; the German source tax on Quadrant 3 must be the same as the German source tax on Quadrant 1.[182]

We know from the facts of *Schumacker* that Germany did not confer personal tax benefits on a uniform source basis to all workers in Germany. Does this mean that Germany put nonresident workers at a competitive disadvantage compared to resident workers? Not necessarily, because Germany could have offered those benefits on a uniform *residence* basis, which would allow exclusion of nonresident taxpayers without violating competitive neutrality. Germany would comply with the requirement to offer tax benefits on a uniform residence basis if it offered the same tax benefits to all its residents, regardless of where they earned their income.[183] In terms of Figure 8, Germany would not violate competitive neutrality as long as it distributed the benefits on a uniform residence basis to all taxpayers in Quadrants 1 and 2, notwithstanding that it denied such benefits to taxpayers in Quadrant 3. Thus, to resolve *Schumacker* under a competitive neutrality interpretation of nondiscrimination, we need to know how Germany taxed Quadrant 2, that is, how it taxed German-resident taxpayers earning income abroad.

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182. While competitive neutrality requires the German source tax on Quadrants 1 and 3 to be the same, and it requires the German residence tax on Quadrants 1 and 2 to be the same, it does not, for example, require the total tax on Quadrant 1 to equal the total tax on Quadrant 3, since taxpayers in Quadrant 1 are taxable by Germany on a source *and* a residence basis, and those taxes can be cumulative. Similarly, workers in Quadrant 3 are subject to German source taxes and the residence taxes of their home state. These taxes can be cumulative, and the foreign residence tax can differ from the residence taxes applicable to Germans.

183. Competitive neutrality requires that the benefits actually be provided in cash or in kind to residents at the same value, regardless of where they work.

If German residents always receive German tax benefits, no matter where they work (as opposed to only if they work in Germany), then they will not reduce the wage they demand in Germany relative to the wage they demand elsewhere on account of those benefits. Thus, if offered on a uniform residence basis, the German benefits would not affect the relative wages paid in Germany or elsewhere, and the German benefits would not distort the matching of workers and jobs. If Germany conferred tax benefits in this way, nonresidents would not be at a *comparative* disadvantage when competing for jobs in Germany against German residents, despite the fact that German residents would receive tax benefits that nonresidents like Schumacker did not. Because he would be entitled to fewer tax benefits in Germany than German residents, a nonresident like Schumacker might pay higher absolute taxes than comparable German residents working in Germany. But this would not affect his ability to compete with German residents for jobs because competitive neutrality is concerned with comparative advantage. Thus, for a tax system to be competitively neutral it is not necessary that all workers in the same jurisdiction face the same absolute tax rates (or receive the same personal tax benefits). Instead, in order for a tax system to be competitively neutral, it is only necessary that the system not change comparative advantage. Higher or lower taxes—as long as they are conferred on a uniform source or residence basis—will not affect comparative advantage and therefore will not compromise competitive neutrality.[184]

This conclusion may seem counterintuitive. If Germany denies Schumacker personal tax benefits, and Schumacker has no income at home in Belgium against which he can use Belgian personal tax benefits, he seems to be at a tax-induced competitive disadvantage. That may be, but the disadvantage would not stem from his tax treatment in Germany, provided Germany confers personal tax benefits on a uniform residence basis to all German workers. Instead, the disadvantage would stem from his treatment at home in Belgium. If Belgium offered personal tax benefits on a nonuniform basis, such that Belgian residents received personal tax benefits only if they worked in Belgium, then Belgium would violate competitive neutrality. In contrast, if Belgium did not offer personal tax benefits at all, or if it offered them on a uniform source basis only to residents and nonresidents who worked in Belgium, then Schumacker would not be at a competitive disadvantage compared to German residents working in Germany, notwithstanding that Schumacker would receive personal tax benefits nowhere in the EU.

184. *See supra* Section II.D.

Likewise, imagine that Schumacker had managed to secure personal tax benefits at home in Belgium because Belgium offered them on a (fully refundable) residence basis. This would not dispose of the question of whether he should also have received them in Germany under a competitive neutrality interpretation of tax nondiscrimination. If Germany offered its personal tax benefits only to Germans working at home—that is, on a nonuniform (source or residence) basis only to taxpayers in Quadrant 1—then notwithstanding that Schumacker secured personal tax benefits at home in Belgium, the German fiscal system would still discourage Schumacker and all other nonresidents from working in Germany.[185]

To see why, consider a German resident who is just as productive as Schumacker in both Belgium and Germany. If Belgium offers personal tax benefits on a uniform residence basis, then Schumacker will not reduce the wage he seeks in Belgium relative to the wage he seeks in Germany on account of the Belgian personal tax benefits because he receives them no matter where he works. But if Schumacker's competitor, the German resident, receives German personal tax benefits *only* when she works at home in Germany, then she will lower the wage she seeks in Germany relative to the wage she seeks in Belgium on account of those benefits. The nonuniform German tax preference thus allows the German to bid down the wages she seeks in Germany relative to those she seeks in Belgium on account of the benefit, allowing her to out-compete Schumacker (and other foreign workers) in Germany. Of course, in a case where Schumacker received personal tax benefits at home, he might appear to be a less compelling plaintiff, but he should not be, because the German tax system just described would discourage Schumacker from working in Germany by putting him at a tax-induced competitive disadvantage compared to German workers who receive personal tax benefits from Germany *only* if they work in Germany.

This analysis suggests that under a competitive neutrality approach to nondiscrimination, the ECJ should not determine whether there has been discrimination by examining whether the cross-border worker has received personal tax benefits at least "once somewhere" in the EU.[186] Competitive neutrality does not require that taxpayers receive at least one set of personal tax benefits. Instead, all competitive neutrality requires is that states confer benefits on a uniform basis. They must confer benefits either on a uniform source basis to everyone working in their territory (no matter where they

185. Since violations of competitive neutrality cause distortions in two directions, it would also discourage Germans from working outside of Germany.

186. *See supra* text accompanying notes 69-73.

reside) or on a uniform residence basis to all residents (no matter where they work).[187] This makes sense because EU member states retain autonomy under EU law to decide whether they want to offer personal tax benefits at all. If an EU member state decided not to offer personal tax benefits, the "once somewhere" method would lead the court astray. Checking for double recoveries or double denials is no more effective a way to identify violations of competitive neutrality than is comparing absolute tax rates.[188]

Our analysis of *Schumacker* ends with the observation that, as a matter of tax policy, most states offer their own residents the same family deductions and other personal tax benefits regardless of where in the world those residents earn their income. In terms of Figure 8, they offer benefits on a uniform residence basis to taxpayers in Quadrants 1 and 2, while excluding taxpayers in Quadrant 3. This common practice does not violate competitive neutrality. If Germany followed this traditional practice, then it did not place Schumacker at a comparative tax disadvantage in Germany, even if it denied him those benefits. Thus, a competitive neutrality interpretation of nondiscrimination would not force states to alter the well-settled practice, memorialized in the OECD model tax treaty, of excluding nonresident taxpayers from personal tax benefits.[189] Whether Germany actually offered the tax benefits at issue in *Schumacker* on a uniform residence basis was not addressed by the ECJ, likely because no one thought it relevant to the issue at hand.

The other case discussed in Part I was *De Groot*, in which the defendant state was the taxpayer's residence state. Recall that De Groot, a Dutch resident, challenged the Dutch practice of proportionately reducing residents' personal tax benefits on account of their exempt foreign-source income. Proportionality can be illustrated by a simple example. Suppose a Dutch resident earned 40% of his income in the Netherlands and 60% abroad. The Netherlands would tax only the 40% of income that was earned in the Netherlands, but it also would grant him only 40% of Dutch personal tax benefits. The Netherlands argued that such a cross-border worker should seek the remainder of his personal tax benefits from the source state where he earned (and paid tax on) the other 60%

187. That is, states may confer benefits uniformly on Quadrants 1 and 3, or they may confer benefits uniformly on Quadrants 1 and 2. But they may not, for example, confer benefits only on Quadrant 1.

188. *See* the numerical examples discussed *supra* Subsection II.D.3.

189. The OECD Model Tax Treaty nondiscrimination article provides that a source state is not obliged "to grant to residents of [its tax treaty partner] any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents." OECD Model Tax Treaty, *supra* note 13, art. 24, para. 3.

of his income.[190] The ECJ struck down the Dutch proportionality method, holding that except in *Schumacker* situations, conferring personal tax benefits is the resident state's responsibility.

It would have been easy for the ECJ to dispose of *De Groot* under either a locational neutrality or a leisure neutrality interpretation of tax discrimination. The Netherlands' reduction of De Groot's personal tax benefits on account of his foreign-source income represented a clear violation of locational neutrality, which requires uniform taxation of residents' foreign and domestic income. The residence tax regime challenged in *De Groot* also violated leisure neutrality, since any residence-based taxation violates leisure neutrality.

In order to resolve *De Groot* under a competitive neutrality interpretation of nondiscrimination, we need more information. If the Netherlands extended personal tax benefits only on a residence basis, but it denied residents a fraction of those benefits proportional to their foreign-source income, then the practice would violate competitive neutrality because it would be a nonuniform residence tax. In terms of Figure 8, the Netherlands would be applying different residence taxes to Quadrants 1 and 2.

But recall that, in addition to offering personal tax benefits on a uniform residence basis, competitive neutrality also permits states to offer them on a uniform *source* basis to all workers earning income in the jurisdiction. If the Netherlands applied the proportionality method on a uniform source basis, such that the Netherlands conferred personal tax benefits to all workers in the Netherlands, regardless of their residence (i.e., to everyone in Quadrants 1 and 3), then proportionality would constitute a uniform source tax that would not violate competitive neutrality.

The facts of *De Groot* do not resolve the question of whether the Netherlands conferred personal tax benefits on a uniform source basis. However, Professor Peter Wattel wrote an article about the case that reproduced much of the opinion he rendered in his role as Advocate General for the case when it came before the Supreme Court of the Netherlands prior to referral to the ECJ.[191] In his opinion, Advocate General Wattel found it probative that the Netherlands would extend personal tax benefits to both resident *and nonresident* workers in proportion to their Dutch-taxable

190. Case C-385/00, De Groot v. Staatssecretaris van Financiën, 2002 E.C.R. I-11819, paras. 54-60.

191. Peter J. Wattel, *Progressive Taxation of Non-Residents and Intra-EC Allocation of Personal Tax Allowances: Why* Schumacker, Asscher, Gilly *and* Gschwind *Do Not Suffice*, 40 EUR. TAX'N 210 (2000). Like Advocates General for the ECJ, Advocates General for the Dutch Supreme Court do not represent any litigant in the case and provide advisory opinions to the court in advance of its ruling.

income.[192] Thus, in our terminology, the Netherlands offered personal tax benefits on a uniform source basis. From an international tax perspective, this practice is highly unusual. However, conferral of personal tax benefits on a uniform source basis maintains competitive neutrality. Perhaps for this reason, Wattel advocated that all the EU member states should adopt the Dutch proportionality method for conferring personal tax benefits.[193] If the nondiscrimination principle were interpreted to require competitive neutrality, the Dutch proportionality method would be nondiscriminatory: if the Netherlands confers personal tax benefits on a uniform source basis to both resident and nonresident workers, it does not violate competitive neutrality.

