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David Elkins

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A Critical Reassessment of the Role of Neutrality in International Taxation

David Elkins*

Abstract:

Neutrality plays a central role in the literature on international taxation. In its most prevalent form, the concept of neutrality posits that in order to maximize aggregate global welfare, capital needs to flow to where it would produce the highest pretax return. The thesis of this Article is that neutrality is ordinarily inapplicable in the field of international taxation.

When considering neutrality in the international arena, the problem that one encounters is that the term "international taxation" is commonly used to describe a number of very different types of tax regimes (what the Article refers to as "intranational taxation," "supranational taxation," and "inter-jurisdictional taxation"). Although the literature tends not to distinguish among them, the different types of international tax regimes are conceptually distinct and require radically dissimilar guiding principles. The Article argues that neutrality is an appropriate principle with regard to only one type of international taxation: a hypothetical non-Pigouvian supranational tax. With regard to intranational taxation, neutrality has no role to play, as a rational country will exploit its tax system to promote the welfare of its own constituents without regard to which investments it would have attracted in a no-tax world. With regard to a hypothetical Pigouvian supranational tax and in particular with regard to the much-scrutinized field of inter-jurisdictional taxation, neutrality is irrelevant, as here it is the after-tax return and not the pretax

[*] Professor, Netanya College School of Law, Israel; Visiting Senior Research Fellow, Singapore Management University – Tax Academy Centre for Excellence in Taxation (Summer 2018); Visiting Professor, Cornell Law School (spring 2020). LL.B, Hebrew University of Jerusalem, 1982; LL.M, Bar-Ilan University, 1992; Ph.D., Bar-Ilan University 1999. For their helpful comments I would like to thank Reuven Avi-Yonah, Joseph Bankman, and Tsilly Dagan. Drafts of this paper were presented at the Atara Kaufman Annual Conference on Law and Globalization at IDC Herzliya Harry Radzyner Law School; the Sixth International Conference on Taxation and Tax Policy at Netanya Law School, and at the Law and Society Association annual meeting in Washington DC. This article is one of a series in which I critically explore the principles underlying the international tax discourse. Other articles in the series include *The Merits of Tax Competition in a Globalized Economy*, 91 INDIANA L.J. 905 (2016); *The Case Against Income Taxation of Multinational Enterprises*, 36 VA. TAX REV. 143 (2017); *Critical Issues in Comparative and International Taxation II: Taxation and Migration: The Elusive Definition of Corporate Tax Residence*, 62 ST. LOUIS U. L.J. 219 (2017); *The Myth of Corporate Tax Residence*, 9 COLUM. J. OF TAX L. 5 (2017).

return that is determinative of allocative efficiency. Promoting neutrality would undermine the very goals that the principle of neutrality purports to serve.

The Article concludes by noting that the current discourse with regard to international taxation is fraught with conceptual confusion. First, there is a tendency to rely upon concepts that were developed within the context of domestic taxation without a thorough examination of their applicability to the international arena. Second, there is a tendency to lump together a number of very distinct types of tax regimes under the overbroad category of international taxation, and to ignore the fact that due to the fundamental dissimilarities among them, the principles of tax theory relevant to each will also be different.

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I. INTRODUCTION

The concept of neutrality plays a central role in the literature on international taxation. In its most prevalent form, it posits that taxes should not be a factor in investment decisions.[1] The underlying idea is that in order to maximize aggregate global welfare, capital needs to flow to where it is able to produce the highest pretax return. Consequently, when those investments that offer the highest pretax returns do not offer the highest after-tax return, capital will be misdirected. Therefore, allocative efficiency can only be achieved when alternative investments bear similar tax burdens.[2]

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[1] The idea that taxes should not influence investment decisions is often referred to as capital export neutrality (CEN). CEN prescribes that capital should be subject to the same tax burden whether it is invested at home or abroad. *See, e.g.*, CHRISTOPHER H. HANNA, TAX POLICY IN A NUTSHELL 231 (2018); Ruth Mason & Michael S. Knoll, *What is Tax Discrimination?*, 121 YALE L.J. 1014, 1043 (2012); STEPHANIE HUNTER MCMAHON, PRINCIPLES OF TAX POLICY 330-31 (2018); Org. for Econ. Co-operation & Dev. [OECD], *Are the Current Treaty Rules for Taxing Business Profits Appropriate for E-Commerce? Final Report*, at 13 (2004), http://www.oecd.org/tax/treaties/arethecurrenttreatyrulesfortaxingbusinessprofitsappropriatefore-commerce.htm. Although ordinarily stated terms of a two-option scenario (home or abroad), CEN is actually a multiple-option scenario. It effectively requires that capital be subject to the same tax burden wherever it is invested. Other concepts of neutrality discussed in the literature include capital import neutrality (CIN) and capital ownership neutrality (CON). *See, e.g.*, JANE GRAVELLE, CONG. RESEARCH SERV., RL34115, REFORM OF U.S. INTERNATIONAL TAXATION: ALTERNATIVES 5-10 (2010); CHARLES H. GUSTAFSON, ROBERT J. PERONI & RICHARD CRAWFORD PUGH, TAXATION OF INTERNATIONAL TRANSACTIONS 20-22 (4th ed. 2011); Fadi Shaheen, *International Tax Neutrality: Reconsiderations*, 27 VA. TAX REV. 203, 205 (2007). Under CIN, all capital invested in a particular jurisdiction should be subject to the same tax burden. CON requires that it be "impossible to increase output by trading capital ownership among investors." Mihir A. Desai & James R. Hines, Jr., *Evaluating International Tax Reform*, 56 NAT. TAX. J. 487, 495 (2003). One prominent commentator has described the various types of neutrality as "alphabet soup" and has castigated the debate over which should guide international tax policy as a "battle of the acronyms." DANIEL N. SHAVIRO, FIXING U.S. INTERNATIONAL TAXATION 14 (2014). Nevertheless, CEN has dominated the international tax discourse and is the subject matter of this Article.

[2] *See, e.g.*, Reuven Avi-Yonah, *Globalization, Tax Competition and the Crisis of the Welfare State*, 113 HARV. L. REV. 1573, 1578 (2000) [hereinafter *Avi-Yonah, Crisis*]; J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Formulary Apportionment in the International Income Tax System: Putting Lipstick on a Pig?*, 36 MICH. J. INT'L L. 1, 12-13, n.43 (2014); Michael J. Graetz, *The David R. Tillinghast Lecture: Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 TAX L. REV. 261, 285 (2001), *reprinted in* MICHAEL J. GRAETZ, FOLLOW THE MONEY: ESSAYS ON INTERNATIONAL TAXATION 83 (2016); Yoram Keinan, *The Case for Residency-Based Taxation of Financial Transactions in Developing Countries*, 9 FLA. TAX REV. 1, 34-35 (2008); RICHARD A. MUSGRAVE & PEGGY B. MUSGRAVE, PUBLIC FINANCE IN THEORY AND PRACTICE 569 (5th ed. 1989); Avi Nov, *The "Bidding War" to Attract Foreign Direct Investment: The Need for a Global Solution*, 25 VA. TAX REV. 835, 844 (2006); Oleksandr Pastukhov, *International Taxation of Income Derived From Electronic Commerce: Current*

A number of means have been suggested to help achieve this goal. One is for countries to tax the worldwide income of their individual residents and domestic corporations at the same rates (for the sake of convenience, I will refer both to individual residents and to domestic corporations as "residents").[3] When a taxpayer is faced with the same tax rate wherever it chooses to invest, then those investments that offer the highest pretax return will also offer the highest after-tax return. However, even when countries do impose tax on the worldwide income of their residents, those ostensibly subject to their home country's tax regime can often escape – or at least defer – the payment of tax on their foreign income by operating abroad via foreign corporations or foreign subsidiaries.[4] To combat such maneuvers, countries sometimes tax the foreign income not only of their residents but also of foreign corporations that are owned or controlled by residents.[5] In fact, one of the proposals raised in the Organisation for Economic Co-operation and Development's (OECD) Action Plan on Base Erosion and Profit Shifting (BEPS) is that countries strengthen their Controlled Foreign Corporation (CFC) tax regime.[6]

Another method that has been suggested for achieving neutrality in the international arena and which has been the focus of most of the literature in international taxation since the turn of the current century, is to harmonize

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Problems and Possible Solutions, 12 B.U. J. SCI. & TECH. L. 310, 325-326 (2006); Adam H. Rosenzweig, *Why Are There Tax Havens?* 52 WM. & MARY L. REV. 923, 946-947 (2010); Shaheen, *supra* note 1, at 233; SHAVIRO, *supra* note 1, at 114; Joel Slemrod & Reuven Avi-Yonah, *(How) Should Trade Agreements Deal With Income Tax Issues?*, 55 TAX L. REV. 533, 554 (2002).

3 *See, e.g.*, Michael P. Devereux, *Taxation of Outbound Direct Investment: Economic Principles and Tax Policy Considerations*, 24 OXFORD REV. ECON. POL'Y 698, 707 (2008); Edward Troup & Paul Hale, *EU Initiatives on Tax Harmonization: Do as I Say, Not as I Do?*, 17 TAX NOTES INT'L 1081, 1082 (1998).

4 Furthermore, corporations that are residents of high-tax countries can often expatriate and thereby escape their ex-home country's tax regime. In the United States, because the criteria for determining corporate residency is place of incorporation, tax advisors have developed a number of techniques known as inversions, that effectively operate to convert a U.S.-registered corporation into a foreign-registered corporation. *See, e.g.*, Steven Goldman, *Corporate Expatriation: A Case Analysis*, 9 FLA. TAX REV. 71 (2008); GRAETZ, *supra* note 2, at 321; Omri Marian, *Jurisdiction to Tax Corporations*, 54 B.C. L. REV. 1613, 1654-55 (2013); DONALD J. MARPLES & JANE G. GRAVELLE, CONG. RESEARCH SERV., R43568, CORPORATE EXPATRIATION, INVERSIONS, AND MERGERS: TAX ISSUES 4-5 (2016); Adam H. Rosenzweig, *Source as a Solution to Residence*, 17 FLA. TAX REV. 471, 497 (2015); Joseph A. Tootle, *The Regulation of Corporate Inversions and "Substantial Business Activities,"* 33 VA. TAX REV. 353, 354 (2013).

5 *See, e.g.*, I.R.C. §§ 951 (controlled foreign corporations), 951A (global intangible low-taxed income), 954(c) (foreign personal holding company), 1297 (passive foreign investment company) (Westlaw 2017).

6 *See* Org. for Econ. Co-operation & Dev. [OECD], *Designing Effective Controlled Foreign Company Rules, Action 3 – 2015 Final Report* (2015) [hereinafter *OECD, Action 3*], https://www.oecd-ilibrary.org/docserver/9789264241152-en.pdf?expires=1557652675&id=id&accname=guest&checksum=8BFE625B1A05DF8CD7A77CD3A6DFFE14.

the tax regimes of the various countries, at least as far as the taxation of international investments is concerned. Again, if an investor faces similar tax burdens wherever it chooses to invest, then investment decisions will not be driven by tax forces and capital will flow to where it can produce the highest pretax return. The goal of neutralizing the effect of tax on investment decisions is one of the key justifications raised by the OECD for its campaign of combatting tax competition.[7]

International tax scholars generally agree that pretax return is determinative of allocative efficiency and, furthermore, that when investment decisions are influenced by tax considerations the result is a misallocation of resources and a diminution of aggregate global welfare. True, not all scholars believe that it is appropriate for countries to cooperate in order to create a neutral international tax regime. Some contend that countries should pursue their own national interests even when it conflicts with broader global interests.[8] Others hold that because it is impossible in practice to guarantee full cooperation by all countries and even a small number of non-conformers is enough to create distortions, countries are justified in pursuing their own narrow national interests.[9] Nonetheless, even those who justify the pursuit of national interest in the design of tax regimes tend to accept the underlying proposition that there is an inherent conflict between national interest and global interest and that a neutral international tax regime, in which investment decisions are not influenced by tax considerations, would better promote global welfare.[10]

This Article challenges that proposition. Its primary thesis is that, in most instances, allocative efficiency in the international arena requires that capital flows to the venue that offers the highest after-tax return. Attempts to neutralize the effects of taxation and to direct capital to those venues that offer the highest pretax return would, in most instances, produce allocative

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[7] *See, e.g.*, Reuven S. Avi-Yonah, *The OECD Harmful Tax Competition Report: A Retrospective After a Decade*, 34 BROOK. J. INT'L L. 783, 793 (2009); Yariv Brauner, *An International Tax Regime in Crystallization*, 56 TAX L. REV. 259, 263, 291, 294-97 (2003); Steven A. Dean, *More Cooperation, Less Uniformity: Tax Deharmonization and the Future of the International Tax Regime*, 84 TUL. L. REV. 125, 151 (2009) ("The primary appeal of . . . harmonization is rooted in a concern for economic efficiency."); GRAETZ, *supra* note 2, at 320-23; Charles E. McLure, Jr., *Legislative, Judicial, Soft Law, and Cooperative Approaches to Harmonizing Corporate Income*, 14 COLUM. J. EUR. L. 377, 386, 389 (2008).