III. EU NONDISCRIMINATION AS COMPETITIVE NEUTRALITY

In the previous Part, we described three alternative efficiency-based benchmarks that the ECJ could use to define nondiscrimination, showed how each approach could be implemented, and applied each approach to two ECJ cases. Interpreting the tax nondiscrimination principle to require any of the three alternative efficiency benchmarks described in this Article would have several advantages, including making tax discrimination cases much easier to resolve. However, because the benchmarks contain contradictory prescriptions for how states should tax, no court can pursue all three benchmarks simultaneously.[194] It is our view that, in the context of the EU common market, nondiscrimination should be interpreted to promote competitive neutrality. Accordingly, we describe in this Part some aspects of the language, structure, and history of the EU treaties that support or are consistent with our interpretation. We also describe some of the benefits that would accrue if the ECJ explicitly adopted a competitive neutrality interpretation of nondiscrimination.

Before diving into that discussion, it is worth looking at the choices that the ECJ faces with its tax discrimination jurisprudence. One possibility is for the ECJ to continue to decide cases in an ad hoc way that gives little guidance to future parties. That is not an attractive option. The extensive critical commentary of the ECJ's tax discrimination jurisprudence and the ongoing

192. *Id.* at 215 (calling the Dutch approach a "solution with a very high degree of international neutrality and therefore, from the perspective of the Internal Market, laudable").

193. *Id.* at 222-23 (arguing for the Dutch proportionality method in terms consistent with interpreting the nondiscrimination principle to require competitive neutrality); *see, e.g.*, *id.* at 222 ("Taxing non-residents as if they were residents would remove both the progression advantage and the allowance disadvantage . . . .").

194. *See* discussion *supra* Section II.D.

efforts of practitioners, government officials, and scholars to determine what tax discrimination means underscore the need for clearer guidance. A second possibility is that the ECJ could reverse itself and hold that the nondiscrimination principle does not apply to direct taxation. That is also unattractive because the requirement of member state unanimity for EU-wide direct tax legislation has resulted in the court's nondiscrimination doctrine being the principal means of removing direct tax obstacles to the EU common market. Removing direct taxation from the scope of the nondiscrimination principle would eviscerate it. Member states could then enact with impunity all sorts of nonuniform tax laws that burdened nonresidents and interstate commerce more heavily than residents and domestic commerce. If the nondiscrimination principle did not cover direct taxation, it would be far more difficult for the ECJ to protect free movement rights. A third possibility would be for the court to identify as the motivation behind the tax nondiscrimination principle a single value (or a set of values) other than the three we discuss in this Article, and to enforce the nondiscrimination principle in a way that rigorously promotes that value (or values). The problem with this option is that we are unaware of any values other than those that we discuss in this Article that have been seriously proposed as a foundation for the nondiscrimination principle. Nor have we any to offer. The fourth approach is to choose between the three efficiency values that we discuss: locational neutrality, leisure neutrality, and competitive neutrality. We thus believe that the ECJ should make a choice.

Support for a competitive neutrality interpretation of tax discrimination derives from the goals of the EU common market, the language and structure of the EU treaties, and the ECJ's case law. Although we do not primarily advocate competitive neutrality from first principles, in this Part, we also consider some normative arguments (including economic efficiency) for a competitive neutrality interpretation of nondiscrimination.[195] As part of this analysis, we observe that expressly interpreting the EU nondiscrimination principle to require competitive neutrality would link the fundamental freedoms with a value espoused not only by economists, but also by taxpayers, politicians, lawyers, and policy analysts.

195. We do not argue in favor of a competitive neutrality interpretation for tax discrimination from economic or philosophical first principles. Thus, we do not argue that a competitive neutrality interpretation of nondiscrimination would do a better job of promoting economic welfare or any specific notion of the good, justice, or fairness than other possible interpretations that might be imposed on the member states.

A. Interpretive Arguments

This Section describes how the goals of the EU and the language and structure of the fundamental freedoms support a competitive neutrality interpretation of nondiscrimination. Because leisure neutrality receives so little support as a goal of international tax policy, we primarily focus on comparing locational neutrality with competitive neutrality. [196]

1. The Goals of the EU Treaties

The nondiscrimination principle derives from the fundamental freedoms, which themselves represent the foundation of the EU's internal market. That market is intended to encourage increased competition, increased specialization, and larger economies of scale. A competitive neutrality interpretation of nondiscrimination would advance the EU goal to integrate the economies of Europe because it would constrain state practices (including tax laws) that decrease competition, hamper specialization, and prevent the exploitation of economies of scale.

Support for the contention that creating an integrated market in which larger companies can operate and compete was one of the purposes behind the establishment of the common market can be found in the 1956 Spaak Report, one of the EU's few foundational documents that were readily available to the states that initially created what would later become the EU.[197] The report[198] is named for Belgian foreign minister Paul-Henri Spaak, chair of the Intergovernmental Committee on European Integration. The report calls for a European common market that would fuse together separate national markets in order to promote the growth of Europe's productive facilities.[199] The report emphasized that this common market should prize competition and forbid

196. Commentators often advocate for a tax system that achieves locational neutrality. Rarely, if at all, do commentators advocate pursuing leisure or savings neutrality. When they advocate for exemption, the argument is usually on the grounds of competitiveness.

197. Joseph J. A. Ellis, *Source Material for Article 85(1) of the EEC Treaty*, 32 FORDHAM L. REV. 247, 248 (1961) (noting that few of the preparatory acts to the Rome Treaty were published or submitted to the national legislatures when states introduced bills to ratify the Rome Treaty).

198. COMITÉ INTERGOUVERNEMENTAL CRÉÉ PAR LA CONFÉRENCE DE MESSINE, RAPPORT DES CHEFS DE DÉLÉGATION AUX MINISTRES DES AFFAIRES ETRANGÈRES: REPORT OF THE HEADS OF DELEGATION TO THE MINISTERS OF FOREIGN AFFAIRS, Doc. MAE 120 f/56 (1956) [hereinafter SPAAK REPORT].

199. de la Feria & Fuest, *supra* note 35, at 3.

national laws that would restrain competition, since "[s]ystems of protection which eliminate outside competition have . . . particularly harmful consequences on the progress of production and the raising of the standard of living . . . ."[200] The Report was a crucial step in the path to the Treaty of Rome, a predecessor to the modern TFEU.[201]

As the Spaak Report makes clear, one of the motivations behind the creation of a European common market was to encourage the formation and development of large, competitive European companies that could operate on a multinational scale without becoming monopolies. Achieving this goal required companies based in one member state to be able to acquire productive assets in other member states. A prohibition against tax systems that distort competition to acquire such assets furthers that vision, while allowing member states to maintain significant control of their domestic tax systems. Although the treaties governing the EU have been amended over time, the prominent place accorded competition has not. For example, the member states hope to make the EU "the most competitive and dynamic knowledge-based economy in the world."[202]

2. *The Language and Structure of the Treaty*

The last Subsection explained that interpreting the nondiscrimination principle to promote level competition among EU nationals would advance the overarching goals of the EU. This Section discusses aspects of the structure and language of the TFEU that support a competitive neutrality interpretation of nondiscrimination.

a. *Avoiding Construing Treaty Provisions as Superfluous*

Whereas construing the nondiscrimination principle to require competitive neutrality would give independent force to each of the fundamental freedoms, construing nondiscrimination to require either locational or leisure neutrality in taxation would render some of the fundamental freedoms superfluous.

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200. SPAAK REPORT, *supra* note 198, at 13-14, *translated in* Ellis, *supra* note 197, at 261-62.

201. Pinar Akman, *Searching for the Long-Lost Soul of Article 82EC*, 29 OXFORD J. LEGAL STUD. 267, 278 (2009); de la Feria & Fuest, *supra* note 35, at 3.

202. *Towards an Internal Market Without Tax Obstacles—A Strategy for Providing Companies with a Consolidated Corporate Tax Base for their EU-Wide Activities*, at 3, COM (2001) 582 final (Oct. 23, 2001).

For example, Article 49 of the TFEU, which sets forth the freedom of establishment, would be unnecessary if the only goal of the fundamental freedoms were to achieve locational neutrality.[203] To obtain locational neutrality with respect to capital, it is sufficient to provide for the free movement of portfolio investments ("capital movements" in EU parlance). Allowing free movement of direct investments ("establishments" in EU parlance) simply is not necessary for achieving locational neutrality. Thus, in order for the freedom of establishment to have meaning independent of the freedom of capital movement, the freedom of establishment must pursue a goal or goals other than locational neutrality.[204]

In the same vein, the ECJ has interpreted Article 63 of the TFEU, the freedom of capital movement, to apply to both portfolio and direct investment.[205] But again, free movement of portfolio investments is sufficient to achieve locational neutrality for capital. Protecting direct investments makes sense only if the provision aims to promote a goal other than locational neutrality, such as competitive neutrality.

Similarly, interpreting the nondiscrimination principle to require savings neutrality (leisure neutrality's capital analogue) likewise would render certain fundamental freedoms superfluous. For example, free movement of portfolio investments is sufficient to secure savings neutrality because savings neutrality requires only that individual investors earn the same after-tax rate of return regardless of where they reside. Thus, if the exclusive purpose of the fundamental freedoms were to promote savings neutrality, the freedom of capital movement would be sufficient to achieve that purpose, rendering the freedom of establishment superfluous. In contrast, construing the nondiscrimination principle to require competitive neutrality would give each of these provisions independent meaning because each provision is needed for there to be competitive neutrality with respect to the subject matter covered by that freedom.

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203. *See* TFEU, *supra* note 45, art. 49.

204. *See* Horst, *supra* note 60, at 796.

205. For a nonexhaustive list of covered capital movements, see Council Directive 88/361/EEC, Annex 1, 1998 O.J. (L 178) 5, 8-11. Although this Directive implemented Articles 69 and 70 of the Treaty Establishing the Economic Community, which is no longer in force, the ECJ has continued to refer to the Directive's Annex for the list of covered capital investments. *See, e.g.*, Case C-510/08, Mattner v. Finanzamt Velbert, para. 19 (2010), *available at* http://curia.europa.eu/juris/document/document.jsf?text=&docid=83008&pageIndex=0&doclang=EN&mode=doc&dir=&occ=first&part=1&cid=40969HTML ("[T]he Court has previously recognised the nomenclature which forms Annex I to Directive 88/361 as having indicative value, even though that directive was adopted on the basis of Articles 69 and 70(1) of the EEC Treaty . . . .").

b. Consistency in Interpreting the Fundamental Freedoms

The nondiscrimination principle applies not only to taxes, but also to all other areas of law. And there is no reason to think that the interpretation of the nondiscrimination principle or the fundamental freedoms should be different in the tax area than in other areas.

Taxation is one of the few areas in which it is theoretically possible for member states to achieve locational neutrality without harmonizing their policies. That is because taxes are assessed in money, and so one state's taxes (those of the source state) can be offset by another state's taxes (those of the residence state).[206] That is precisely how worldwide taxation with an unlimited foreign tax credit in principle works. Through the residence state's taxes and credits, the source state's taxes are effectively rendered invisible to the taxpayer. However, in other situations, the allegedly offending practices are rules and regulations. In such cases, residence states cannot readily offset the practices of source states—there is no equivalent of the foreign tax credit for regulation. Instead, to assure efficient allocation across the EU of the factors of production (i.e., to secure locational neutrality), member states would have to either harmonize their substantive law or forbid regulation by source states.[207] In contrast, a competitive neutrality interpretation of nondiscrimination would carry the same implication for regulation that it carries for taxation, namely, that destination (source) states must apply the same regulation to residents and nonresidents and that origin (residence) states must apply the same regulation to residents engaged in domestic and intra-EU commerce. Thus, if the nondiscrimination principle were interpreted to promote competitive neutrality in the tax area, that interpretation could be carried over into other regulatory areas.[208]

c. The Language of the Fundamental Freedoms

The language of the fundamental freedoms supports a competitive neutrality interpretation of nondiscrimination. For example, Article 45 calls for the "abolition of any discrimination based on nationality between workers of

206. Ian Roxan, *Assuring Real Freedom of Movement in EU Direct Taxation*, 63 MOD. L. REV. 831, 833-34 (2000).

207. This latter option would be the regulatory equivalent of "residence-only" taxation, that is, the prohibition of source taxes.

208. It is not clear how leisure neutrality is affected by regulations. That states could regulate as they please without any limitation is another reason for rejecting a leisure neutrality interpretation of nondiscrimination.

the Member States as regards employment, remuneration and other conditions of work and employment."[209] Likewise, Article 45 ensures that EU nationals may "stay in a Member State for the purpose of employment," and that they may "remain in the territory of a Member State after having been employed in that State."[210] Similarly, Article 45 includes the right of nationals of a member state to "accept offers of employment."[211] This language protects cross-border workers themselves, and it reflects concerns about the matching of jobs and workers, which is a part of competitive neutrality.[212]

Other articles are similar. For example, Article 49, which sets forth the freedom of establishment, states that "restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State shall be prohibited."[213] This language suggests that the freedom applies on both an inbound and an outbound basis—that is, it restrains an EU national's own member state from preventing that national from establishing business abroad, and it also prevents a host member state from preventing an EU national of another member state from establishing business in its own territory. Thus, the freedom of establishment applies to both residence states and source states, which is consistent with the idea of leveling competition among businesses. Indeed, Article 49 emphasizes obligations on source states: "Freedom of establishment shall include the right to take up and pursue activities as self-employed persons and to set up and manage undertakings, in particular companies or firms . . . under the conditions laid down for its own nationals by the law of the country where such establishment is effected."[214] This emphasis on uniformity of treatment in the source state is consistent with the idea of leveling competition among businesses. Moreover, as noted earlier, the freedom of establishment would be superfluous if efficient allocation of capital were the only goal of the fundamental freedoms, since an efficient allocation of capital can be achieved via the free movement of portfolio investments alone.

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209. TFEU, *supra* note 45, art. 45, para. 2.

210. *Id.* art. 45, paras. 3(c) & 3(d).

211. *Id.* art. 45, para. 3(a).

212. *Cf. Communication from the Commission to the Spring European Council: Implementing the Renewed Lisbon Strategy for Growth and Jobs*, para. 2.3, COM (2006) 816 final (Dec. 12, 2006), *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=SPLIT_COM:2006:0816(01):FIN:EN:PDF (describing the Lisbon strategy as pursuing "flexicurity" for workers, and noting that "[r]ather than protecting jobs, the aim is to protect the *worker*, help them deal with rapid change and so ensure secure employment" (emphasis added)).

213. TFEU, *supra* note 45, art. 49.

214. *Id.*

3. ECJ Nondiscrimination Doctrine

The ECJ's tax discrimination case law also supports a competitive—but not a locational or leisure—neutrality interpretation of the tax nondiscrimination principle.

a. "Direct Effect"

Interpreting the nondiscrimination norm to require competitive neutrality is consistent with the idea found in many legal contexts that discriminatory taxes harm specific, identifiable taxpayers. For example, bilateral tax treaties give taxpayers legal recourse against the contracting states for violating the nondiscrimination article of the tax treaty. Likewise, state and federal courts in the United States regularly hear tax discrimination cases brought by individual taxpayers under the dormant Commerce Clause and the Privileges and Immunities Clause. In the EU, the doctrine of "direct effect" reflects the notion that violations of the nondiscrimination principle constitute violations of personal rights.[215] Under this doctrine, EU nationals may sue their own (or other) member states for discrimination that violates EU law. That courts pay careful attention to whether challenging taxpayers possess standing to bring their claims shows that courts regard discriminatory taxes as harming specific, identifiable taxpayers.

The notion that discriminatory taxes harm particular parties aligns well with competitive neutrality, but not with locational or leisure neutrality. For example, identifying the specific taxpayers harmed by violations of locational neutrality is problematic because such violations do not disadvantage a particular taxpayer relative to another. Instead, in the simplest models, a violation of locational neutrality distorts the location of capital and labor to the detriment of *everyone*. Rather than creating winners and losers (or even larger and smaller losers) or leaving some with more than others, locational distortions cause all investors to earn a lower return on their capital and all workers to earn lower after-tax wages. Thus, locational neutrality simply does not make sense as a personal right. Nor does leisure neutrality.[216] In this sense,

215. *See* Case C-26/62, Van Gend en Loos v. Nederlandse Administratie der Belastingen, 1963 E.C.R. 1 (holding that EC rights have direct effect, that is, they give rise to a private right of enforcement in national courts).

216. While it is possible to conceptualize a violation of leisure neutrality as a violation of a personal right, all income tax systems distort choices between labor and leisure because all income tax systems currently tax the returns from labor, but they do not tax leisure. Thus, income taxes distort labor/leisure decisions even for residents of a single state engaged in

construing nondiscrimination as requiring competitive neutrality fits the plain meaning of nondiscrimination better than does construing it to require locational neutrality. Conceiving of tax nondiscrimination as a personal right also matches conventional nontax notions of nondiscrimination, including prohibitions of discrimination on the basis of race, sex, or nationality. Thus, the framing of tax discrimination as a violation of personal rights seems to accord better with competitive neutrality than with locational neutrality.

A competitive neutrality interpretation of nondiscrimination is also consistent with the court's general approach to resolving tax cases, in which it compares the tax treatment of idealized taxpayers; typically the court compares a resident taxpayer with purely domestic income to a resident taxpayer with foreign income or to a nonresident taxpayer with income sourced in the defendant state. Comparing the tax treatment of particular taxpayers in this way is a sensible approach to identifying discrimination if discrimination means violations of competitive neutrality. This is because, as explained in Part II, the court can identify violations of competitive neutrality by comparing taxpayers' relative tax rates on work opportunities.[217] In contrast, because violations of locational neutrality involve tax distortions to the overall allocation of workers across member states, comparing the tax treatment of a resident taxpayer and a cross-border taxpayer would not tell the court whether there has been a violation of locational neutrality.

b. Tax Cases

As we discussed in Part II, the ECJ's decisions in *Schumacker* and *De Groot* provide anecdotal evidence that the ECJ does not interpret the nondiscrimination principle to require locational neutrality or leisure neutrality. We also explained in Part II that determining whether the ECJ's rulings in these cases comported with competitive neutrality would require more information about the German and Dutch tax systems. In both cases, the rulings could be reconciled with competitive neutrality. While the ability to reconcile these cases with competitive neutrality hardly constitutes persuasive evidence that the ECJ interprets the nondiscrimination principle to require competitive neutrality, at least the court's decisions do not directly violate that

purely domestic economic activities. Furthermore, there is widespread, though not universal, support for tax systems with increasing marginal tax rates. Progressive tax rates distort leisure choices among residents of the same state, but they are not generally understood to discriminate illegally against high-bracket taxpayers or to give rise to personal causes of action for discrimination by such taxpayers.

217. Tax discrimination occurs only when states impose nonuniform source or residence taxes.

principle. In contrast, far from upholding locational or leisure neutrality, the ECJ's rulings in those two cases themselves introduced new locational and leisure distortions.[218]

More probative than the anecdotal evidence provided in just two labor tax cases is the ECJ's overall approach to deciding tax cases. Interpreting the nondiscrimination principle to require locational neutrality would force the ECJ to rule out exemption as a valid method of taxing international income. That is because in the absence of harmonization of member state tax rates, locational neutrality requires states to tax their residents' worldwide income while providing unlimited credits for source taxes. The ECJ, however, has held that nondiscrimination both permits exemption[219] and does not require tax rate harmonization.[220]

Furthermore, locational neutrality would place no nondiscrimination burdens on source states—no matter how onerous or selective their taxes. Under a locational neutrality interpretation, the expectation would be that any source state distortion would be negated by foreign tax credits in the residence state. But the ECJ repeatedly has found source states to discriminate. Taken

218. For example, the ruling in *Schumacker*—that where a cross-border worker earns "almost all" his income in the source state, the source state should grant him personal tax benefits—itself violates both locational and leisure neutrality. *See* Case C-279/93, Finanzamt Köln-Altstadt v. Schumacker, 1995 E.C.R. I-225, para. 38. The ruling also contradicts provisions in tax treaties that expressly disclaim such obligations. *See, e.g.*, OECD Model Tax Treaty, *supra* note 13, art. 24, para. 3 (providing that source states need not extend personal tax benefits to nonresidents). To the extent that the decision in *Schumacker* results in EU taxpayers receiving personal tax benefits in their source state, rather than exclusively from their residence state, it violates locational neutrality by presenting an opportunity for cross-border workers to access substantively different personal tax benefits by working abroad. Such cross-border differences could be expected to distort the global allocation of labor. The ruling in *Schumacker* also violates leisure neutrality because it does not require states to apply the same taxes to resident and nonresident workers. Instead, *Schumacker* requires the source state to tax residents and nonresidents identically only when nonresidents earn "almost all" their income in the source state. Thus, in *Schumacker*, the court ensures maintenance of neither locational nor leisure neutrality. Because the ECJ in *De Groot* applied the *Schumacker* rule, that decision also violates both locational and leisure neutrality.