[8] *See, e.g.*, SHAVIRO, *supra* note 1, at 108-09.

[9] *See, e.g.*, TSILLY DAGAN, INTERNATIONAL TAX POLICY: BETWEEN COMPETITION AND COOPERATION, 58-59 (2018) ("[N]eutrality . . . cannot prevail absent cooperation among states. Significantly, all the efficiency arguments made by proponents of partial neutrality collapse without the cooperation of a large enough number of countries . . . In the current decentralized international tax regime, complete global neutrality is unattainable and partial neutrality highly doubtful. Thus, instead of pursuing the elusive goal of neutrality, states should pursue policies that support their national interests."); *see generally* Mitchell Kane, *Strategy and Cooperation in National Responses to International Tax Arbitrage*, 53 EMORY L.J. 89 (2004).

[10] *See, e.g.*, DAGAN, *supra* note 9, at 57-60; SHAVIRO, *supra* note 1, at 114.

inefficiency to the detriment of aggregate global welfare.

The differences between the domestic arena (where neutrality is usually, although not always, an important goal for policy-makers to pursue) and the international arena (where neutrality is usually, although not always, not only irrelevant as a principle of tax theory but would prove counterproductive if it could be achieved) are that the tax imposed by home countries on foreign residents is not really a tax, but rather a price of access to the host country's territory; that the amount of tax that it can charge is determined by the supply of and demand for international investment and international investment venues; and that because the tax is part and parcel of the market mechanism, it is the relative after-tax return and not the relative pretax return that encapsulates allocative efficiency.

The principle of neutrality was developed in the arena of domestic taxation, where the country is implicitly viewed as a closed economy without any contact with foreign persons, foreign investments, and foreign tax regimes. Part II presents the principle of neutrality as it applies in this arena. It explains how allocative efficiency requires that investments flow to where they can produce that highest pretax return and that when investments that offer the highest pretax return do not offer the highest after-tax return, capital is misdirected and societal welfare suffers. However, it also shows that even within the purely domestic arena, neutrality is not a universally applicable principle, as it does not apply to Pigouvian taxation.

The question that arises then is whether the principle of neutrality is applicable to international taxation. However, in order to answer that question, we first need to explore what is meant by the term "international taxation." Part III argues that the term is overbroad and is used to describe three very different types of tax regimes. The first (which I call "intranational taxation") describes international aspects of a country's domestic tax regime, including but not limited to, its taxation of non-residents. The second (which I call "supranational taxation") describes a hypothetical tax imposed by a supranational entity. The third (which I call "inter-jurisdictional taxation") describes the coordination of various countries' intranational tax regimes. Although the literature often confuses these three types of international tax regimes and refers to them indiscriminately as international taxation, clearly distinguishing among them is crucial, as the principles of tax theory that apply to each are very different.

Part IV then explores the applicability of neutrality to each of these international tax regimes. Supranational taxation is the most similar to purely domestic taxation: neutrality would be an appropriate consideration with regard to supranational taxes, except for supranational Pigouvian taxes. With respect to intranational taxation, I will argue that the tax countries impose on non-residents is in substance not really a tax but rather a price of access to the host country's territory. The goals of a host country in designing its intranational tax regime will include attracting beneficial investment, deterring detrimental investment, and maximizing the tax revenue collected from those investments that do occur. Within such framework, neutrality will not be a relevant concern. Moving to intra-jurisdictional taxation, I will argue that whereas intranational taxation reflects the supply of and the demand for international investment and international investment venues, it constitutes part and parcel of the international market mechanism. Consequently, I will argue that from the perspective of global welfare, it is the after-tax return that indicates where resources are being used most efficiently. Any attempt to disrupt this process by neutralizing the effect of intranational taxation on investments will misdirect capital and create allocative inefficiency.

Part V will summarize the findings and offer some concluding thoughts.

II. NEUTRALITY IN DOMESTIC TAXATION

The concept of neutrality was developed within the realm of purely domestic taxation, that is, where the country is a closed economy with no consideration given to foreign persons, foreign income, or foreign tax systems. Therefore, before we consider neutrality in international taxation we will explore its function in the purely domestic arena. Later, we will introduce international factors and examine how the principle of neutrality fares outside of the purely domestic arena.

A. Non-Pigouvian Taxation

The principle of neutrality proceeds from the presumption that the market is ordinarily an efficient means of allocating resources.[11] The underlying idea is that if there exists a more efficient allocation of resources than the one that exists (i.e., if there is an alternative allocation in which at least one person is better-off and no one is worse-off), and if there are no regulatory or other impediments to their doing so, individuals and firms will exchange goods and services so as to realize the more efficient allocation. To take a simple example, if Adrienne values Bruce's labor at $100 an hour and Bruce values his leisure at $80 an hour, it will be in the interest of both of them for Adrienne to pay Bruce, say, $90 an hour for his work. Such a transaction will constitute a Pareto improvement over the previous distribution.[12] Under classic economic theory, individuals and firms will

[11] Absent this assumption, there would be no reason to attempt to preserve the pretax tax allocation of resources and to strive for neutrality in the tax system. An important exception to the applicability of the principle of neutrality in domestic taxation is Pigouvian taxation. *See infra* Part II.B.

[12] A move from Distribution A to Distribution B constitutes a Pareto improvement if at least one person prefers Distribution B and no one prefers Distribution A. Vilfredo Pareto, *Manuel d'Economie Politique*, *in* A REVIEW OF ECONOMIC DOCTRINES 1870-1929, 225 (T.W.

continue to exchange goods and services until there is no possible exchange that makes anyone better without making someone else worse. At that point, the allocation of resources will satisfy the requirements of Pareto efficiency.[13]

Taxation can disrupt this process by preventing efficiency-enhancing exchanges. To demonstrate, let us return to our example of Adrienne and Bruce, but now assume that the government imposes an income tax at the rate of 30%. The most that Adrienne would be willing to pay Bruce is $100. From Bruce's perspective the best that Adrienne can offer is after-tax pay of $70, which is less than the value he places on his leisure. As there is no price which Adrienne would be willing to pay and which Bruce would be willing to accept, no deal will be consummated. Bruce will end up with leisure that he values at $80; Adrienne will end up without Bruce's labor, which she values at $100, and the government will collect no tax. An opportunity to increase societal welfare will have been squandered.[14]

This phenomenon is described in the economic literature as a deadweight loss.[15] Deadweight loss is defined as the difference between the welfare cost imposed upon individuals by the tax and the amount of tax collected by the government.[16] To demonstrate, if in our example the tax were only 6% and the wage rate remained $90 an hour, Bruce would suffer a $5.40 welfare loss (after-tax income of $84.60 versus non-taxed income of $90), and the government would collect $5.40 in taxes. The deadweight loss – the difference between Bruce's welfare loss and the taxes collected by the government – would be $0. On the other hand, if the tax were 30% and consequently Adrienne did not end up hiring Bruce, Bruce would suffer

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Hutchinson ed. & trans., 1953). The text assumes that Adrienne's hiring of Bruce entails no negative externalities or that any externalities are accounted for by appropriate Pigouvian taxation. *See infra* Part II.B.

[13] Distribution A is Pareto efficient when there is no Distribution B such that Distribution B is a Pareto improvement over Distribution A. Pareto, *supra* note 12, at 225. In other words, a distribution is Pareto efficient when it is not possible to raise anyone's welfare level without lowering someone else's welfare level.

[14] *See, e.g.*, Nancy C. Staudt, *The Hidden Costs of the Progressivity Debate*, 50 VAND. L. REV. 919, 929 n.26 (1997); V. Patrice Wylly, *Now You See it, Now You Don't: Taxpayers' Strategic Use of the Informal Job Market in Their Labor Responses to Effective Marginal Tax Rates Under the Earned Income Tax Credit*, 37 VA. TAX REV. 109, 127 (2017).

[15] *See, e.g.*, 1 RHONA C. FREE, 21ST CENTURY ECONOMICS: A REFERENCE HANDBOOK 258-59 (2010); David Gamage & Darien Shanske, *Three Essays on Tax Salience: Market Salience and Political Salience*, 65 TAX L. REV. 19, 61-62 (2011); Arnold C. Harberger, *The Measurement of Waste*, 54 AM. ECON. REV. 58, 59 (1964); N. GREGORY MANKIW, PRINCIPLES OF ECONOMICS 159-66 (4th ed. 2007).

[16] *See, e.g.*, Terrance O'Reilly, *Principles of Efficient Tax Law: Apocrypha*, 27 VA. TAX REV. 583, 584 (2008); Herwig J. Schlunk, *Little Boxes: Can Optimal Commodity Tax Methodology Save the Debt-Equity Distinction?*, 80 TEX. L. REV. 859, 864 (2002); David A. Weisbach, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, 84 CORNELL L. REV. 1627, 1651 (1999).

a $10 welfare loss (he would have leisure worth $80 instead of $90 cash), Adrienne would suffer a $10 welfare loss (she would have $90 cash instead of labor worth $100), and the government would collect $0 in tax. The deadweight loss in this scenario would be $20.

The principle of neutrality posits that the best types of taxes are those that least affect behavior and thus minimize the deadweight loss. For instance, the concept of neutrality is one of the ideas behind traditional tax reform, which seeks to lower the tax rate by broadening the base. The broader the base the more difficult it is to avoid the tax by changing one's behavior, and the lower the rate the less incentive there is to avoid the tax by changing one's behavior. In contrast, a high tax rate combined with a narrow base provides both the incentive and the opportunity to engage in tax avoidance.[17]

In more technical terms, the principle of neutrality can be described by reference to the substitution effect and its impact on the marginal rate of transformation. In an efficient economy, the marginal rate of substitution (MRS) of one consumer good for another, of leisure for consumer goods, and of present consumption for future consumption will equal their marginal rate of transformation (MRT).[18] Assume, for instance, that marginal consumers consider product P_1 to be worth ten times as much as product P_2 and consequently the price of P_1 is ten times that of P_2. Any factor of production that can produce more than ten times as much P_2 as P_1 will be used to produce P_2, while any factor of production that can produce less than ten times as much P_2 as P_1 will be used to produce P_1. In other words, the MRS (as expressed by consumer preferences) of P_1 for P_2 will equal the MRT of P_1 for P_2. In such a state of affairs, resources are being used in their most efficient manner to satisfy consumer demand.

Now assume that the government imposes an excise tax of 50% on P_1. The price of P_1 will now be fifteen times that of P_2. Consumers for whom P_1 is worth more than ten but less than fifteen times as much as P_2 will now

[17] *See, e.g.*, HENRY J. AARON & WILLIAM G. GALE, ECONOMIC EFFECTS OF FUNDAMENTAL TAX REFORM 1 (1996); Gordon T. Butler, *The One Fund Solution: "It's My Money and I Need It Now!,"* 11 HOUS. BUS. & TAX L.J. 262, 317 (2011); Michael J. Graetz, *The 1982 Minimum Tax Amendments as a First Step in the Transition to a "Flat-Rate" Tax*, 56 S. CAL. L. REV. 527, 530 (1983); Anthony C. Infanti, *Tax Reform Discourse*, 32 VA. TAX REV. 205, 215 (2012); Toru Morotomi, *Japan's Shift to Territoriality in 2009 and the Recent Corporate Tax Reform: A Japan-United States Comparison of Taxing Income From Multinationals*, 14 PITT. TAX REV. 173, 177 (2017); Jason S. Oh, *Will Tax Reform Be Stable?*, 165 U. PA. L. REV. 1159, 1200 (2017).