219. *See, e.g.*, Case C-513/04, Kerckhaert v. Belgium, 2006 E.C.R. I-10967, para. 22 (holding that member states are not obliged to relieve double taxation on cross-border income within the EU and noting that EU law "does not lay down any general criteria for the attribution of areas of competence between the Member States in relation to the elimination of double taxation within the Community"); Case C-336/96, Gilly v. Directeur des Services Fiscaux du Bas-Rhin, 1998 E.C.R. I-2793, para. 24 ("The Member States are competent to determine the criteria for taxation on income and wealth with a view to eliminating double taxation.").

220. *See, e.g.*, *Gilly*, 1998 E.C.R. I-2793, para. 34 (holding that divergences in the "level" of taxation among member states are nondiscriminatory because EU law does not prescribe or harmonize member state tax rates).

together, the ECJ's approval of exemption and national rate differences and its imposition of nondiscrimination burdens on source states suggest that it does not understand the EU tax nondiscrimination principle to require locational neutrality.[221]

The ECJ's case law is also inconsistent with leisure neutrality. First, leisure neutrality would forbid taxation at residence, but the ECJ has upheld a variety of residence taxes under the EU nondiscrimination principle.[222] Second, states would have no specific nondiscrimination obligations when taxing in a residence capacity under a leisure neutrality interpretation of nondiscrimination—beyond the requirement that they exempt foreign-source income. But the ECJ has repeatedly found residence states to have specific nondiscrimination obligations other than exemption.[223] Third, to maintain leisure neutrality, source states would have to tax residents identically in all circumstances for work performed in their jurisdiction, but the ECJ has repeatedly approved different tax treatment of residents and nonresidents.[224] These factors suggest that the ECJ does not understand the nondiscrimination principle to require leisure neutrality.

Because competitive neutrality can be achieved via *either* global adoption of worldwide taxation with unlimited foreign tax credits or global adoption of ideal deduction (of which exemption is one instantiation), none of the holdings just mentioned—that failure to grant unlimited foreign tax credits is not necessarily discriminatory, that EU law does not require tax rate harmonization, that nondiscrimination imposes obligations upon source states, and that nondiscrimination imposes obligations on residence states—is inconsistent with competitive neutrality. Rather, each of these rulings is

221. Slightly fewer than half of ECJ tax claims have been brought against source states, with the remainder brought against residence states. *See* Mason, *supra* note 63, at 95 n.88. Defendant states lose the overwhelming majority of tax cases before the ECJ whether defending their source tax or residence tax regimes. *See id.* at 76 n.18.

222. *See, e.g.*, *Gilly*, 1998 E.C.R. I-2793.

223. *See, e.g.*, Case C-385/00, De Groot v. Staatssecretaris van Financiën, 2002 E.C.R. I-11819 (holding that a state must confer a full complement of personal tax benefits on residents who earn foreign income, even if the state exempts residents' foreign-source income).

224. *See, e.g.*, Case C-279/93, Finanzamt Köln-Altstadt v. Schumacker, 1995 E.C.R. I-225 (holding that the source state's obligation to treat nonresidents the same as residents was triggered only when nonresidents earn "almost all" their income in the source state). Different final tax treatment of residents and nonresidents is permissible under competitive neutrality, but not leisure neutrality. See the numerical example discussed *infra* note 249. Although competitive neutrality requires source taxes to be uniform, it does not require residents and nonresidents to be treated identically, since source states tax nonresidents on only one basis (source), whereas they tax residents on two bases (source and residence), and source and residence taxes can be cumulative. *See* numerical examples, *supra* Section II.D.

consistent with a posture of enforcing the source and residence uniformity requirements of competitive neutrality, while withholding judgment on the legislative question of whether competitive neutrality should be implemented through worldwide taxation or ideal deduction.

Finally, although the ECJ does not express itself formally in terms of competitive neutrality,[225] the language it uses in its decisions evinces concern for the ability of EU taxpayers from different states to compete for jobs on a level tax playing field, which is the logic behind competitive neutrality. For example, in *Schumacker*, the ECJ analyzed whether Germany "discouraged" nonresidents from working in Germany by excluding them from the personal tax benefits it provided to German residents, inquiring whether the German rule placed Schumacker in "a less advantageous position than [German] residents."[226] This language suggests that the ECJ was interested in the competition between German residents and other EU residents for jobs in Germany. The ECJ's approach in *Schumacker* is not unique. The ECJ regularly uses the language of competitive (but not locational or leisure) neutrality when striking down source tax provisions on the grounds that they "discourage" or "deter" cross-border economic activity.[227] In addition, the ECJ applies the same type of analysis to residence taxation. For example, in *De Groot*, the court held that the Dutch practice of reducing home state tax benefits in proportion to residents' foreign-source income "discouraged" De Groot from working in other member states.[228] Application of such principles at both source and residence is compatible only with competitive neutrality.

225. In contrast, U.S. tax discrimination cases are filled with language that invokes competitive neutrality. *See* discussion *infra* Part IV.

226. *Schumacker*, 1995 E.C.R. I-224, para. 52.

227. *See id.* and cases cited *supra* note 82. The ECJ's language about "discouraging" or "deterring" cross-border activity is inconsistent with locational neutrality, which is informed by the aggregate amount of work (or investment) that occurs in a state, not who holds a given job (or makes a particular investment). That one nation's tax policies discourage or encourage residents of a particular member state from working (or investing) in another member state is irrelevant, as long as their absence is made up for by others (most likely from the member state enacting the provision). The ECJ's language about "discouraging" or "deterring" cross-border activity also is inconsistent with the technical and non-intuitive notion of leisure (and savings) neutrality, which concerns the work/leisure (and saving/consumption) tradeoffs made by taxpayers residing in different states.

228. *De Groot*, 2002 E.C.R. I-11819, paras. 84, 103-09.

c. Distinguishing the ECJ's "Nondiscrimination" and "Restrictions" Jurisprudence

Although we argue that the ECJ's interpretation of the principle of tax nondiscrimination hews more closely to competitive neutrality than to locational neutrality (and that it does not coincide at all with leisure neutrality), that argument does not necessarily lead to the conclusion that locational neutrality plays no role in EU law. EU law recognizes two distinct aspects to the fundamental freedoms: prevention of discrimination and prevention of "restrictions" or "obstacles" to movement.[229] Both of these doctrines derive from the fundamental freedoms.[230] Our point in this Article is not to advocate competitive neutrality to the exclusion of the pursuit of locational neutrality in Europe (after all, they can be achieved simultaneously if all states adopt worldwide taxation with unlimited foreign tax credits). Rather, our argument is that the legal concept of tax nondiscrimination found in the TFEU and derived from the fundamental freedoms is best understood as promoting competitive neutrality. If the ECJ expressly adopted this view, the resolution of tax cases in the EU would become a simpler and more straightforward affair. Other scholars have argued that the ECJ's "restrictions" jurisprudence aims to promote locational neutrality, but we offer no view on that question here.[231]

B. Normative Arguments

Although we do not advocate competitive neutrality primarily from first principles, this Section discusses some normative arguments for a competitive neutrality construction of nondiscrimination, namely, that competitive neutrality would promote welfare, decrease legal uncertainty, promote

229. *See, e.g.*, Commission of the European Communities, *The EU and Sport: Background and Context*, ¶ 1.3.1, SEC (2007) 935 final (July 11, 2007) ("For the free movement of workers to be a reality, two main principles must be respected: there must be no discrimination on grounds of nationality, and there must be no obstacles to free movement.").

230. *Id.*

231. Scholars dispute whether the concepts of discrimination and restriction have been distinguished meaningfully in the tax area. *See, e.g.*, Axel Cordewener, *The Prohibitions of Discrimination and Restriction Within the Framework of the Fully Integrated Internal Market*, *in* EU FREEDOMS AND TAXATION 1, 27 (Frans Vanistendael ed., 2006) (pointing out that "a vast number of decisions using the term 'restrictions' in substance actually dealt with discriminatory national measures"); *see also* Mason, *supra* note 17, at 1313 (likening the ECJ's "restriction" doctrine under the fundamental freedoms to the U.S. Supreme Court's "undue burdens" doctrine under the dormant Commerce Clause).

representation reinforcement and political unity among residents of different EU member states, and allow the ECJ to avoid making legislative decisions.

1. *Welfare Promotion*

Of the three neutrality benchmarks we discuss, many economists are likely to view violations of locational neutrality as having the largest negative welfare consequences.[232] In contrast, no one seriously advocates leisure neutrality (or its capital analogue, savings neutrality) as an important goal from a welfare perspective. Although some commentators advocate exemption, which is the only method for achieving leisure neutrality in the absence of tax rate and base harmonization, they generally do so on the grounds that it promotes competitiveness, which is to say competitive neutrality.[233] There is no consensus among economists that competitive neutrality should be the goal for designing cross-border tax systems, or that competitive neutrality is more important than locational neutrality from a welfare perspective. However, economists generally agree that policies that interfere with the matching of owners to investments and workers to jobs reduce welfare. Thus, there is consensus that violations of competitive neutrality reduce welfare. Economists also widely recognize that states, unless they are constrained, will enact trade barriers that tilt the playing field in favor of domestic interests with attendant negative welfare consequences. In other words, absent legal or other restraints, states will tend to violate competitive neutrality, which will reduce welfare.

Thus, we do not argue that the ECJ should adopt a competitive neutrality interpretation of nondiscrimination because a competitively neutral tax system would *best* promote EU welfare. Other more extensive and intrusive tax measures than what we propose here—such as imposing the same tax base and rate structure on all member states—might best promote EU welfare. We take no position on the question of which tax system would best promote EU welfare. Instead, we argue that given the language of the Treaty, the goals of the EU, and the interpretations of the nondiscrimination principle so far, the best interpretation of that principle is that it promotes competitive neutrality.

Nevertheless, a competitive neutrality interpretation of nondiscrimination would improve welfare, compared to a situation in which member states face no constraints on how they tax nonresidents or residents with income sourced

232. Graetz, *supra* note 23, at 270 ("Typically, economists regard [capital export neutrality] as essential for worldwide economic efficiency . . . ."); *id.* at 285 ("[T]aking a worldwide efficiency perspective, [capital export neutrality] generally is thought to dominate [capital import neutrality].").

233. *See id*. at 273.

in other EU member states. As explained above, a competitive neutrality interpretation of tax discrimination would discourage states from enacting tax laws that tilt the playing field for jobs against cross-border workers. Because workers have different skills, nonuniform tax laws interfere with the efficient matching of workers and jobs.[234] Thus, we believe that there would be welfare gains from adopting a competitive neutrality interpretation of tax nondiscrimination.[235] Indeed, such gains (even if only understood intuitively) may be what the founders of the EU hoped to secure by implementing the prohibition on discrimination; those aims likewise may be what the members of the ECJ understand their interpretations in tax cases to pursue. Of course, the institutional limitations on the ECJ mean that even if the court expressly adopted a competitive neutrality interpretation of nondiscrimination, it could not ensure complete competitive neutrality throughout the EU because interactions between states using different methods of eliminating double taxation (that is to say, worldwide taxation or the ideal deduction method) will undermine competitive neutrality. Nevertheless, the court's express adoption of a competitive neutrality interpretation of nondiscrimination, and its enforcement of the uniformity requirements of competitive neutrality, would sharply restrict the member states from using their tax systems to provide advantages for their residents over nonresidents. In contrast, an interpretation of tax discrimination that does not look to competitive neutrality risks allowing states to design their tax systems to explicitly and directly tilt the playing field in favor of domestic residents and domestic economic activity. That would be a dangerous path—and it could potentially have large negative welfare consequences—because protectionist sentiments can be strong, especially during tough economic times, and because the EU already regulates many alternative tools that states have traditionally used to favor residents.

2. Increased Predictability

A common criticism of courts interpreting nondiscrimination principles is that their decisions are unpredictable.[236] This uncertainty is not only a problem for the parties to any given litigation; it is a serious problem for the states subject to legal obligations to avoid tax discrimination. States need to enact and administer tax systems without fear that particular tax provisions will be held

234. *See supra* Section II.D.

235. Of course, the general theory of the second best precludes making conclusive statements about welfare as long as some distortions remain.

236. *See* sources cited *supra* notes 2-8.

discriminatory and therefore need to be rewritten or replaced. Explicitly interpreting nondiscrimination as competitive neutrality and requiring states to enact uniform taxes would provide clear guidance to state legislatures, tax administrators, and taxpayers. As we showed in Part II, the legality of any tax would be easy to assess under a competitive neutrality interpretation of nondiscrimination, so states could enact and administer their tax laws with clear guidance and substantial flexibility.[237]

3. Promotion of Representation Reinforcement and Political Unity

Although the tax nondiscrimination norm principally promotes economic efficiency, the fundamental freedoms also promote noneconomic values. Two important noneconomic values that a competitive neutrality interpretation of nondiscrimination promotes are representation reinforcement and political unity. Explicit adoption of a competitive neutrality construction of nondiscrimination would promote representation reinforcement by protecting nonresidents from being exploited by residents entitled to participate in the source state's political process.[238] By insisting that source states tax nonresidents the same way as residents, competitive neutrality ensures that the interests of nonresidents secure proxy representation in the source jurisdiction, which helps prevent the exploitation of nonresidents. Such proxy representation links the interests of residents and nonresidents, and also may help to promote feelings of political unity among residents of the common market.

Likewise, by removing tax barriers to cross-border economic activity, the nondiscrimination principle also seeks to promote the notion that the relevant community is not the state, but the whole community subject to the nondiscrimination rule.[239] This, too, promotes political unity. Finally, if economic integration promotes political unity, then by striking down tax provisions that would otherwise hinder such integration, competitive neutrality is likely to further promote political unity. Indeed, reducing animus among the peoples of Europe by tying their economic fates was one of the principal motivations for the formation of the EU.[240] Thus, in addition to

237. This benefit would also arise if nondiscrimination were alternatively interpreted as locational or leisure neutrality.

238. *Cf.* Heinzerling, *supra* note 84, at 220-21 (describing the representation reinforcement rationale for the dormant Commerce Clause).

239. *Cf. id.* at 222 (describing the political unity rationale for the dormant Commerce Clause).

240. Schuman Declaration of 9 May 1950, *available at* http://europa.eu/abc/symbols/9-may/decl_en.htm (describing the coal and steel community as "a first step in the federation promoting efficiency, a competitive neutrality interpretation of nondiscrimination advances two non-efficiency values promoted by common markets, namely, representation reinforcement and political unity.

4. *Avoidance of Legislative Decisions*

Because a competitive neutrality interpretation of nondiscrimination would allow courts to decide tax cases based on a formal inquiry regarding the uniformity of the challenged state tax law, it would help courts avoid making the kinds of policy decisions that are typically made by legislatures.

For example, consider the *Gerritse* case in which the ECJ ruled that although an EU member state taxing in a source capacity could not exclude a resident of another EU member state from the benefit of its progressive tax rates, it could exclude the nonresident from its personal tax exemption.[241] The ECJ reached this ruling because, in its view, the personal exemption represented a tax benefit related to the worker's "personal and family situation," which, under the *Schumacker* rule, had to be accounted for by his residence state, unless the cross-border worker earned "almost all" of his income in the source state. While the ECJ may have been confident that the personal exemption represented a "personal and family" tax benefit, while progressive tax rates did not, the history of tax expenditure analysis has shown that it is difficult or impossible to distinguish social welfare benefits administered through the tax system (such as family deductions) from structural or income-defining tax provisions.[242] Is the personal exemption a family benefit, or is it simply the zero bracket of a progressive tax system? By distinguishing between different kinds of tax benefits, the court inadvertently drew an unworkable distinction between personal and family tax benefits and other tax provisions.

In contrast, a competitive neutrality interpretation of nondiscrimination would eschew thorny questions regarding what kinds of tax benefits must be extended to outsiders by insisting only that *all* tax provisions and *all* personal tax benefits—whatever their content—apply on either a uniform source or a uniform residence basis. Because a competitive neutrality interpretation of tax nondiscrimination would allow courts to decide cases on a purely formal basis

of Europe" that would produce a "solidarity in production" and make "any war between France and Germany not merely unthinkable, but materially impossible").

241. Case C-234/01, Gerritse v. Finanzamt Neukölln-Nord, 2003 E.C.R. I-5933.

242. *See, e.g.*, STAFF OF JOINT COMM. ON TAXATION, 110TH CONG., A RECONSIDERATION OF TAX EXPENDITURE ANALYSIS (Comm. Print 2008) (reviewing long-standing academic debates concerning how to define tax expenditures).

by checking for uniformity, it would allow courts to avoid making legislative decisions.[243]

C. Settling Open Questions

Express recognition of competitive neutrality as the value motivating the efficiency component of the tax nondiscrimination principle would also settle a number of vexing questions that have generated controversy among commentators. In this Section, we describe how our approach would resolve some important and longstanding controversies.

1. Comparing Absolute Tax Rates

For reasons discussed at length in Part II, express adoption of a competitive neutrality construction of nondiscrimination would imply that comparing a resident's and a nonresident's absolute tax rates is not an effective way to identify tax discrimination. Noneconomists—including members of the ECJ[244]—tend to believe that a tax's impact on competitiveness can be ascertained simply by comparing competitors' absolute tax rates. Under this reasoning, if a French resident has an effective marginal tax rate of 20% in France, while a German resident has an effective marginal tax rate of 40% in France, the French resident has a tax-induced competitive advantage in securing a job in France. This reasoning is intuitive, but wrong. To establish that the French resident has a competitive advantage over the German resident in acquiring the job in France, we need to know more. Specifically, we need to know what effective tax rate the French resident would face if she worked elsewhere, as well as the effective tax rate the German worker would face if he worked elsewhere. While this point is well understood by public finance economists, it may have been lost by advocates general and judges interpreting nondiscrimination principles, leading to unsatisfying decisions.[245]

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243. This benefit would also arise if nondiscrimination were alternatively interpreted as locational or leisure neutrality.

244. *See, e.g.*, Case C-513/04, Kerckhaert v. Belgium, 2006 E.C.R. I-10967, paras. 26-27 (opinion of Advocate General Geelhoed) (evaluating whether there was discrimination by comparing absolute tax rates). *But see* Mason, *supra* note 17, at 1295-97 (arguing that the comparison of absolute tax rates in *Kerckhaert* was insufficient because a tax credit granted by the source state obscured underlying discrimination by the taxpayer's residence state).

245. Mason, *supra* note 17, at 1295-97. For more on measuring tax-induced competitive advantages, see generally Michael S. Knoll, *Taxation and the Competitiveness of Sovereign Wealth Funds: Do Taxes Encourage Sovereign Wealth Funds To Invest in the United States?*, *2. Progressive Taxation*

Another open question is what implications the nondiscrimination principle has for progressive taxation. All the member states of the EU have progressive income tax systems, but each state has a different rate structure. Which state's progressive tax rates should apply to an EU national with income from more than one state? One of the authors of this Article previously analyzed this question from an equity perspective and concluded that the progressive tax rates of the cross-border worker's residence state should apply to his income.[246] This conclusion was based in part on the fact that the residence state is generally the one where the cross-border worker votes, and as a result, the cross-border worker helps to decide both the content of the tax rates and the public expenditures that those rates fund.[247] From an administrative perspective, assessment of progressive tax rates only at residence is also desirable because residence states generally have better access to information on taxpayers' overall income and because assessment of progressive tax rates only at residence relieves cross-border taxpayers of the need to file full returns in every state in which they earn income.[248]

Competitive neutrality allows states to apply progressive tax rates to their own residents' worldwide income while applying flat tax rates to nonresidents for work performed in their territory. For example, as long as Germany applies the flat taxes on a uniform source basis to both residents and nonresidents working in Germany, then Germany's assessment of additional progressive taxes on a uniform residence basis need not violate competitive neutrality.[249]

82 S. CAL. L. REV. 703 (2009); and Michael S. Knoll, *The UBIT: Leveling an Uneven Playing Field or Tilting a Level One?*, 76 FORDHAM L. REV. 857 (2007).

246. Mason, *supra* note 20, at 1585-93.

247. *Id.*

248. *Id.* at 1599-1604.