[18] The rates of transformation of one consumer good for another, of leisure for consumer goods, and of present consumption for future consumption are prices, wages, and interest, respectively. MUSGRAVE & MUSGRAVE, *supra* note 2, at 61. *See also* David Aschauer & Jeremy Greenwood, *A Further Exploration in the Theory of Exchange Rate Regimes*, 91 J. OF POL. ECON. 868, 869-872 (1983); Robert E. Hall, *Intertemporal Substitution in Consumption*, 96 J. OF POL. ECON. 339, 341 (1988); Oscar Lange, *The Foundations of Welfare Economics*, 10 ECONOMETRICA 215, 217 (1942).

purchase P_1 instead of P_2.[19] Such change is known as the substitution effect, the tendency to replace behavior that is subject to a relatively heavy tax burden with behavior that is subject to a relatively light tax burden.[20] The increased demand for P_2 and the decreased demand for P_1 will cause the price of P_2 to rise and the price of P_1 to fall. Producers will respond by shifting to the production of P_2 some factors of productions (land, labor, and so forth) that had been used to produce P_1. As the supply of P_2 increases and the supply of P_1 decreases, the price of P_1 will rise and the price of P_2 will fall. Eventually, a new equilibrium will be reached. This will occur, let us assume, when the pretax market price of P_1 is eight times than of P_2 and the post-tax price of P_1 is twelve times that of P_2. At that point, those factors of production that can produce more than eight times as much P_2 as P_1 will be used to produce P_2, those factors of production that can produce less than eight times as much P_2 as P_1 will be used to produce P_1, those consumers for whom P_1 is worth more than twelve times as much as P_2 will purchase P_1, and those consumers for whom P_1 is worth less than twelve times as much as P_2 will purchase P_2. In other words, the MRS (as expressed by consumer preferences) is 12:1, while the MRT is 8:1. Because of this discrepancy, the market is no longer operating efficiently: too few factors of production are being used to produce P_1 and too many factors and being used to produce P_2. Due to the tax, factors of production are no longer being used most efficiently to satisfy consumer demand.

In contrast, assume that instead of imposing an excise tax on one product only, the government were to impose a tax on all consumer products, so that consumers are unable to avoid the tax by switching from one product to another. Because the relative demand for various consumer goods will remain the same as it was prior to the imposition of taxation, the relative prices of those goods will remain the same, and consequently there will be no incentive to move factors of production from one consumer good to another. If before the imposition of the tax, the MRS of the various goods

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19 The tax will not affect the behavior of consumers for whom P_1 is worth less than ten times as much as P_2, nor that of consumers who consider P_1 to be worth more than fifteen times as much as P_2. The former would have purchased P_2 before the imposition of the tax and will continue to do so after the imposition of the tax; the latter would have purchased P_1 before the imposition of the excise and will continue to do so after the imposition of the tax.

20 Rosanne Altshuler, *The Case for Fundamental Tax Reform*, 21 KAN. J.L. & PUB. POL'Y 399, 400 (2012); DAVID N. HYMAN, PUBLIC FINANCE: A CONTEMPORARY APPLICATION OF THEORY TO POLICY 39 (9th ed. 2008); Jacob Nussim, *To Confuse and Protect: Taxes and Consumer Protection*, 1 COLUM. J. TAX L. 218, 233 (2010); Linda Sugin, *Tax Expenditures, Reform, and Distributive Justice*, 3 COLUM. J. TAX L. 1, 4 (2011); Susannah Camic Tahk, *Making Impossible Tax Reform Possible*, 81 FORDHAM L. REV. 2683, 2685 (2013); Binh Tran-Nam, *Tax Reform and Tax Simplification: Some Conceptual Issues and a Preliminary Assessment*, 21 SYDNEY L. REV. 500 (1999); Susanah Camic Tahk, *Public Choice Theory and Earmarked Taxes*, 68 TAX L. REV. 755, 758-59 (2015); James P. Ziliak, *Taxes and Labor Supply*, *in* THE ENCYCLOPEDIA OF TAXATION AND TAX POLICY 235 (Joseph J. Cordes, Robert D. Ebel & Jane G. Gravelle, eds., 2005).

equaled their MRT, the equilibrium will hold after the imposition of tax. To demonstrate, let us return to our previous example but now assume that P_1 and P_2 are subject to the same rate of tax. Although the after-tax price of both products will rise, P_1 will continue to cost ten times that of P_2, factors of production that can produce more than ten times as much P_2 as P_1 will be used to produce P_2, and factors of production that can produce less than ten times as much P_2 as P_1 will be used to produce P_1. The MRS (as expressed by consumer preferences) of P_1 for P_2 and the MRT of P_1 for P_2 will each remain 10:1.

Nevertheless, the fact that the broad-based tax is more neutral and thus more economically efficient than the narrow-based tax does not mean that the former is completely neutral and that it does not entail any deadweight loss. For instance, the higher prices of consumer goods following the imposition of tax could cause individuals to favor leisure over wages. Thus, while the tax may not affect the trade-off of one consumer good for another, it may affect the work/leisure trade-off and lead to inefficiency in the labor market (as in our previous example of Adrienne and Bruce).[21]

The conclusion that when relative after-tax prices differ from relative pretax prices then factors of production will be used in an inefficient manner is relevant not only for consumer goods and for wages, but also for rates of return to capital investment. The effect of taxation on the relative return to capital investment will prove particularly significant for our discussion of neutrality in the context of international taxation. However, for the moment, we will continue to consider only the domestic arena. Investments exploit resources and produce goods. A higher rate of return indicates a greater capacity to transform economic resources into goods that consumers value. In a no-tax world, capital will thus tend to flow to those investments that most efficiently utilize resources.

The introduction of taxation can disrupt this equilibrium. The key point here is that although efficiency is reflected in relative pretax returns, capital will flow to those investments with highest after-tax returns. If different types of investments are subject to differing tax burdens, then capital may be used in an inefficient manner. As an example, assume that the expected pretax return from investing in pharmaceutical research is 12% and that the expected pretax return from real estate development is 10%.

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[21] The fact that consumer goods now cost more than they did before the imposition of the tax may cause individuals to work more so as to be able to afford the goods that they need. This phenomenon is known as the income effect. JOSEPH A. PECHMAN, FEDERAL TAX POLICY 76 (5th ed. 1987); Ziliak, *supra* note 20. From a statistical perspective, the income effect can mask the extent of the substitution effect. For example, an empirical observation that a broad-based tax on wages or on consumer goods does not affect labor supply does not justify the conclusion that there is no substitution effect and that the tax entail no deadweight loss. There might be a substantial substitution effect along with a substantial deadweight loss. All that one may reasonably conclude from the data is that the substitution effect equals the income effect. STEPHEN W. SMITH, LABOUR ECONOMICS 12 (1994); Ziliak, *supra* note 20 at 235.

Assume further that the former is subject to a higher effective tax rate than is the latter, so that the expected after-tax returns are 7% and 9%, respectively. The discrepancy between the relative pretax returns and the relative after-tax returns will lead to underinvestment in pharmaceutical research and overinvestment in real estate development to the detriment of aggregate societal welfare. The principle of neutrality posits that it is only when the various investment alternatives are subject to the same rate of tax that the tax will not affect investor behavior and will not misdirect capital.[22] In our example, if investments in pharmaceutical research and investments in real estate development were both subject to an equivalent effective tax burden of, say, 40%, then the former would produce an after-tax return of 7.2% and the latter would produce an after-tax return of 6%. As the after-tax ranking is the same as the pretax ranking, the tax would not affect the ability of the market to direct resources to their most efficient uses.

The principle of neutrality is probably the least controversial of the three traditional linchpins of domestic tax theory.[23] Vertical equity – the idea that those who are better off should bear a greater tax burden than those who are not as well off – is the subject of vociferous philosophical and political debate. Not only are there those who disagree with the entire concept of redistribution,[24] but even among those who do believe that redistribution of wealth is a legitimate aim of the tax system there is no confluence of opinion regarding the appropriate extent of redistribution. Horizontal equity – the idea that taxpayers who are equally well-off should bear equivalent tax burdens – may have strong intuitive appeal, but there is a serious doubt as to whether it has any cogent normative basis.[25] In

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[22] *See, e.g.*, Boris I. Bittker, *Equity, Efficiency, and Income Tax Theory: Do Misallocations Drive Out Inequities*, 16 San Diego L. Rev. 735, 739-40 (1979).

[23] The three dominant motifs in modern tax theory are horizontal equity, vertical equity, and neutrality. *See, e.g.*, David Elkins, *Horizontal Equity as a Principle of Tax Theory*, 24 YALE L. & POL'Y REV. 43, 44 (2006); Hayes Holderness, *Taxing Privacy*, 21 GEO. J. POVERTY L. & POL'Y 1, 5-7 (2013); Michael A. Livingston, *Radical Scholars, Conservative Field: Putting Critical Tax Scholarship in Perspective*, 76 N.C. L. REV. 1791, 1792 (1998); Suellen M. Wolfe, *Recovery from Halper: The Pain from Additions to Tax is Not the Sting of Punishment*, 25 HOFSTRA L. REV. 161, 179-80 (1996).

[24] RICHARD A. EPSTEIN, TAKINGS: PRIVATE PROPERTY AND THE POWER OF EMINENT DOMAIN 283-305 (1985); ROBERT E. HALL & ALVIN RABUSHKA, THE FLAT TAX 40-44 (2d ed. 2007); LUDWIG VON MISES, HUMAN ACTION: A TREATISE ON ECONOMICS 802-07 (1998); ROBERT NOZICK, ANARCHY, STATE, AND UTOPIA 149-231 (1974).

[25] *See generally, e.g.*, Elkins, *supra* note 23; Brain Galle, *Tax Fairness*, 65 WASH. & LEE L. REV. 1323 (2008); Louis Kaplow, *A Note on Horizontal Equity*, 1 FLA. TAX REV. 191 (1992); Louis Kaplow, *Horizontal Equity: Measures in Search of a Principle*, 42 NAT'L TAX J. 139 (1989); Ira K. Lindsay, *Tax Fairness by Convention: A Defense of Horizontal Equity*, 19 FLA. TAX REV. 79 (2016); Paul R. McDaniel & James R. Repetti, *Horizontal and Vertical Equity: The Musgrave/Kaplow Exchange*, 1 FLA. TAX REV. 607 (1993); Richard A. Musgrave, *Horizontal Equity: A Further Note*, 1 FLA. TAX REV. 354 (1993); Richard A. Musgrave, *Horizontal Equity, Once More*, 43 NAT'L TAX J. 113 (1990); James Repetti & Diane Ring, *Horizontal Equity Revisited*, 13 FLA. TAX REV. 135 (2012).

contrast, all would presumably agree that a tax that does not interfere with market incentives is preferable to one that discourages the effective use of resources. The only legitimate debate with regard to neutrality is how to rank it when it conflicts with some other goal of the tax system. For example, reasonable minds may well differ regarding the relative merits of two alternative tax regimes, one of which is less neutral but more vertically equitable than the other.[26] However, it is incontrovertible that, all else being equal, taxes should be designed to be as neutral as possible.

B. Pigouvian Taxation

Our discussion of neutrality in domestic tax theory is subject to one important caveat. The principle of neutrality does not apply to Pigouvian taxation. Pigouvian taxes – named after the British economist Cecil Pigou who first proposed them in 1920 – are a means by which the government can attempt to overcome the problem of externalities, a phenomenon that can prevent the market from achieving an efficient allocation of resources.[27]

Actions (or omissions) often impose costs on third parties. If the cumulative cost imposed on third parties is greater than the benefit that the parties to the action can themselves procure from their behavior, the consequence of individuals and firms pursuing their own self-interest will be a net reduction in total societal welfare. For example, assume that a firm is considering the construction of a noise-producing factory near a residential neighborhood. In making its decision, it will account for the cost of building and operating the factory and the income that the factory is expected to produce. It will have no economic incentive to consider the effect of the construction and operation of the factory on the welfare of its neighbors. Thus, if the income that the factory is expected to produce is greater than the costs that the firm expects to incur – including direct costs, time value of money, opportunity costs, and so forth – then the firm will likely go ahead and construct the factory. However, if the disturbance to the neighbors is greater than the benefit that the firm expects to procure – in economic terms, if the minimum amount that the neighbors would cumulatively agree to receive as compensation for being disturbed by the noise is greater than the amount that the firm would be willing to pay for the right to operate the factory – then the factory would bring about a net reduction of societal welfare. Externalities such as the noise pollution produced by the factory present a challenge to one of the primary

[26] Neutrality may also conflict with other principles besides those traditionally associated with tax theory. For example, Rawls rejected what economic and legal literature refer to as an endowment tax (and which Rawls called a "head tax"), a tax one of whose principal virtues is its respect for neutrality. His primary objection was that such a tax interferes with liberty. JOHN RAWLS, JUSTICE AS FAIRNESS: A RESTATEMENT 157-58 (Erin Kelly ed., 3d ed. 2003); John Rawls, *Reply to Alexander and Musgrave*, 88 QUAR. J. OF ECON. 633, 654-55 (1974).