249. To subject nonresidents to flat tax rates while subjecting residents to progressive taxation consistently with competitive neutrality requires use of the ideal deduction method in which source taxes apply uniformly to both resident and nonresident workers, and in which residents are uniformly taxable on their worldwide income, but all source taxes are deductible from income.

For example, suppose that in addition to a 25% German source tax, which applies uniformly to resident and nonresident workers, Germany also taxes its residents on their worldwide labor income. Suppose further that Germany allows residents to deduct any source taxes (including German source taxes) assessed against that income. (Thus, Germany implements ideal deduction.) Moreover, assume that Germany's progressive residence tax rate ranges from negative 33⅓% to positive 33⅓%. Under those assumptions, the total tax paid by German residents would range from 0 to 50%. Thus Wilhelm, a German resident who earns €100 in Germany and has no other income, would pay €25 in source taxes to

Because free mobility of labor will tend to push after-tax wages into equality across states for the residents of any state, the fact that residents and nonresidents pay different total (source and residence) tax rates on work in Germany will not compromise competitive neutrality because it is differences in relative tax rates—not differences in absolute tax rates—that affect competition. This is an important result because it accords with our intuitions about what equity demands. It also preserves longstanding tax practices memorialized in thousands of bilateral tax treaties of taxing nonresidents at flat rates but residents at progressive rates. Finally, it substantially reduces taxpayer compliance costs by avoiding the need for cross-border workers to file full income tax returns in every jurisdiction where they earn income.

3. Double Benefits and Burdens

Express adoption of a competitive neutrality interpretation of tax nondiscrimination also provides insight into how to resolve cases involving double burdens and double benefits. As we noted earlier, in the *Schumacker* line of cases, the ECJ expressed concern that cross-border EU workers should not be completely denied personal tax benefits, nor should they be able to secure duplicative benefits from their source and residence states. We characterized this as the "once somewhere" approach, but the issue can be cast more generally. Instead, it really concerns whether the reviewing court should resolve tax discrimination questions by appeal only to the challenged state's law, or whether it should take into consideration the laws of any other state

Germany. He would also be liable to Germany for residence taxes on his worldwide income of €100. Against the €100, Germany would allow a deduction of €25 for the German source tax, leaving €75 against which Germany's progressive residence tax rates would apply. If we assume that all of Wilhelm's net income is taxable at the highest German residence rate (33⅓%), he would owe an additional €25 in taxes to Germany, which would leave him with €50 after taxes, yielding a net effective tax rate of 50%. Had Wilhelm been subject to the lowest German residence rate (negative 33⅓%), he would have received a refundable credit of €25, bringing his net effective tax rate to zero. We constructed this example with residence tax rates ranging from negative 33⅓% to positive 33⅓% in order to approximate the actual progressive tax rates for German residents described in the well-known *Gerritse* case, which ranged from 0 to 50%. *See* Case C-234/01, Gerritse v. Finanzamt Neukölln-Nord, 2003 E.C.R. I-5933, para. 55 (holding that, for nonresidents that do not earn almost all their income in the source state, the source state may deny nonresidents the benefit of personal tax exemptions but not the benefit of progressive tax rates).

In the example just explored, nonresidents would be subject to source tax in Germany at 25%, whereas German residents would be subject to source tax in Germany at 25% *and* to residence tax in Germany at rates ranging from negative 33⅓% to positive 33⅓% (before deduction of German source taxes), which translates into net taxes from 0 to 50% (after deduction of German source taxes). This tax regime does not violate competitive neutrality.

that taxes the cross-border worker. For example, suppose the challenged tax rule is a source rule. When making its determination of whether there has been discrimination, some commentators have suggested that courts also must take into consideration any rules to which the taxpayer may be subject in his or her residence state. This view has been endorsed by at least one ECJ Advocate General,[250] and the ECJ has vacillated between the two approaches.[251]

Competitive neutrality provides a convincing justification for limiting judicial review to the laws of the challenged state. Violations of competitive neutrality can be identified simply by checking to see whether the challenged tax law (be it a residence rule or a source rule) applies uniformly. The interactions of the rules of the source and residence states have no bearing on this inquiry. This is a good result because it simplifies judicial decisionmaking in an area characterized by highly complex substantive law. Furthermore, by limiting analysis to the laws of only one state, a competitive neutrality conception of nondiscrimination would prevent the possibility that a single tax law will be held to be discriminatory when applied to workers from some, but not all, other states.

Thus, despite the intuitive appeal of the "once somewhere" approach, limiting judicial review to the laws of only the challenged state accords better with the economic principles that ground the nondiscrimination principle. It has the added advantage of simplifying judicial review in an already complex area. Finally, we observe that because no law we are aware of requires any state to offer personal tax benefits, the "once somewhere" approach would lead courts astray because the failure of an EU national to secure personal tax benefits does not necessarily indicate wrongdoing by *any* state.

4. A Way out of the Labyrinth

Finally, a competitive neutrality interpretation provides a powerful response to the claims by Professors Graetz and Warren. Graetz and Warren argue that the ECJ's approach to nondiscrimination, under which it imposes burdens upon both source and residence states, is incoherent because it simultaneously promotes both locational neutrality and savings neutrality (the capital analog of leisure neutrality). But these two neutralities are inconsistent

250. *See* Case C-374/04, Test Claimants in Class IV of the ACT Grp. Litig. v. Comm'rs of Inland Revenue, 2006 E.C.R. I-11673, para.95 (opinion of Advocate General Geelhoed) (supporting the "overall" approach).

251. *Compare* Case C-294/97, Eurowings Luftverkehrs AG v. Finanzamt Dortmund-Unna, 1999 E.C.R. I-7447, paras. 43-44 (adopting the per-country approach), *with* Case C-319/02, *In re* Manninen, 2004 E.C.R. I-7477, para. 54 (adopting the overall approach).

with one another in the absence of tax rate harmonization. We have shown that imposition of nondiscrimination obligations at both source and residence does not necessarily imply that a court is trying to do the impossible by simultaneously achieving locational and savings (or leisure) neutrality without harmonizing taxes. Instead, such an approach can be consistent with competitive neutrality. Moreover, the notion that the nondiscrimination norm should apply at both source and residence is in accordance with many people's intuition that states may impermissibly discriminate in either capacity: when taxing in a source capacity, they may discriminate between resident and nonresident workers; when taxing in a residence capacity, they may discriminate between residents' foreign and domestic income.

IV. TAX NONDISCRIMINATION IN THE UNITED STATES

In laying out our arguments about how legal prohibitions of tax discrimination in common markets might be interpreted, we relied on examples from the ECJ for several reasons. First, our arguments are designed in part to respond to Graetz and Warren's criticism that imposition of nondiscrimination obligations at both source and residence is incoherent. Although this criticism also could be leveled against U.S. courts, which have imposed nondiscrimination burdens at source and residence, Graetz and Warren addressed the EU context, and so we found it appropriate to respond by analyzing ECJ cases. Second, the new efficiency conception we offer in this Article derives from economics literature that analyzes international taxation. Although taxation of cross-border labor income by U.S. states bears substantial similarity to taxation of international income by nation-states, the ECJ cases are a better fit because they involve taxation of international income by nation-states. Finally, the ECJ decides many more tax discrimination cases than does the Supreme Court. As a result, it is easier to find cases with straightforward legal and factual scenarios in the ECJ doctrine. One reason for the relative abundance of ECJ tax cases could be that the ECJ cannot refuse to hear tax cases because there presently is no EU counterpart to the U.S. certiorari process.[252] As a result, tax cases constitute about 10% of the ECJ's caseload.[253] Despite our use of EU examples to illustrate our arguments, this Part shows

252. As two chroniclers of the Court noted, Justice Brennan's typical reaction to a certiorari request in a tax case was: "This is a tax case. Deny." BOB WOODWARD & SCOTT ARMSTRONG, THE BRETHREN: INSIDE THE SUPREME COURT 362 (1979).

253. *See* Mason, *supra* note 17, at 1281 (citing annual statistics kept by the ECJ).

that those arguments apply with equal, if not more, force to the interpretation of constitutional prohibitions of U.S. state tax discrimination.

U.S. states taxing interstate income face challenges similar to those of nation-states taxing international income. For example, when a taxpayer resides in one U.S. state but works in another, both states may tax him.[254] To avoid double taxation, the residence state typically credits the income taxes levied on the labor income by the source state.[255] The taxation of interstate workers by the U.S. states raises issues similar to those raised by taxation of intra-EU workers by the EU member states. The Supreme Court, lower federal courts, and state courts have decided important tax discrimination cases, mostly under the Commerce Clause and the Privileges and Immunities Clause.[256]

The nondiscrimination provisions in the U.S. Constitution are even less explicit than those in the TFEU. For example, in the Supreme Court's view, because the Constitution reserves the power exclusively to Congress "to regulate Commerce . . . among the several States," in the absence of federal regulation, the states may not regulate or inhibit interstate commerce, including by applying discriminatory taxes that interfere with interstate commerce (this negative implication of the Commerce Clause has been called the "dormant Commerce Clause").[257] Likewise, the Supreme Court has interpreted the Privileges and Immunities Clause of Article IV, which provides that "[t]he Citizens of each State shall be entitled to all Privileges and Immunities of Citizens in the several States," to prohibit tax discrimination by one U.S. state against residents of another U.S. state.[258]

254. HELLERSTEIN & HELLERSTEIN, *supra* note 10, ¶ 20.10.

255. *Id.*

256. The Supreme Court also has decided some tax discrimination cases under the Equal Protection Clause, which provides that "[n]o state shall . . . deny to any person within its jurisdiction the equal protection of the laws." U.S. CONST. amend. XIV, § 1; *see, e.g.*, Metro. Life Ins. Co. v. Ward, 470 U.S. 869 (1985) (holding that, under the Equal Protection Clause, Alabama could not assess nonresident insurance companies to higher taxes than resident insurance companies); *see also* HELLERSTEIN & HELLERSTEIN, *supra* note 10, ¶¶ 3.01-.05 (analyzing tax discrimination jurisprudence under the Equal Protection Clause).

257. U.S. CONST. art. I, § 8, cl. 3; *see, e.g.*, Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977) (setting forth four factors used in evaluating whether states comply with the dormant Commerce Clause: nondiscrimination, nexus, fair apportionment, and reasonable-relation-to-government-services-provided). *See generally* HELLERSTEIN & HELLERSTEIN, *supra* note 10, ¶¶ 4.01-.26 (analyzing tax discrimination jurisprudence under the Commerce Clause).