[27] *See* A. C. PIGOU, M.A., THE ECONOMICS OF WELFARE 192 (4th ed. 1932).

justifications for reliance on the market to allocate resources: that individuals operating in their own best interests will cumulatively promote overall welfare.[28]

One means by which the government can contend with this type of market failure is to prohibit or otherwise limit behavior that entails significant negative externalities. In our example, it might prohibit noise above a certain decibel level within a certain radius of residential neighborhoods. However, there are a number of problems with this approach. The first is that focusing on the externality – as government regulation tends to do, proscribing the behavior when the negative externality is great and permitting the behavior when the negative externality is small – misses the bigger picture. In order to ascertain the effect of the action of overall societal welfare, the government would need to assess not only the extent of the externality but also the expected benefit that the parties to the action expect to procure. If, and only if, the absolute value of the former is greater than the absolute value of the latter would prohibition be appropriate. In our example, if, and only if, the profits that the firm expects to earn are less than the cumulative discomfort experienced by the neighbors would it be appropriate to prohibit the construction or operation of the factory. Such fine-tuning is ordinarily beyond the capacity of non-tax regulation. Thus, a ban on activity that involves significant negative externalities would prevent that activity even in those cases in which the benefit is greater than the cost, and vice versa. A second problem with *proscribe-or-permit* regulation is that, even if it were possible to determine expected benefit and compare it to the expected externality, a finding that the benefit exceeds the cost and the action should therefore be permitted would involve distributive injustice as it would permit the enrichment of some at the expense of others.

To overcome both the allocative and the distributive problems encountered by *proscribe-or-permit* regulation, Pigou proposed that the government should impose a tax that would quantify the negative externalities generated by the taxpayer's behavior.[29] Returning to our example, the government could impose a tax on those who produce noise in or near residential neighborhoods, scaling the tax to reflect the degree, the hour, and the duration of the noise and the number of individuals affected. The amount of the tax would ideally reflect the psychic cost imposed on the neighbors, that is, the amount that they would be willing to receive in exchange for bearing the noise pollution. If properly constructed, a

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[28] Adam Smith, *Of Restraints Upon the Importation from Foreign Countries of Such Goods as Can Be Produced at Home, in* AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 347, 349 (1776) (". . . [B]y directing that industry in such a manner as its produce may be of the greatest value, [every individual] intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention.").

[29] *See* PIGOU, *supra* note 27, at 192.

Pigouvian tax would force market actors to internalize the externalities of their behavior and to determine on an individualized basis whether the benefit they hope to procure is worth the cost. Pursuing their own self-interest, they would use communal resources if, and only if, the use of such resources would serve to promote overall societal welfare. No less importantly, those who do undertake such behavior would be forced to compensate the rest of society for their use of those communal resources.[30]

Does the principle of neutrality have a role to play in the design of Pigouvian taxation? As we saw, the reasoning underlying the principle of neutrality is that (a) the market is an efficient allocator of resources, (b) taxes cause people to change their behavior as a way of avoiding the tax, (c) the substitution effect creates a deadweight loss that decreases social welfare, and (d) taxes should therefore be designed so as to limit the substitution effect. However, three of these four propositions are inaccurate with regard to Pigouvian taxation.[31] Where externalities are present, the market is not an efficient allocator of resources. The Pigouvian tax is a means of overcoming this type of market failure by forcing the internalization of those externalities. Like other taxes, Pigouvian taxes encourage people to change their behavior. However, the fact that people will modify their behavior in light of the tax by opting for less heavily taxed courses of action over more heavily taxed courses of action than they would otherwise have chosen is hardly a censurable feature of Pigouvian taxation. On the contrary, a significant substitution effect indicates that the previously unaccounted-for externality constituted a serious impediment to achieving an efficient allocation. Thus, the more that a properly constituted Pigouvian tax induces behavior modification, the greater the justification for its enactment. In other words, a neutral Pigouvian tax is a contradiction in terms.[32]

Focusing now on the rate of return from investment, we saw that with regard to non-Pigouvian taxation, it is the pretax return that determines efficiency. Consequently, when relative after-tax returns differ from relative pretax returns, capital will be misdirected. In the case of Pigouvian taxation, the opposite is true: it is the after-tax return, not the pretax return, that determines efficiency. For instance, assume that the firm constructing the factory in our previous example expects a return on investment of 15% and that constructing the factory in the best alternative venue would produce an

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[30] Ideally, the government would make the affected neighbors economically whole by transferring to each a portion of the tax revenue. In the absence of direct transfer payments, members of the local population will receive indirect compensation as the government will be able to use the tax revenue to provide additional public services or to reduce their tax liability.

[31] The only proposition that holds for Pigouvian taxation is (b).

[32] *See, e.g.*, Edward J. McCaffery, *Taxation and the Family: A Fresh Look at Behavioral Gender Biases in the Code*, 40 UCLA L. REV. 983, 1048 (1992) (". . . [A] Pigouvian tax . . . will not meet the traditional static distributive test of neutrality.").

expected return of 12%. In a no-tax world, it would construct the factory near the residential population. Now assume that the government imposes a tax on noise pollution, that the tax properly quantifies the welfare loss by those affected by the noise, and that the tax reduces the expected return from a factory constructed need a residential neighborhood from 15% to 10%. Although in a no-tax world the return on investment from constructing the factory near the residential neighborhood would be higher than in the best alternative venue, after the imposition of the tax, the return from the former would be less than the return from the latter. As what dictates firms' behavior is the after-tax return on their investments, the firm in our scenario would presumably decide to construct the factory in the alternative venue. However, the fact that following the imposition of the tax the firm will choose a different course of action than it would have in the absence of taxation is hardly an indictment of the Pigouvian tax. Considering the welfare of everyone concerned – the neighbors, the firm's stakeholders, the firm's customers, and so forth – it is apparent that the alternative venue will better promote aggregate social welfare, and this fact is reflected in the greater after-tax return available from that venue.

Summing up our brief discussion of neutrality in domestic taxation, we need to distinguish between non-Pigouvian and Pigouvian taxes. With regard to non-Pigouvian taxation, the pretax return reflects allocative efficiency, and neutrality is therefore a relevant principle in the design of non-Pigouvian taxes. With regard to Pigouvian taxation, it is not the pretax return but the after-tax return that is determinative of allocative efficiency. Consequently, the type of neutrality discussed here has no role to play in the design of Pigouvian taxes.[33]

III. THE TYPES OF INTERNATIONAL TAXATION

Writers in the field of international taxation tend to rely upon the principle of neutrality without first examining whether it is applicable in the international context. For example, the OECD's report on Harmful Tax Competition, a report that later served as the background for the OECD's BEPS project, states that:

> . . . [T]he proposals set out in this Report, although not covering all aspects of tax competition, will further promote these objectives by reducing the distortionary influence of taxation…thereby promoting fair competition for real economic activities. If governments can agree that these location[al] decisions should be driven by economic considerations and not primarily by tax factors, this will help move toward[] the "level playing field" which is so essential to the

[33] The very classification of Pigouvian taxes as "taxes" is questionable. *See infra* Part IV.B.

continued expansion of global economic growth.[34]

In other words, in designing the international tax regime, we should strive to neutralize the effect of taxation on investment decisions so that capital can flow to its most productive venue. This assumption, which underlies much of the discourse in the field of international taxation, deserves to be examined critically.

However, before we can do so, we need to clarify what is meant by international taxation. The problem here is that the literature employs the term international taxation as a catchall phrase to describe what are essentially a number of very distinct concepts. It is essential to distinguish among them, as each requires its own set of analytical tools. Principles that are appropriate to one of these concepts may be useless or counterproductive if applied to another. This is particularly true with regard to the principle of neutrality. Within the framework of one type of international tax regime, neutrality is a useful measure for promoting efficiency. Within the framework of another type of international tax regime, striving for neutrality would likely inhibit the achievement of an efficient allocation of resources. However, because commenters and policymakers refer indiscriminately to all types of international tax regimes under the overbroad category of international taxation, they tend to ignore the unique aspects of each and, in the name of promoting global welfare, to rely upon the principle of neutrality in instances when doing so would in fact be detrimental to global welfare.

This Part will consider the three usages of the term 'international taxation,' usages that I will refer to as 'intranational taxation,' 'supranational taxation,' and 'inter-jurisdictional taxation.' Part IV will then consider the neutrality principle in each type of international tax regime.

A. Intranational Taxation

One use of the term international taxation – what I will refer to as intranational taxation – describes the international scope of an individual jurisdiction's tax laws.[35] In the context of income taxation, whether to tax the foreign-source income of nonresident citizens[36] and whether (and at

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[34] Org. for Econ. Co-operation & Dev. [OECD], *Harmful Tax Competition: An Emerging Global Issue*, at 9 (1998), www.oecd.org/tax/transparency/44430243.pdf.

[35] *See, e.g.*, REUVEN S. AVI-YONAH, DIANE M. RING & YARIV BRAUNER, U.S. INTERNATIONAL TAXATION 1 (4th ed. 2019).

[36] Citizens of the United States, including those residing abroad, are liable for U.S. tax on their worldwide income. Section 61 of the Internal Revenue Code, which defines gross income as "all income from whatever source derived," is not qualified with regard to the identity of the taxpayer or the geographical source of the income. Section 871 stipulates that, in the case of nonresident aliens, gross income includes only U.S.-source income (or income effectively connected with the conduct of a trade or business within the United States). Section 882(b) contains a similar provision with regard to foreign corporations. As neither of these sections applies to nonresident citizens, they are subject to the Section 61 default rule.

what rate) to tax the domestic-source income of nonresidents (or of nonresident aliens)[37] are questions of intranational taxation. However, intranational taxation is not restricted to income taxation. Every tax must, explicitly or implicitly, provide rules for the international scope of the tax and must therefore possess an international tax regime. A property tax might apply to all property in the jurisdiction regardless of the residence of the property owner, or it might apply only to resident-owned property. A sales or purchase tax might apply to all sales of goods within the jurisdiction, or it might exempt sales or purchases by nonresidents (or by nonresidents who do not maintain a physical presence or an economic nexus within the jurisdiction).[38] Furthermore, if residence is relevant, the law would need to determine who is to be considered a resident and who is to be considered a non-resident for the purpose of that particular tax. If the location of property or the place in which where property is sold is relevant, the law would need to determine the situs of property or the place of sale for the purpose of that particular tax, and so forth. The reason that I refer to this type of regime as intranational taxation is that the source of these rules is the domestic law of the taxing jurisdiction.

The need for intranational tax rules is not premised on the existence or reach of other jurisdictions' tax regimes. Even if no other country collected taxes, any legislation imposing taxes would, explicitly or implicitly, include an intranational tax regime. When other jurisdictions do impose taxes, and particularly when they impose taxes of a similar nature (e.g., on income, on property, or on sales), the jurisdiction concerned will need to consider the effects of the foreign tax on domestic tax liability. The spectrum of options for treating foreign tax liability is extraordinary broad. On the one extreme, the law may simply ignore the fact that other jurisdictions impose taxes. On the other extreme, it may provide a complete exemption any time a foreign jurisdiction imposes taxes. More moderate – and more common – responses

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See I.R.C., §§ 61, 871, 882(b) (Westlaw 2017). JOSEPH ISENBERGH, INTERNATIONAL TAXATION 9 (3d ed. 2010). The United States taxes the foreign-source income of non-resident aliens. Reuven S. Avi-Yonah, *International Tax as International Law*, 57 TAX L. REV. 483, 487-90 (2004). For discussion of the appropriateness of taxing nonresident citizens, *see* Michael S. Kirsch, *Revisiting the Tax Treatment of Citizens Abroad: Reconciling Principle and Practice*, 16 FLA. TAX REV. 117 (2014); Michael S. Kirsch, *Taxing Citizens in a Global Economy*, 82 N.Y.U. L. REV. 443 (2007); Ruth Mason, *Citizenship Taxation*, 89 S. CAL. L. REV. 169 (2016); Bernard Schneider, *The End of Taxation Without End: A New Tax Regime for U.S. Expatriates*, 32 VA. TAX REV. 1 (2012); Daniel Shaviro, *Taxing Potential Members' Foreign Source Income*, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2625732 (2015); Edward A. Zelinsky, *Citizenship and Worldwide Taxation: Citizenship as an Administrable Proxy for Domicile*, 96 IOWA L. REV. 1289 (2010).

[37] *See* I.R.C. §§ 871-72 (non-resident aliens) (Westlaw 2017); *Id.* at §§ 881-82 (foreign corporations) (Westlaw 2017).