258. U.S. CONST. art. IV, § 2, cl. 1; Lunding v. N.Y. Tax Appeals Tribunal, 522 U.S. 287 (1998) (holding that New York violated the Privileges and Immunities Clause when it denied alimony deductions to a Connecticut resident with New York-taxable income while permitting New York residents to deduct alimony). *See generally* HELLERSTEIN &

One question that immediately presents itself is whether the tax nondiscrimination principle under the dormant Commerce Clause means the same thing as the tax nondiscrimination principle under the Privileges and Immunities Clause. The Supreme Court has not interpreted the two provisions the same way. For example, the personal scope of those provisions differs because corporations cannot raise nondiscrimination claims under the Privileges and Immunities Clause. Likewise, although Congress can consent to state tax rules that would violate the nondiscrimination principle under the dormant Commerce Clause, congressional consent cannot cure tax discrimination that violates the Privileges and Immunities Clause. Although the personal scope and available justifications for tax discrimination vary across these two constitutional provisions, it is possible (and we suggest here plausible) that the economic efficiency component of both prohibitions of tax discrimination seeks to promote competitive neutrality. This notion is perfectly consistent with the idea that nondiscrimination under the dormant Commerce Clause emphasizes economic efficiency more than does nondiscrimination under the Privileges and Immunities Clause, which emphasizes equality more.

A second preliminary question is whether there is any reason to think that the nondiscrimination principle in either of these constitutional provisions would have the same meaning as the EU nondiscrimination principle. We suggest that there is. The U.S. Constitution and the EU treaties both reflect the goals of their framers to foster political and economic unity among the residents of each union. Prohibiting states from using their tax systems to interfere with economic integration is an important part of that process. And, like the ECJ, in deciding tax discrimination cases, the Supreme Court emphasizes the goal, embodied in the Constitution, of forming a common market where state laws do not unreasonably impede interstate commerce. Thus, although a premise of this Article is that tax nondiscrimination principles have not been interpreted clearly, one clear purpose of those principles in both the U.S. Constitution and the TFEU is to prevent states from enacting tax barriers to interstate commerce. In other words, although nondiscrimination principles in different contexts may promote different values, one component that they have in common is the goal of promoting a level playing field among residents of different member states.

Moreover, the case for a competitive neutrality interpretation of nondiscrimination is, if anything, stronger in the United States than in the EU because in applying nondiscrimination, the Supreme Court expressly considers whether the challenged tax distorts competition between in-state residents and

HELLERSTEIN, *supra* note 10, ¶ 20.06 (analyzing tax discrimination jurisprudence under the Privileges and Immunities Clause).

out-of-state residents. For example, in *West Lynn Creamery v. Healy*, the Supreme Court used the dormant Commerce Clause to strike down a tax that applied to both in-state and out-of-state milk dealers doing business in Massachusetts because it was linked to a preferential subsidy for in-state milk producers. In the Court's view, the combination of the tax and preferential subsidy "neutraliz[ed] the advantage possessed by lower cost out-of-state producers."[259] This analysis expressly evinces a concern that states should not use taxes to undermine out-of-state residents' comparative advantage over in-state residents.

Likewise, the Supreme Court's interpretation of the Privileges and Immunities Clause suggests that that Clause also promotes competitive neutrality. For example, in one of its earliest interpretations, the Court stated that the purpose of the Clause was to "place the citizens of each State upon the same footing with citizens of other States, so far as the advantages resulting from citizenship in those States are concerned."[260] Similarly, in a concurring opinion in *Toomer v. Witsell*, Justice Frankfurter argued that the decisions under the Privileges and Immunities Clause "bar a State from penalizing the citizens of other States by subjecting them to heavier taxation merely because they are such citizens or by discriminating against citizens of other States in the pursuit of ordinary livelihoods *in competition with local citizens*."[261] And writing for the majority in *Travis v. Yale & Towne Manufacturing Co.*, Justice Pitney expressed the concern that an out-of-state worker who was denied a personal exemption by a source state nevertheless had to "compet[e]" with in-state workers "as to wages, salaries, and other terms of employment."[262] Thus, the Supreme Court has expressly appealed to competitive neutrality values in deciding tax discrimination cases.

The Supreme Court's interpretation of the nondiscrimination principle as having what the Europeans call "direct effect" bolsters the claim that the principle promotes competitive neutrality. Specifically, violations of the nondiscrimination principles of both the dormant Commerce Clause and the Privileges and Immunities Clause give rise to private rights of action by affected taxpayers. Such direct effect is consistent with competitive, but not locational, neutrality. Explicit adoption by the Supreme Court of a competitive

259. West Lynn Creamery, Inc. v. Healy, 512 U.S. 186, 194 (1994); *see also id.* at 193 (noting that the Constitution forbids internal tariffs because they "artificially encourage in-state production even when the same goods could be produced at lower cost in other states").

260. Paul v. Virginia, 75 U.S. 168, 180 (1868).

261. 334 U.S. 385, 408 (1948) (Frankfurter, J., concurring) (emphasis added).

262. 252 U.S. 60, 80 (1920) (holding that a state violated the Privileges and Immunities Clause when it denied nonresident taxpayers personal exemptions available to resident taxpayers).

neutrality construction of nondiscrimination and endorsement of the interpretive rules we develop in this Article could bring predictability and coherence to the Court's tax discrimination jurisprudence. It would also generate some of the advantages discussed in the previous Part.

For example, like the ECJ, the Supreme Court has been caught up in legislative questions in its own tax discrimination jurisprudence. In *Lunding v. New York Tax Appeals Tribunal*, the Supreme Court set forth its views on personal tax benefits.[263] Unlike the ECJ in *Schumacker*, the Supreme Court in *Lunding* refused to hold that personal expenses generally should be allocated to the taxpayer's residence state.[264] Instead, the Supreme Court concluded that a source state could categorically deny nonresidents personal expense deductions only under limited circumstances, such as when the particular expense could be "geographically fixed" in another state.[265] The Court gave examples of personal expenses that it believed could be geographically fixed, including mortgage interest and real estate taxes.[266] But the Supreme Court's "geographic" approach in *Lunding* is no more administrable than the ECJ's "personal and family" benefit approach in *Schumacker*. For example, in her dissent in *Lunding*, Justice Ginsburg argued that the quality of house that a taxpayer can afford (and therefore the size of her mortgage) relates to how much she earns overall.[267] This point calls into question the majority's assertion that mortgage interest deductions have a clear geographic nexus with the state in which the property is located, as opposed to the state or states in which the homeowner earns her income.[268] The Supreme Court's express adoption of a competitive neutrality interpretation of tax nondiscrimination would render unnecessary the need to categorize tax benefits by reference to their geographic nexus with a particular state. Instead, the Court would have to ensure that both taxes and tax benefits were conferred on either a uniform source or a uniform residence basis.[269]

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263. 522 U.S. 287 (1998).

264. *Id.* at 314.

265. *Id.* at 311.

266. *Id.* The *Lunding* Court considered how to allocate a deduction for an expense actually incurred by the taxpayer. It is unclear how the Court's reasoning in *Lunding* would apply to other personal tax benefits, although the Court previously had held that a source state could not categorically deny nonresidents personal tax exemptions. *Travis*, 252 U.S. at 79.

267. *Lunding*, 522 U.S. at 327 (Ginsburg, J., dissenting).

268. *See id.* at 327-28.

269. Accordingly, under a competitive neutrality interpretation, the Supreme Court should have upheld New York's tax treatment of alimony payments, because it appears that New York offered the alimony deduction on a uniform residence basis. That is, New York provided the

Likewise, members of the Supreme Court could leave behind their debates about whether constitutional prohibitions of tax discrimination require a two-state or a single-state analysis. Consider again *Lunding*, which involved a Connecticut resident's privileges-and-immunities claim of discrimination against New York for New York's failure to grant him the same alimony deductions that it granted to New York residents. Both the majority in *Lunding* and Justice Ginsburg writing in dissent considered what significance to assign to the fact that Lunding could not obtain an alimony deduction in Connecticut because at that time Connecticut neither taxed income nor allowed deductions for alimony.[270] While the majority found the law of Connecticut had no bearing on whether New York discriminated, Justice Ginsburg thought it mattered. A competitive neutrality interpretation of nondiscrimination, however, would imply that the Court should consider only the law of the defendant state. This approach is largely consistent with the Supreme Court's practice. Notwithstanding Justice Ginsburg's dissent in *Lunding*, the Court generally has adopted a single-state approach because to do otherwise would mean that the constitutionality of the defendant state's tax law "would depend on the shifting complexities of the tax codes of 49 other States."[271]

The Supreme Court's tax discrimination jurisprudence resembles that of the ECJ in another way. The Supreme Court has been criticized for producing a series of confused and incoherent tax discrimination decisions.[272] For example, although they do not raise the issue, the criticism that Professors Graetz and Warren level against the ECJ's tax jurisprudence also could be leveled against the tax jurisprudence of U.S. state and federal courts. Specifically, because courts have applied the nondiscrimination principle to

deduction on the same basis to all New York residents, no matter where they earned their income. This alimony treatment is furthermore consistent with New York's overall method of taxation, under which it taxed residents on their worldwide income and granted credits for the taxes paid to other states.

270. *Id.*

271. Armco Inc. v. Hardesty, 467 U.S. 638, 645 (1984).

272. Tracy A. Kaye, *Tax Discrimination: A Comparative Analysis of U.S. and EU Approaches*, 7 FLA. TAX REV. 47, 80, 91 (2005) (calling tax cases decided under the Privileges and Immunities Clause "ad hoc"); *see also id.* at 91 (quoting Professor Kirk Stark as saying that the Court's tax jurisprudence has a "wild west quality to it"); *id.* at 90-91 (noting that, in *Boston Stock Exchange*, "the Supreme Court itself observed again that its judicial application of constitutional principles to the multitude of state tax cases 'left much room for controversy and confusion and little in the way of precise guides to the States in the exercise of their indispensable power of taxation'" (quoting Bos. Stock Exch. v. State Tax Comm'r, 429 U.S. 318, 329 (1977))).

states taxing in both source[273] and residence capacities,[274] U.S. courts could be seen as attempting to pursue both locational neutrality and leisure (or savings) neutrality. But pursuit of both goals simultaneously is futile unless all U.S. states harmonize their tax rates. However, as the Supreme Court has acknowledged, the Constitution does not require the U.S. states to harmonize their tax rates.[275] Competitive neutrality resolves the seeming incongruity of imposing nondiscrimination obligations at both source and residence in the absence of rate harmonization.