[38] For the constitutionality of states imposing sales tax on nonresident vendors, *see* *South Dakota v. Wayfair, Inc.*, 138 S.Ct. 2080 (2018), *overruling Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

include a credit or a deduction for foreign taxes.[39]

Note that, because the rules of intranational taxation vary from one jurisdiction to another and from one tax to another, the term intranational taxation is devoid of substantive meaning without the name of a jurisdiction and a tax attached to it. For instance, the question 'What are the intranational tax rules of Canadian income tax (or of Brazilian property tax)?' admits of an answer. The question 'What are the rules of intranational taxation?' does not.[40]

A further distinction that we need to make within the context of intranational taxation is between the taxation of residents on their foreign property or foreign economic activity on the one hand and the taxation of nonresidents on their domestic property or domestic economic activity on the other. In the context of income taxation, these two categories of tax are often referred to as "outbound" and "inbound," respectively.[41] Adopting that terminology, one may refer to the imposition of tax by a country on the foreign property or foreign economic activity of its residents as "outbound intranational taxation" and to the imposition of tax by a country on the domestic property or economic activity of nonresidents as "inbound intranational taxation." In the discussion that follows, I will focus primarily on the taxation that countries impose on the economic activity of non-residents. Thus, the term intranational taxation, unless otherwise specified, refers to inbound intranational taxation.

B. Supranational Taxation

The term international taxation is also used to describe a tax that is imposed not by an individual jurisdiction, but by a supranational entity. I will refer to this type of tax as supranational taxation. The purest case of supranational taxation would be tax imposed by a hypothetical global

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39 The United States ordinarily provides a credit for foreign income taxes paid. I.R.C. § 901 (Westlaw 2017). The OECD model treaty recognizes both the exemption method and the credit method. Org. for Econ. Co-operation & Dev. [OECD], *Model Tax Convention on income and on Capital*, at 376-406 (2017), https://read.oecd-ilibrary.org/taxation/model-tax-convention-on-income-and-on-capital-condensed-version-2017_mtc_cond-2017-en#page1.

40 On its own, the term intranational taxation does have formal meaning. As described in the text, the term denoted the rules adopted by a jurisdiction to determine the international scope of a particular tax. It has no substantive meaning as the rules vary from jurisdiction to jurisdiction and from tax to tax. For a discussion of the difference between substantive or concrete rules and formal rules, *see* CHAIM PERELMAN, THE IDEA OF JUSTICE AND THE PROBLEM OF ARGUMENT 15 (John Petrie trans., 1963) ("The question is to find a formula of justice which is common to the different conceptions we have analysed. This formula must contain an indeterminate element—what in mathematics is called a variable—the determination of which will give now one, now another, conception of justice. The common idea will constitute a definition of *formal* or *abstract* justice. Each particular or *concrete* formula of justice will constitute one of the innumerable values of formal justice") (emphases in the original).

41 ISENBERGH, *supra* note 36, at 4.

government in a world in which individual countries did not exist.[42] Less extreme examples of a supranational tax – also hitherto unimplemented but whose adoption is presumably more likely than is the dissolution of individual countries and the emergence of a world government – include proposals for taxing electronic commerce, foreign-exchange markets, and carbon emissions.[43]

Needless to say, in practice supranational taxes are rare. One conceptually controversial example of supranational taxation might be those taxes collected by the European Union. Under the relevant provisions of EU law, the EU receives custom duties from goods entering the EU, a percentage of each member state's gross national income, and a portion of the value added tax collected by each member state.[44] However, the classification of EU taxes as supranational is problematic. It is arguable that the EU should not be viewed as a supranational entity but rather as something more akin to a weak federal (or confederal) state.[45] From this perspective, the distribution of tax revenue between the EU and its member states and the collection of tax on goods entering the territory of the EU would not be examples of supranational taxation, but simply facets of European domestic taxation.[46]

Perhaps a better example of an existing supranational tax would be the

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42 *See, e.g.*, 2 JAMES LORIMER, THE INSTITUTES OF THE LAW OF NATIONS: A TREATISE OF THE JURAL RELATIONS OF SEPARATE POLITICAL COMMUNITIES 287 (1884) (proposing a supranational tax to fund an international body with powers resembling those of a global federated state).

43 *See, e.g.*, TONY ADDISON, GEORGE MAVROTAS & MARK MCGILLIVRAY, WORLD INST. FOR DEV. ECON. RES., DEVELOPMENT ASSISTANCE AND DEVELOPMENT FINANCE: EVIDENCE AND GLOBAL POLICY AGENDAS, at 11-13 (2005); Rifat Azam, *Global Taxation of Cross-Border E-Commerce Income*, 31 VA. TAX REV. 639 (2012); Bernard P. Herber & Jose T. Raga, *An International Carbon Tax to Combat Global Warming: An Economic and Political Analysis of the European Union Proposal*, 54 AM. J. ECON. & SOCIOL. 257 (1995); U.N. DEP'T. OF ECON. & SOC. AFF., WORLD ECONOMIC AND SOCIAL SURVEY 2012: IN SEARCH OF NEW DEVELOPMENT FINANCE, U.N. Sales No. E.12.II.C.1 (2012).

44 European Parliamentary Research Service, *Own Resources of the European Union: Reforming the EU's Financing System*, at 2 (Nov. 2018), http://www.europarl.europa.eu/RegData/etudes/BRIE/2018/630265/EPRSBRI(2018)630265_EN.pdf.

45 MICHAEL BURGESS, FEDERALISM AND EUROPEAN UNION: THE BUILDING OF EUROPE, 1950-2000 49 (2000) ("Our theoretical analysis suggests that the EC/EU is neither a federation nor a confederation in the classic sense. But it does claim that the European political and economic elites have shaped and moulded [sic] the EC/EU into a new form of international organization, namely a species of 'new' confederation."); Jean Michel Josselin & Alain Marciano, *The Political Economy of European Federalism* 3-4 (Ctr. For Res. In Econ. & Mgmt., Pub. Econ. & Soc. Choice Working Paper WP 2006-07, 2006), https://web.archive.org/web/20080819213748/http://crem.univ-rennes1.fr/wp/2006/ie-200607.pdf ("[T]he European Union is mainly a confederation but it already contains elements of a federation.").

46 It is not even an issue of intranational taxation as its primary concern is not the international scope of European tax law, but rather the distribution of tax revenue between the two levels of government.

dues paid by member states to the United Nations. Under the arrangements currently in force, dues are calculated as a function of the country's gross national product and then adjusted to reflect per capita income and external debt.[47] While described as 'dues' and theoretically voluntary (as they apply only to member states) that are members of the international body, both the fact that refraining from membership in the UN may not be a practical option[48] and the formula by which the dues are calculated mean that these dues are least very similar to, and in many ways effectively function as, a supranational tax.

While supranational taxes are rare, if they exist at all, defining the term, understanding the nature of supranational tax, and distinguishing between supranational taxation and other types of taxes that are commonly grouped together under the heading of international taxation, is important for our discussion. When discussing intranational taxation (or inter-jurisdictional tax, a term that will be defined shortly), the literature tends to apply the norms and principles that rationally should apply to supranational taxation but that are inappropriate with regard to intranational or to inter-jurisdictional taxation. Identifying and understanding the concept of supranational taxation, the principles that would apply to it were it to exist, and why those principles would apply will help clarify which principles are and which principles are not relevant with respect to intranational and inter-jurisdictional taxation.

C. Inter-jurisdictional Taxation

A third sense of the term international taxation, which I will refer to as inter-jurisdictional taxation, involves attempts by countries to coordinate their intranational tax regimes. In the early to mid-twentieth century, the focus of inter-jurisdictional taxation was the prevention of double taxation, the imposition of tax on the same income by a number of jurisdictions.[49]

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[47] In any case, no country will contribute more than 22% or less than 0.001% of the United Nation's budget. G.A. Res. 73/271, ¶¶ 6 (f), (h) (Dec. 22, 2018); Rakesh Dubbudu, *How Much Do Various Counties Contribute to the UN Budget?* FACTLY (Dec. 13, 2016), https://factly.in/united-nations-budget-contributions-by-member-countries/.

[48] Even perennially neutral Switzerland finally joined the United Nations in 2002. Rory Carroll, *Switzerland Decides to Join UN*, THE GUARDIAN (Mar. 3, 2002), https://www.theguardian.com/world/2002/mar/04/unitednations (Switzerland's referendum on joining the United Nation "billed as a battle for the country's soul.").

[49] *See* REPORT ON DOUBLE TAXATION SUBMITTED TO THE FINANCIAL COMMITTEE OF THE LEAGUE OF NATIONS BY PROFESSORS BRUINS, EINAUDI, SELIGMAN AND SIR JOSIAH STAMP (1923), *reprinted in* 4 STAFF OF JOINT COMM. ON TAX'N, LEGISLATIVE HISTORY OF UNITED STATES TAX CONVENTIONS 4003 (1962) [hereinafter *League of Nation's Report on Double Taxation*]. *See also* ORG. FOR ECON. CO-OPERATION & DEV., MODEL DOUBLE TAXATION CONVENTION ON INCOME AND CAPITAL (1977) [hereinafter *OECD 1977 Model Convention on Double Taxation*], https://read.oecd-ilibrary.org/taxation/model-double-taxation-convention-on-income-and-capital_9789264055919-en#page1. In addition to the fact that the later document's title refers explicitly and exclusively to "double taxation," it also proposes the

One motivation for such efforts was a fear that the threat of double taxation would inhibit the development of international trade.[50] By the late twentieth and early twenty-first centuries, the focus of inter-jurisdictional taxation had shifted from preventing double taxation to preventing what the OECD refers to as "double non-taxation," the phenomenon of multi-national corporations not paying tax in any jurisdiction or bearing an extraordinarily low overall tax burden.[51] The OECD's Action Plan on Base Erosion and Profit Shifting (BEPS) is one example of an attempt to forge an inter-jurisdictional tax regime.[52]

It is important to distinguish between the branch of law to which inter-jurisdictional taxation belongs and the subject matter of inter-jurisdictional taxation. From the perspective of the legal norms to which it conforms, inter-jurisdictional taxation belongs to the field of public international law. For instance, the primary means by which countries coordinate their intranational tax regimes is by entering into bilateral or, more rarely, multi-national tax treaties.[53] As international treaties, tax treaties are part of

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following as a title for treaties executed between nations and based on the model language: "Convention between (State A) and (State B) for the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital." *Id.* at 1, 23.

[50] *See League of Nation's Report on Double Taxation*, *supra* note 49, at 4009-21.

[51] *See, e.g.*, *Avi-Yonah, Crisis*, *supra* note 2; Rifat Azam, *Minimum Global Effective Corporate Tax Rate as General Anti-Avoidance Rule*, 8 COLUM. J. TAX L. 4, 49 (2017); Steven A. Bank, *The Globalization of Corporate Tax Reform*, 40 PEPP. L. REV. 1307, 1318-19 (2013); Ilan Benshalom, *Taxing the Financial Income of Multinational Enterprises By Employing a Hybrid Formulary and Arm's Length Allocation Method*, 28 VA. TAX REV. 619, 626-32 (2009); Jasmine M. Fisher, *Fairer Shores: Tax Havens, Tax Avoidance, and Corporate Social Responsibility*, 94 B.U. L. REV. 338, 342 (2014); GRAETZ, *supra* note 2; Edward D. Kleinbard, *Stateless Income*, 11 FL. TAX REV. 699 (2011); Edward D. Kleinbard, *The Lessons of Stateless Income*, 65 TAX L. REV. 99 (2012); Robert T. Kudrle & Lorraine Eden, *The Campaign Against Tax Havens: Will it Last? Will it Work?*, 9 STAN. J.L. BUS. & FIN. 37 (2003); Henry Ordower, *Utopian Visions Toward a Grand Unified Global Income Tax*, 14 FLA. TAX REV. 361 (2013). *See also* ORG. FOR ECON. CO-OPERATION & DEV., ARTICLES OF THE MODEL CONVENTION WITH RESPECT TO TAXES ON INCOME AND ON CAPITAL (2017). As opposed to the 1977 model, *see OECD 1977 Model Convention on Double Taxation*, *supra* note 49, the title of the 2017 convention does not include the term "double taxation" and adopts instead the more neutral phraseology, "with respect to taxes." More significantly, the 2017 model proposes as a title for bilateral treaties, "Convention between (State A) and (State B) for the Elimination of Double Taxation with Respect to Taxes on Income and on Capital *and the Prevention of Tax Evasion and Avoidance"* (emphasis added). ORG. FOR ECON. CO-OPERATION & DEV., MODEL CONVENTION WITH RESPECT TO TAXES ON INCOME AND CAPITAL 27 (2017), https://read.oecd-ilibrary.org/taxation/model-tax-convention-on-income-and-on-capital-condensed-version-2017_mtc_cond-2017-en#page28.

[52] *See generally* ORG. FOR ECON. CO-OPERATION & DEV., ACTION PLAN OF BASE EROSION AND PROFIT SHIFTING (2013), www.oecd.org/ctp/BEPSActionPlan.pdf; Org. for Econ. Co-operation & Dev. [OECD], *BEPS 2015 Final Reports* (2015), https://www.oecd-ilibrary.org/docserver/9789264263437-en.pdf?expires=1571708218&id=id&accname=guest&checksum=AC7F6F21A6D6D70BFA45C9244294D7D0.

[53] There are currently more than 2,000 international tax treaties in force. AVI-YONAH ET

conventional international law and are consequently subject to the rules that govern the validity, form, and interpretation of international treaties.[54] In the context of U.S. constitutional law, treaties, once ratified by the Senate, have the status of statutory law.[55] Conflicts between treaties and other legislation are resolved in accordance with the ordinary rules of statutory interpretation and in particular the rule that when two statutes conflict, the provision enacted later in time prevails.[56] This rule is the source of Congress' constitutional authority to override treaty provisions through subsequent legislation.[57] While a legislative override constitutes a violation of a conventional obligation undertaken by the United States and is expressly prohibited by the Vienna Convention on the Law of Treaties,[58] for the purpose of U.S. domestic law, the override is effective.[59]

Another example of how inter-jurisdictional taxation belongs to the field of the international law is the question of whether the common practice of taxing the worldwide income of residents and the domestic-source income of nonresidents is simply a matter of international usage or has acquired the status of customary international law. In accordance with the rules of international law, the answer depends upon whether countries refrain from taxing the foreign-source income of nonresidents because of the belief that customary international law prohibits them from doing so. If it can be shown that countries refraining from taxing foreign-source income are motivated by such a belief, then the practice would constitute customary international law and states would be precluded under international law from taxing the foreign-source income of foreigners. If those countries are not motivated by such a belief, then taxing the foreign-source income of foreign residents, while perhaps unusual and at variance from international

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AL., *supra* note 35, at 1.

54 *See, e.g.*, Klaus Vogel, *Double Tax Treaties and Their Interpretation*, 4 INT'L TAX & BUS. L. 1 (1986).

55 U.S. CONST., art. VI.

56 *See, e.g.*, *The Cherokee Tobacco*, 78 U.S. 616, 621 (1870); *Whitney v. Robertson*, 124 U.S. 190, 195 (1888); *The Head Money Cases*, 112 U.S. 580, 599 (1884); *Chae Chan Ping v. United States*, 130 U.S. 581, 600 (1889).

57 *See, e.g.*, *Chae Chan Ping*, 112 U.S. at 600.

58 *See* Vienna Convention on the Law of Treaties art. 27, May 23, 1969, 1155 U.N.T.S. 331 ("A party may not invoke the provisions of its internal law as justification for its failure to perform a treaty."). The Vienna Convention is considered a declarative treaty (codifying pre-existing customary international law). Consequently, even countries – such as the United States – that are not parties to the convention are nonetheless bound by its terms. *See also, e.g.*, Legal Regulation of Use of Force, 1980 Digest § 7, at 1041, n.43, *cited in* Andrew M. Beato, *Newly Independent and Separating States' Succession to Treaties: Considerations on the Hybrid Dependency of the Republics of the Former Soviet Union*, 9 AM U.J. INT'L L. & POL'Y, 525, 533 n.31 (1994) (the United States government considers the Vienna Convention "declarative of customary international law").

59 I.R.C. § 7852(d)(1) (Westlaw 2017) ("For purposes of determining the relationship between a provision of a treaty and any law of the United States affecting revenue, neither the treaty nor the law shall have preferential status by reason of its being a treaty or law.").

usage, would not constitute a violation of international customary law.[60]

However, for the purpose of our discussion, what is important is not the form but rather the content of inter-jurisdictional taxation. While inter-jurisdictional taxation is a branch of international law, its subject matter is the regulation and co-ordination of the various countries' intranational tax regimes.

D. The Substance of Semantics

As already noted, the literature in the field of international taxation tends to employ the term international taxation indiscriminately to refer to intranational taxation, supranational taxation, and inter-jurisdictional taxation. The common attribute of these three concepts is that they are all concerned with international aspects of taxation. In other words, in a world in which persons, capital, goods, and services did not cross borders, there would be no practical need for intranational or inter-jurisdictional taxation and the chance that any sort of supranational tax would be adopted would be even more remote than it is in our world.[61] It is only because countries are not isolated entities that it is necessary to delineate the international reach of a country's tax regime, attempt to coordinate individual countries' tax regimes, and consider the possibility that a supranational tax regime is even fathomable.[62]

However, these similarities are largely superficial. In substance, intranational taxation, inter-jurisdictional taxation, and supranational taxation are fundamentally different concepts. One particularly significant way in which they differ is the degree to which neutrality – developed within the framework of domestic taxation – is a proper goal of the tax systems. The failure to distinguish among these three very different

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[60] *See, e.g.*, Nancy H. Kaufman, *Fairness and the Taxation of International Income*, 29 L. & POL'Y INT'L BUS. 145, 148 n.23 (1998); H. David Rosenbloom, *The David R. Tillinghast Lecture International Tax Arbitrage and the "International Tax System,"* 53 TAX L. REV. 137, 166 (2000); *see generally* Reuven S. Avi-Yonah, *Does Customary International Tax Law Exist?* L. & Econ. Working Papers (2019), https://repository.law.umich.edu/cgi/viewcontent.cgi?article=1271&context=law_econ_current; J. Clifton Fleming, Jr., *To What Degree Does Customary International Law Require Accommodation of a Source Country's Right to Tax High, Tax Low or Not Tax at All?*, *in* A COMMITMENT TO EXCELLENCE: ESSAYS IN HONOUR OF EMERITUS PROFESSOR GABRIËL A. MOENS (Augusto Zimmermann ed., 2018).

[61] Although anachronistic, this model of a closed society forms the basis of much contemporary social philosophy. *See, e.g.*, JOHN RAWLS, POLITICAL LIBERALISM 577 (1996) ("This fundamental relation of citizenship has two special features: first, it is relation of citizens within the basic structure of society, a structure we enter only by birth and exit only by death . . . .").

[62] Even social philosophers who support the concept of international distributive justice tend to accept that the norms of distributive justice would not apply if countries were indeed closed systems. *See, e.g.* CHARLES R. BEITZ, POLITICAL THEORY AND INTERNATIONAL RELATIONS 136-169 (1979); THOMAS W. POGGE, REALIZING RAWLS 240 (1989).

concepts has led both scholars and policy-makers to attempt to apply the principle of neutrality in an inappropriate manner and is one of the sources of the incoherence prevalent in the current discourse on international taxation.

IV. NEUTRALITY IN INTERNATIONAL TAXATION

Part II analyzed the principle of neutrality as it applies in the domestic arena. Part III described the three types of tax regimes commonly grouped together under the overbroad title of international taxation. This Part will consider whether the principle of neutrality as developed in the context of domestic taxation is applicable in the international arena.

As one might expect, we will discover that there is no monolithic answer to this question. Because the different types of international tax regimes are conceptually distinct, the principles appropriate to each will also differ.

A. Supranational Taxation

For the purpose of our discussion, the existence or even the political and practical feasibility of a supranational regime is not particularly relevant. The importance of discussing the role that neutrality would play in such a regime is not that one is likely to be adopted in the foreseeable future, but rather to compare and contrast the role of neutrality in a supranational tax regime with its role in either an intranational tax and inter-jurisdictional tax regime. The literature – which indiscriminately includes all three regimes within the single catchall phrase international taxation – tends to apply principles to intranational and to inter-jurisdictional tax regimes that are inappropriate, but would be appropriate to a supranational tax regime. By analyzing how neutrality would apply to a supranational regime, we will be better able to discern why it is inapplicable to intranational and inter-jurisdictional regimes.

As a rule, the principles of tax theory as they were developed in the purely domestic arena would (or should) provide appropriate guidance for the framers of a supranational tax regime. The reason that domestic tax theory is applicable in the supranational context is that purely domestic taxation and supranational taxation share the same theoretical background conditions. In each case, the implicit context is a closed economic system with a tax regime that is not in competition with other tax systems. More significantly, in each case, the taxing authority owes a fiduciary duty to the taxpaying public: the taxing authority has no legitimate independent desire for tax revenue other than what is necessary to promote the welfare of the taxpaying public itself.[63] In other words, if the theory of purely domestic

[63] The fiduciary duty of domestic and supranational taxing authorities vis-à-vis the taxpaying public is explained in more depth in our discussion of intranational taxation, *see infra* subpart B.

taxation concerns the principles of taxation that would apply to an 'island country,' then the theory of supranational taxation concerns the principles of taxation that would apply to an 'island planet.' The only difference between purely domestic taxation and supranational taxation is the size of the relevant jurisdiction.

Consider a supranational entity charged with raising funds, say for the purpose of supplying international public goods or redistributing global wealth. In designing the structure of its tax system, the supranational entity, like its domestic counterpart, would need to consider the possible economic side effects of any tax it imposed. Specifically, as in the domestic context, the tax would likely induce taxpayers to change their behavior, and the resulting deadweight loss would reduce aggregate global welfare.[64] This would most clearly be the case if those subject to the supranational tax were individuals and private firms (their response to a supranational tax would be similar to their response to a similarly constituted domestic tax). It would also hold if those subject to the tax were countries. For example, suppose that the supranational entity was to impose on each country a tax equal to a percentage of its government's annual budget. The result would be that the cost to a country of supplying domestic public goods or of redistributing domestic wealth would be greater than in the absence of the supranational taxation. If the supranational tax rate were substantial enough, countries might reduce the goods that they supply their residents and lessen their domestic redistributive efforts. For instance, assume that a country is considering imposing a tax of $1 billion on its residents in order to fund investment in its infrastructure. It calculates that the aggregate benefit that its residents would derive from such investment is greater than $1 billion. However, implementing the project would increase its national budget by $1 billion and would therefore subject it to additional supranational taxation of $1 billion times the tax rate. If, after factoring in the additional supranational tax, the cost turns out to be greater than the benefit, the project would likely be abandoned. The deadweight loss is the difference between the benefit that residents would have derived from the project and the cost of the project in the absence of supranational tax.

Like in the domestic arena, the principle of neutrality posits that the supranational taxing entity designs its taxes so as minimize the substitution effect and the consequent deadweight loss. For example, again assuming that those subject to the tax are countries and not individuals or private firms, using the country's GNP as a tax base instead of its national budget may better conform to the principle of neutrality.[65] It is reasonable to assume that countries would be less likely to refrain from permitting their

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[64] *See supra* Part II.A.

[65] GNP, or gross national product, is the market value of all goods and services produced during a specific time period. *See, e.g.*, JAMES D. GWARTNEY, RICHARD L. STROUP, RUSSELL S. SOBEL & DAVID A. MACPHERSON, MACROECONOMICS: PRIVATE AND PUBLIC CHOICE 107-08 (2014).

GNP to grow in response to a supranational tax than to refrain from increasing their budget.

A further parallel between domestic taxation and supra-national taxation is that in both instances, the principle of neutrality is applicable only to non-Pigouvian taxes. The primary goal of Pigouvian taxation is to induce market actors to refrain from behavior whose social cost is greater than the benefit that they expect to derive therefrom.[66] Therefore, the fact that taxpayers change their behavior in response to Pigouvian taxation is a positive, not a negative, feature of the tax. For example, a well-designed supra-national tax on greenhouse gas emissions would effectively limit the emission of greenhouse gasses to those instances in which the benefit of emitting the gas is greater than the cost imposed on the global community.[67] The fact that market actors would change their behavior and reduce their emission of greenhouse gasses is not an unfortunate side effect that the framers of the tax would need to minimize to the extent possible, but rather the successful realization of its stated objective.[68]

B. Intranational Taxation

In order to determine the role, if any, of neutrality in intranational taxation, we first need to discuss the nature of intranational taxation and the relationship between the host country and those subject to its intranational tax regime. Only then we will be in a position to consider the principles that would guide the host country in designing its intranational tax regime and, specifically, whether neutrality would have a role to play in that regard.