One more lesson can be drawn from comparing U.S. and EU law, and it relates to the issue we raised earlier of the competence of courts to impose any of the efficiency benchmarks in their respective jurisdictions. As we noted above, the ECJ lacks the institutional competence to impose upon the member states a specific method for taxing cross-border income, even though international harmonization of the method for taxing cross-border income is a prerequisite to fully achieving competitive neutrality.[276] Similarly, the U.S. Supreme Court lacks authority to impose upon the U.S. states a common method for dividing interstate income among the states,[277] although Congress could impose a common method on the states, or the states could coordinate a common method among themselves.[278]

273. *See, e.g.*, Travis v. Yale & Towne Mfg. Co., 252 U.S. 60 (1920) (holding that a state violated the Privileges and Immunities Clause when it denied nonresident taxpayers personal exemptions available to resident taxpayers).

274. Fulton Corp. v. Faulkner, 516 U.S. 325 (1996) (striking down a state intangibles tax that had the effect of exempting the stock of a corporation doing all of its business in-state, while taxing the stock of a corporation doing none of its business in-state); Ceridian Corp. v. Franchise Tax Bd., 102 Cal. Rptr. 2d 611, 615 n.2 (Ct. App. 2000) (striking down under the Commerce Clause a state dividends-received deduction that was limited to the portion of the dividends that came from in-state sources).

275. Allied Stores of Ohio, Inc. v. Bowers, 358 U.S. 522, 526-27 (1959) (discussing states' wide discretion in taxation).

276. *See, e.g.*, Case C-336/96, Gilly v. Directeur des Services Fiscaux du Bas-Rhin, 1998 E.C.R. I-2793, para. 24 ("The Member States are competent to determine the criteria for taxation on income and wealth with a view to eliminating double taxation . . . ."); Case C-513/04, Kerckhaert v. Belgium, 2006 E.C.R. I-10967, para. 22 (noting that EU law "does not lay down any general criteria for the attribution of areas of competence between the Member States in relation to the elimination of double taxation within the Community").

277. *See* Moorman Mfg. Co. v. Bair 437 U.S. 267, 279 (1978) (holding that since the Constitution prescribed no standards for choosing a single method for dividing cross-border income among the states, the Supreme Court would not impose such a standard, and stating that "[t]he Constitution . . . is neutral with respect to the content of any uniform [apportionment] rule").

278. *See id.* at 280 ("[T]he legislative power granted to Congress by the Commerce Clause of the Constitution would amply justify the enactment of legislation requiring all States to adhere

U.S. states (like nation-states) tax labor income according to source and residence principles, but unlike nation-states, U.S. states do not tax active business income according to source and residence principles. Instead, they use formulary apportionment.[279] Rather than focusing on the (often elusive) geographic source of income, formulary apportionment divides the overall profits of an integrated enterprise doing business in the United States among the states in which the enterprise does business according to a formula that takes into account the presence in each state of the enterprise's productive factors, such as its payroll, property, and sales.[280] If every state used the exact same formula to determine its portion of the enterprise's overall income, no double taxation would arise, even if the states applied different tax rates.

Unfortunately, not all states use the same apportionment formula, and differences in the formulas lead to gaps and overlaps in state income taxation. Use of different apportionment formulas by the U.S. states gave rise to dormant Commerce Clause challenges by taxpayers claiming that overlaps in state apportionment formulas discriminated against out-of-state businesses or imposed unjustifiable burdens on interstate commerce.[281] Despite the Supreme Court's acknowledgement of its lack of institutional competence to impose upon the states a common method for dividing interstate income,[282] the Court has taken a strong position on what the nondiscrimination principle of the dormant Commerce Clause requires of state apportionment formulas. Notwithstanding the states' substantial latitude in taxing cross-border income, the Court has held that states may not choose a method for dividing cross-border income that is biased against nonresidents or interstate commerce.

Specifically, the Court developed the "internal consistency test" to judge whether state apportionment formulas violate the dormant Commerce Clause. Under this test, the Supreme Court asks: If all fifty states adopted the challenged formula, would multiple taxation inevitably result?[283] If so, the

to uniform rules for the division of income. It is to that body, and not this Court, that the Constitution has committed such policy decisions.").

279. *See* HELLERSTEIN & HELLERSTEIN, *supra* note 10, ¶¶ 20.05-.10.

280. The model formula under the Uniform Division of Income for Tax Purposes Act (UDITPA) equally weighs sales, property, and payroll. For example, if a taxpayer had $100 of apportionable income, and 30% of its payroll, property, and sales were located in California, California would apply its tax rate to $30. For analysis and criticism of UDITPA, see Charles E. McLure, Jr., *A Comprehensive and Sensible UDITPA*, 37 ST. TAX NOTES 929 (2005).

281. *See, e.g.*, Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159, 169 (1983); *Moorman*, 437 U.S. 267.

282. *Moorman*, 437 U.S. 267.

283. Okla. Tax Comm'n v. Jefferson Lines, Inc., 514 U.S. 175, 185 (1995); *see also Container Corp.*, 463 U.S. at 169 (holding that a state's apportionment formula "must be such that, if applied

apportionment formula is invalid. The internal consistency test provides a formal method for courts to evaluate whether a state's tax law improperly impedes interstate commerce without embroiling the reviewing court in legislative second-guessing and without invading states' tax sovereignty. Thus, under the dormant Commerce Clause, states retain substantial tax autonomy—they can select their tax base, rates, and apportionment formulas—but their tax choices are nevertheless constrained by the dormant Commerce Clause and judicial review. The Supreme Court recognized that it could not always prevent taxation from being a drag on cross-border commerce because states' use of different apportionment formulas create such drags, and the Court lacks institutional authority to impose a common formula. However, the internal consistency test ensures that states do not adopt formulas that are inherently biased against cross-border commerce.

Like the Supreme Court, the ECJ faces institutional constraints that prevent it from fully achieving any of the neutrality benchmarks on its own. Instead, achieving any of the benchmarks would require legislative cooperation to harmonize states' methods for taxing cross-border income. In light of the need for legislative harmonization to fully achieve any of the neutrality benchmarks, we argued earlier that courts should advance competitive neutrality by interpreting the nondiscrimination principle to require fidelity to competitive neutrality's uniformity requirements, namely the requirements of uniform residence taxes and uniform source taxes. The requirement under competitive neutrality that states apply only uniform source and residence taxes works similarly to the U.S. internal consistency test. While it does not eliminate the drags on cross-border commerce that stem from states' use of different methods of taxing cross-border income (for example, worldwide taxation or exemption), it nevertheless strikes down tax provisions that directly tilt the tax playing field between residents and nonresidents. The Supreme Court's deployment of the internal consistency test shows that courts can coherently advance notions of economic efficiency even when they lack institutional competence to impose particular legislative outcomes upon states. We urge the ECJ similarly to advance tax neutrality without overstepping its institutional authority.

by every jurisdiction, it would result in no more than all of the unitary business' income being taxed").

CONCLUSION

If taxes imposed at either source or residence can disrupt cross-border commerce by tilting the playing field against cross-border workers, one might then ask, why have courts failed to expressly adopt a competitive neutrality interpretation of nondiscrimination? Our answer is that until recently formally trained economists all but ignored competitive neutrality, so judges and lawyers have lacked guidance on what competitive neutrality required of state tax rules.

Contrary to the requirements for competitive neutrality, the requirements for locational and savings neutrality have long been understood. Thus, had the ECJ wanted to interpret nondiscrimination to require either of these two traditional capital neutrality benchmarks, the court and legal advocates could have found clear direction in the economic literature. Even if judges and advocates did not understand the implications for labor taxation of the traditional capital neutrality benchmarks (because they have, until now, lacked the analysis provided in Part II of this Article), they still could have applied the traditional benchmarks to capital tax cases. However, as Graetz and Warren showed, despite their ready availability and prominent use in international tax policymaking, the ECJ did not coherently apply either traditional benchmark to capital tax discrimination cases. Nor, we would add, has the Supreme Court coherently applied either traditional benchmark in its own tax discrimination case law, despite long-standing scholarly calls for it to do so.[284] Because courts failed to interpret the nondiscrimination principle as requiring either of the two traditional neutrality benchmarks, commentators justifiably concluded that the tax nondiscrimination concept was empty, incoherent, or inconsistent.

In contrast, formal economic analysis of taxation and competitive neutrality only came to prominence in 2004 when economists Desai and Hines published their influential paper on the effects of capital taxation on competition for the ownership of assets.[285] Although economists are only now formalizing the connection between taxes and competitiveness, noneconomists have long been concerned with considerations of competitiveness, including how taxation can tilt the playing field between residents and nonresidents. Thus, it would not be surprising if such non-experts read protections for level competition into legal prohibitions of tax discrimination.

284. *See, e.g.*, Daniel Shaviro, *An Economic and Political Look at Federalism in Taxation*, 90 MICH. L. REV. 895 (1992) (advocating that the nondiscrimination principle in the dormant Commerce Clause should be interpreted to require locational neutrality).

285. Desai & Hines, *supra* note 33, at 494.

Moreover, as we show above, competitive neutrality remains a complex and subtle concept. That may help explain why, even though we argue that applications of tax nondiscrimination rules in the EU and United States reflect competitive neutrality goals, they do not reflect rigorous application of our formal conception of competitive neutrality. The complexities and subtleties of competitive neutrality do not, however, make it an unworkable standard for enforcement by noneconomist judges. As we have explained, to interpret nondiscrimination to promote competitive neutrality, courts would not have to conduct in-depth economic analysis. Instead, to uphold a challenged tax, a court would merely have to confirm that the defendant state assessed it uniformly. Specifically, if a state assesses the challenged tax on a residence basis, then the tax must apply the same way to both residents with out-of-state income and residents with domestic income. Similarly, if the state assesses the challenged tax on a source basis, then the tax must apply the same way to both residents and nonresidents working within the jurisdiction. All that a court must do to assess whether a tax provision is discriminatory is to ask whether the provision applies on a uniform residence or uniform source basis. Sophisticated economic analysis shows this to be the right question to ask, but the answer to the question in a particular case does not depend on fancy economic theories, reams of data, or advanced econometrics.

For courts that agree with our argument that nondiscrimination requires competitive neutrality, we provide simple guidelines for resolving practically any case. For courts that do not agree with our conclusions, we also provide clear guidelines for interpreting nondiscrimination to require adherence to either of the traditional efficiency goals of locational or savings (and leisure) neutrality. Whether they agree with our analysis or not, we hope our Article will encourage courts to articulate the goal or goals that they believe the nondiscrimination principle promotes and to undertake a rigorous analysis of whether a challenged tax interferes with those goals.