Intranational taxation (i.e., the tax imposed on non-residents who engage in economic activity in the territory of the host country)[69] is in substance not really a tax. True, it does meet the formal definition of a tax. As defined in Black's Law Dictionary, a "tax" is "[a] charge, usu. monetary, imposed by the government on persons, entities, transactions, or property to yield public revenue."[70]

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[66] *See* PIGOU, *supra* note 27, at 192.

[67] *See, e.g.*, Reuven S. Avi-Yonah & David M. Uhlmann, *Combating Global Climate Change: Why a Carbon Tax is a Better Response to Global Warming than Cap and Trade*, 28 STAN. ENVTL. L.J. 3 (2009); Gilbert E. Metcalf & David Weisbach, *The Design of a Carbon Tax*, 33 HARV. ENVTL. L. REV. 499 (2009); Jonathan Baert Wiener, *Global Environment Regulation: Instrument Choice in Legal Context*, 108 YALE L.J. 677, 786 (1999).

[68] *See* McCaffery, *supra* note 32, at 1048, and the accompanying text.

[69] *See supra* Part III.A for a discussion of limiting the scope of this term for the purpose of this article.

[70] *Tax*, BLACK'S LAW DICTIONARY (11th ed. 2019). *See also Tax*, OXFORD DICTIONARY OF ENGLISH (Angus Stevenson ed., 3d ed. 2010) ("A compulsory contribution to state revenue, levied by the government on workers' income and business profits, or added to the cost of some goods, services, and transactions."); *Tax*, MERRIAM WEBSTER.COM, https://www.merriam-webster.com/dictionary/tax (last visited Sept. 22, 2019) ("[A] charge usually of money imposed by authority on persons or property for public purposes.").

Indeed, the tax imposed by a host country on foreign residents is (a) a charge, (b) imposed by a government, (c) on persons, entities, transactions, or property, (d) to yield public revenue. Moreover, intranational taxation displays all of the outer trappings of a tax. It is imposed under the authority of the government's taxing power. The constitutional requirements for imposing intranational tax are likely the same as they are for imposing purely domestic tax, and the two are usually included within the same statute.[71] Administration of the intranational tax regime is likely entrusted to the same agency that administers domestic taxation. The judicial remedies available to the taxpayer in the event of a disagreement with administrative authorities with regard to intranational taxes are likely the same as in the case of domestic taxes.

However, for our purposes the significant question is not whether intranational taxation satisfies the legal definition of a tax but rather whether it functions economically as a tax. Consider, for instance, the economic definition of a tax, which is "a compulsory levy made by public authorities for which nothing is received directly in return."[72]

In other words, for a charge to constitute a tax in the substantive sense of the term, the payer must receive no direct quid pro quo. If the payer does receive a direct quid pro quo, then the payment is in fact not a tax but rather a fee.[73] A corollary to the no direct quid pro quo condition is that taxes are of necessity compulsory payments. The reasoning here is simple: if the payment is not compulsory, then rational persons will agree to pay only they receive value at least as great as what they are paying in return. Note, however, that describing a payment as non-compulsory does not mean that those subject to the "tax" can choose to pay or not pay as they fit, any more that those who contract to purchase goods or services can choose to pay or not pay as they see fit. It simply means that the "taxpayer" had the choice not to become subject to the tax in the first place. Taxpayers who agree to subject themselves to the tax indicate by their behavior that the benefit that they receive in exchange is worth at least as much to them as what they are obliged to pay.

As an example, consider the case of Pigouvian taxation (either domestic or supranational). In exchange for the payment, the "taxpayer" is

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71 *See, e.g.*, I.R.C. §§ 871-91 (Westlaw 2017).

72 SIMON JAMES & CHRISTOPHER NOBES, THE ECONOMICS OF TAXATION 10 (12th ed. 2012). *See also* HYMAN, *supra* note 20, at 23; ROBERT W. MCGEE, THE PHILOSOPHY OF TAXATION AND PUBLIC FINANCE 56 (2004); ROBERT E. PODOLSKY, TITANIA: THE PRACTICAL ALTERNATIVE TO GOVERNMENT 129-130 (2002).

73 *See, e.g.*, Richard M. Bird & Thomas Tsiopoulos, *User Charges for Public Services: Potentials and Problems*, 45 CAN. TAX J. 35, 38 (1997); David G. Duff, *Benefit Taxes and User Fees in Theory and Practice*, 54 U. TORONTO L.J. 391, 393 (2004); Hugh D. Spitzer, *Taxes vs. Fees: A Curious Confusion*, 38 GONZ. L. REV. 335, 341 (2002) ("[O]ne must distinguish between taxes from a *legal* standpoint . . . and how taxes *function* from an *economic* standpoint").

permitted to impose costs on third parties. In fact, we have seen that the primary purpose of such a tax is to force market actors to consider those costs and to undertake the cost-imposing behavior only when the quid pro quo is worth more than the tax.[74] This quid pro quo means that in substance Pigouvian taxes are not taxes but fees, and it is because of their fee-like nature that the traditional principles of tax theory do not apply to Pigouvian taxation. In particular, as we have seen, neutrality is not a value in adjudicating the merits of Pigouvian taxation.[75]

Foreign residents who choose to invest in a country or otherwise take part in its economic life subject themselves to the taxing power of the government of the host country. In exchange, they receive access to the host country's territory, resources, and markets. In other words, the "tax" that a host country imposes upon foreign residents is more accurately described as a fee than as a tax. From the perspective of those non-residents, the tax imposed upon them by the host country is simply a cost of doing business in that country. If they believe the charge to be higher than the value received, they have the option of not paying the host country's tax and doing business elsewhere instead.[76]

A further distinction between purely domestic taxation and supranational taxation on the one hand and intranational taxation on the other concerns the relationship between the tax-imposing entity and those who are subject to its taxing power. With regard to both domestic and supranational taxation, the tax-imposing entity owes a fiduciary duty to the taxpaying public. Every act that it undertakes, including the imposition of taxation, must be justified by reference to its impact on the welfare of the public whom it serves. To take one example, taxes imposed for the purpose of supplying goods are justified if, and only if, the aggregate benefit to be derived from the good is greater than the aggregate cost of supplying the good. Moreover, in the case of purely domestic or supranational taxation, the tax paying entity has no legitimate independent need or desire for tax revenue. Consequently, there is no principle asserting that, all else being equal, more taxes are better than less taxes. If the public use of funds better promotes the welfare of the taxpaying public as a whole, then the tax is justified;[77] otherwise it is not.[78]

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[74] *See* PIGOU, *supra* note 27, at 192.

[75] *See supra* Parts II.B and III.B.

[76] *See, e.g.*, Stephen E. Shay, J. Clifton Fleming, Jr. & Robert J. Peroni, *The David R. Tillinghast Lecture - What's Source Got to Do With it - Source Rules and U.S. International Taxation*, 56 TAX L. REV. 81, 91-93 (2002).

[77] Of course, determining the welfare of the taxpaying public as a whole can be far from uncontroversial, particularly when we consider the distributive effect of taxation. A tax scheme favored by some elements of the population may be opposed by others. However, given whatever social utility function is adopted by means of the legitimate operation of the political process, taxes are justified if, and only if, they – along with the services and transfer payments that they fund – promote overall societal welfare. Note that in the case of domestic taxation the relevant population are members of the domestic society, while in the case of

With regard to its intranational tax regime, the position of a government is entirely dissimilar. Vis-à-vis foreign investors, the government of the host country has a clear, independent, and justified desire to increase tax revenue to the extent possible. Every dollar that it collects from international investors is one less dollar that it has to collect from its own constituents, one more dollar that it can spend on promoting their welfare without them having to pay for it, one less dollar that it needs to borrow, and so forth. All else being equal, the more it can successfully collect from international investors, the better.[79]

Furthermore, as opposed to its position vis-à-vis domestic taxpayers, the host country has no fiduciary duty to foreigners. The duties that it owes foreigners are limited to those of fair play: negotiating in good faith, keeping its promises, and so forth. With regard to its own residents, the only legitimate justification for imposing tax is that doing so promotes the welfare of the taxpaying public. If it does not do so, then the tax is an illegitimate use of sovereign power. With regard to foreigners, the only justification the government needs to offer as to why it is imposing tax is that it can. All the government needs to say – all that it implicitly does say – is that it would prefer that its own constituents end up with more and that the foreigner ends up with less.[80]

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supranational taxation the relevant population is humanity as a whole.

[78] True, the ideal described in the text is rarely actualized, even in modern democratic states. Politicians and bureaucrats have interests that are not always fully aligned with those of the overall population. The phenomenon of governments raising funds to support or expand programs and bureaucracies even when there is no rational justification for their size or even for their existence, a phenomenon often referred to as "Leviathan," has been much noted in the literature. Charles B. Blankart & David C. Ehmke, *Fiscal Constitutions, Institutional Congruence, and the Organization of Governments*, *in* JAMES M. BUCHANAN: A THEORIST OF POLITICAL ECONOMY AND SOCIAL PHILOSOPHY 147, 148 (Richard E. Wagner ed., 2018); GEOFFREY BRENNAN & JAMES M. BUCHANAN, THE POWER TO TAX: ANALYTICAL FOUNDATIONS OF A FISCAL CONSTITUTION 1-33 (1980). Similarly, the fact that governments are often especially attuned to the needs of special interest groups to the determent of the general population is also well known. STEPHEN J. BAILEY, PUBLIC SECTOR ECONOMICS: THEORY, POLICY AND PRACTICE 101 (1995). However, the agency problem faced by modern democracies – the misalignment of the interests of politicians and bureaucrats, on the one hand, and the public that they ostensibly serve on the other – does not undermine contemporary tax theory, any more than does the fact the well-meaning policy-makers often err in evaluating the consequences of their actions. The task of tax theory is to describe how taxes should operate, not how they do operate. In fact, it is only within an ideal paradigm of government operating solely for the benefit of the governed that we can critique these phenomena.

[79] *See, e.g.*, *League of Nation's Report on Double Taxation*, *supra* note 49, at 4044 ("A survey of the whole field of recent taxation shows how completely the Governments are dominated by the desire to tax the foreigner."). This observation is as relevant today, in the age of tax competition, as it was a century ago. As explained in the text, what has ebbed is not the *desire* of governments to tax the foreigner, but rather their *capacity* to do so.

[80] In 1775, Samuel Johnson defined a tax as "a payment exacted by authority from part of the community for the benefit of the whole." SAMUEL JOHNSON, TAXATION NO TYRANNY: AN ANSWER TO THE RESOLUTIONS AND ADDRESS OF THE AMERICAN CONGRESS 13 (1775). Note

However, the fact that the relationship between the host country and international investors is more akin to a contractual relationship in which each party attempts to promote its own interest than it is to a fiduciary relationship is a double-edged sword. While residents have little choice but to be subject to their country's tax system – they can try to reduce their tax liability within the system by modifying their behavior, but they are subject nevertheless to the system as a whole – foreign investors have a choice.[81] As with any contractual negotiation, they can accept the terms offered by the other side, negotiate for better terms, or reject the offer and do business elsewhere. Thus, while in the domestic arena the government has fairly free rein to determine what it considers to be the appropriate tax structure and to use the sovereign power at its disposal to enforce its will, in the international arena its tax-imposing capacity is subject to a simple 'no' from potential taxpayers.[82] Despite its desire to collect as much revenue from foreigners as possible, it needs to moderate its demands.

Such being the case, what are the principles that will guide a rational country in designing its intranational tax regime?

From the perspective of the host country, international investment entails both non-tax benefits and costs. The minimum tax that a rational country would be willing to accept from a foreign investor is an amount equal to the expected cost minus the expected benefits (net cost). Anything less than that and the investment will constitute a net drain on the host country's resources and no rational country would agree to such a proposition. Note that the terms, "net cost" and "tax" may take either positive or negative values. Consequently, if the benefits of hosting an investment outweigh the costs (producing a net benefit or a negative net cost), the minimum tax the country would be willing to impose is a negative

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the limiting phrase, "from part of the community." *Id.* As foreigners are not part of the community, it is arguable that Johnson would not include the taxation of foreigners within the ambit of a tax.

81 True, in one sense residents also have a choice. If they believe the tax burden imposed by their government is onerous, they have the option of emigrating (and, in the case of the United States, renouncing their citizenship) and thereby escaping the grip of the country's tax laws. *See, e.g.*, J. Clifton Fleming, Jr., Robert J. Peroni, & Stephen E. Shay, *Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income*, 5 FLA. TAX REV. 299, 309 n.18 (2001) ("[A]n expatriate's decision not to renounce U.S. citizenship can be seen as evidence that the benefits of citizenship are worth facing an annual U.S. tax on worldwide income."). For an interesting contrast, see Nancy H. Kaufman, *Fairness and the Taxation of International Income,* 29 L. & POL'Y INT'L BUS. 145, 146 (1998) ("Regarding individual taxpayers, President Clinton and members of Congress have taken steps to prevent wealthy U.S. taxpayers from escaping federal income tax by the simple expedient of giving up their U.S. citizenship."). However, in practice individuals are much less mobile than is capital. Only in rare circumstances will individuals emigrate from the country in which they reside (and, in the case of the United States, renounce their citizenship) because of changes in the tax laws. *Cf.* Reuven S. Avi-Yonah, *And Yet It Moves: Taxation and Labor Mobility in the Twenty-First Century*, 67 TAX L. REV. 169 (2014).

82 *See, e.g.*, DAGAN, *supra* note 9, at 12-15.

tax (i.e., a grant or a subsidy), the absolute amount of which is equal to the net benefit that it expects to procure. For example, assume that the net benefit of hosting an investment is $100. The net cost is -$100, and the minimum tax that the host country would be willing to accept is the same. In other words, it would be willing to offer grants and subsidies of up to $100 in order to attract the investment.

However, imposing a tax equal to net cost (whether positive or negative) is far from ideal from the perspective of the host country. As already noted, the more that the host country can successfully collect from foreign residents the better. The minimum is covering costs. Beyond that the sky is the limit.[83] The only limitation is the foreign investor's ability to say 'no,' a scenario that would mean not only a loss of tax revenue but also a loss of non-tax benefits (if the investment would indeed have produced net non-tax benefits).

With regards to large investments, tax is often negotiated on a case-by-case basis. A multinational enterprise might approach a number of countries, ask each what it is willing to offer, negotiate terms, and then choose the option that offers the highest possible after-tax return.[84] In terms

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83 At this point, a brief comparison between intranational taxation and Pigouvian tax is perhaps in order. We have seen that Pigouvian taxation and intranational taxation share the attribute of being in substance not a tax, but rather a fee, as the taxpayer receives a direct quid pro quo: the right to impose a cost on other members of society or access to a country's territory, resources, and markets, respectively. Furthermore, we have already seen that neutrality is inapplicable to Pigouvian taxation and will soon see that it is inapplicable to intranational taxation. Nevertheless, there is an important distinction between them. Pigouvian taxation is still part of a country's domestic tax regime, meaning that the Pigouvian taxpayers are members of the collective to which the government owes a fiduciary duty and whose interests it is bound to serve. Consequently, a properly constructed Pigouvian tax will quantify exactly the cost imposed on third parties. In other words, the social cost of the taxpayer's behavior is both the minimum and the maximum of the ideal Pigouvian tax. In contrast, the government owes no fiduciary duty to foreign investors when selling access. Just covering the social cost of hosting the investment is far from an ideal situation from the perspective of the host country. From its perspective the more that it can successfully charge, the better.

84 *See, e.g.*, Nov, *supra* note 2, at 841-82; *Intel in Israel: A Fad Relationship Faces Criticism*, KNOWLEDGE@WHARTON (Sept. 29, 2014), http://knowledge.wharton.upenn.edu/article/intel-israel-old-relationship-faces-new-criticism/ ("Israel has to compete with other countries every few years to be the site of the next new and upgraded plant. In 2012, Ireland won the race to host Intel's next generation 14-nanometer chip plant because the company deemed Israel's offer of 1 billion shekels in aid as insufficient."). The phenomenon exists also with regard to state and local taxation. Bill Bradley, *Nike Made $25 Billion Last Year, Still Got a Tax Break from Oregon*, NEXT CITY (Aug. 16, 2013), https://nextcity.org/daily/entry/nike-had-25-billion-last-year-still-got-a-tax-break-from-oregon (Oregon passed special legislation guaranteeing Nike's preferential tax treatment in response to Nike's threat to leave the state); Jacob Passy, *This is what Amazon's 'HQ2' was going to cost New York taxpayers*, MARKETWATCH (Feb. 16, 2019), https://www.marketwatch.com/story/what-amazons-hq2-means-for-taxpayers-in-new-york-and-virginia-2018-11-14 (Boeing, Alcoa, Foxconn, Amazon, General Motors, Ford, Sempra Energy, and Nike received incentive packages of $2 billion to $8.7 billion from cities and

of negotiating theory, the host country's best alternative to negotiated agreement (BATNA) is equal to the net cost (positive or negative) of hosting the investment.[85] The investor's BATNA is the amount of tax that produces the same after-tax return as in the most attractive alternative venue.[86] If the host country's BATNA is higher that the investor's BATNA (i.e., the least tax that the host country would agree to accept is less than the most that the investor would be willing to pay), then there is no zone of possible agreement (ZOPA),[87] a fact that the negotiators will eventually discover. If there is a ZOPA (i.e., if the host country's BATNA is lower than the investor's BATNA), then the host country will of course attempt to determine and settle as close to the investor's BATNA as possible.[88]

However, case-by-case negotiation is often impractical. For example, assume that a lender is negotiating the terms of a loan to a resident of another country. It is not ordinarily practical for the lender to enter into simultaneous negotiations with the treasury of the borrower's home country regarding the tax implications of the loan. For this reason, countries enact statutory intranational tax regimes, effectively offering access to all comers and setting forth a price for such access.[89] In such instances, the dilemma facing the host country is analogous to that facing any other seller of goods or services who sets a fixed price. The higher the price, the more it will earn from each sale but the fewer sales it will make; the lower the price, the more it will sell but the less it will earn from each sale. Finding the appropriate balance is a matter of being aware of what other countries are offering and having a proper evaluation of one's own bargaining position; to wit, the relative advantages and disadvantages from the perspective of international investors of investing in one's country.

The principle of neutrality has no role to play in the design of an

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states).

[85] *See generally*, DEEPAK MALHOTRA & MAX H. BAZERMAN, NEGOTIATION GENIUS: HOW TO OVERCOME OBSTACLES AND ACHIEVE BRILLIANT RESULTS AT THE BARGAINING TABLE AND BEYOND 20–23 (2007).

[86] For instance, assume that investment in Country A offers a pretax return of 16%, that investment in Country B offers a pretax return of 15%, and that the minimum tax that County B is willing to accept is equal to 20% of the pretax return. Because the after-tax return in Country B is 12% (pretax return of 15% minus a 20% tax), the MNE's BATNA is negotiating with Country A is a tax equal to 25% of its pretax return: with a 16% pretax return and a tax rate of 25%, the after-tax return from investing in Country A will be 12%, equal to the after-tax return in the best alternative venue.

[87] *See generally* MALHOTRA & BAZERMAN, *supra* note 85, at 23.

[88] *See generally Id.* at 23-24.

[89] *See, e.g.*, I.R.C. §§ 865(a)(1) (Westlaw 2017) (effectively exempting from tax the gain on sale of personal property by non-resident aliens and foreign corporations); 871(a) (30% tax on gross FDAP income of non-resident aliens), (b) (graduated tax on taxable business income of non-resident aliens), (h) (exemption from tax on portfolio interest of non-resident aliens); 881(a) (30% tax on gross FDAP income of foreign corporations), (c) (exemption from tax on portfolio interest of foreign corporations); 882(a) (standard corporate-rate tax on business income of foreign corporations).

intranational tax regime, whether such a regime is negotiated on a case-by-case basis or is imposed by statute. Neutrality posits that taxes should disturb investment patterns as little as possible so that capital flows to the same investments that it would have in the absence of taxation.[90] In the intranational sphere, neutrality would require the host country to view the international investments that it would have received in the absence of taxation as a model and to design its intranational tax regime so as to disturb this ideal investment pattern as little as possible. There is no rational reason for a host country to adopt such a policy. If the taxes that a country imposes discourage investments that would have constituted a net drain on the country's resources, then it is a positive phenomenon. If by means of its tax system a country is successfully able to woo investments that carry the potential of providing net after-tax benefits to residents of the host country (and that would otherwise have gone elsewhere), this too is a positive phenomenon. From the perspective of the host country, the fact that in each case, the host country's intranational tax regime disturbs the investment pattern that would have occurred in a no-tax world is irrelevant.

In more general terms, countries will strive to sell access to their territories, their resources, and their markets at the highest price that the market will bear, provided that the tax they receive is greater than the net cost of hosting the investment.[91] The ideal intranational tax regime is one in which the sum of non-tax benefits and tax revenue from hosting international investment is maximized.

A host country has no need or incentive to adopt a neutral intranational tax regime (i.e., one that attempts to replicate the investment patterns that would have prevailed in a no-tax world). It is not merely that other considerations are often more pressing and that neutrality must occasionally be sacrificed for the sake of achieving alternative goals.[92] It is that neutrality is quite simply not a consideration at all.

C. Inter-jurisdictional Taxation

It is with regard to inter-jurisdictional taxation–the attempt to coordinate various countries' intranational tax regimes–that the tendency to blur the lines separating the different types of international taxation is perhaps the most prevalent and the consequences of doing so the most egregious. A prevalent theme in the international tax literature is that while neutrality may not be a relevant consideration from the perspective of

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90 *See supra* Part II.A.

91 Recall that the terms "tax" and "net cost" can take negative values, so that when net cost is negative, the minimum tax will also be negative (i.e., when there is a net benefit, the host country will be willing to offer grants and subsidies).

92 In the domestic (and supranational) non-Pigouvian arena, neutrality, although an important goal, must often be balanced against competing goals. *See* text accompanying note 26, *supra*.

individual host countries, it is a relevant consideration from a global perspective.[93] For example, assume that Country A offers a higher pretax return, while Country B offers a higher after-tax return. Because what motivates investors is after-tax return, capital will flow to Country B even though–so it is claimed–the capital would be more efficiency deployed in Country A. Thus, one important policy objective of contemporary inter-jurisdictional taxation is to neutralize the effect of taxes in investment decisions and to replicate, to the extent possible, the investment pattern that would have prevailed in a no-tax world.[94]

True, most commentators agree that neutralizing the effect of taxation on international investments is not an achievable aim.[95] The most straightforward way of removing tax as a factor in investment decisions would be to equalize by international convention the tax burden imposed by all countries on economic activity in their territories. However, any attempt to do so would face insurmountable theoretical and practical obstacles. First, it is generally recognized that countries have the sovereign right to determine the size of their public sector. Those that desire a relatively large public sector will generally impose a higher burden on the taxpaying public than those that prefer a relatively small private sector.[96] Forcing all countries to equalize the tax burdens that they impose on economic activity in their territories in an attempt to neutralize the effect of taxation in international investment decisions would effectively deny them the right to determine the size of their government.[97] Second, even if there were a

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93 *See, e.g.*, GRAVELLE, *supra* note 1, at 4 ("A country can . . . choose a policy that leads to the greatest welfare for its own citizens, even if that policy distorts the allocation of capital (is not neutral) and leads to less efficient worldwide production. The optimal policy from the perspective of a country, in other words, may not be the most efficient in terms of the worldwide allocation of capital, and may not be the optimal policy from the perspective of world economic welfare.").

94 *See, e.g.*, James R. Hines, Jr., *The Case against Deferral: A Deferential Reconsideration*, 52 NAT'L TAX J. 385, 395-96 (1999); Donald J. Rousslang, *Deferral and the Optimal Taxation of International Investment Income*, 53 NAT'L TAX J. 589, 590 (2000); Desai & Hines, *supra* note 1, at 492.

95 *See, e.g.*, Allison D. Christians, *Tax Treaties for Investment and Aid to Sub-Saharan Africa: A Case Study*, 71 BROOK. L. REV. 639, 684 ("Elimination of competition and tax sensitivity could be achieved if all countries adhered to principles of capital export neutrality. However, this would require international coordination and cooperation to a degree that appears overwhelmingly unattainable."); Victor Thuronyi, *International Tax Cooperation and a Multinational Treaty*, 26 BROOK. J. INT'L L. 1641, 1642 n.8 (2001). Tax is not the only forum within which counties compete. *See generally, e.g.,* Mitchell Kane & Edward B. Rock, *Corporate Taxation and International Charter Competition*, 106 MICH. L. REV. 1229 (2008).

96 Reuven S. Avi-Yonah, *Bridging the North/South Divide: International Redistribution and Tax Competition*, 26 MICH. J. INT'L L. 371, 375, 384 (2004). For a discussion of the role of sovereignty in the development of tax law, see Allison Christians, Steven Dean, Diane Ring, & Adam Rosenzweig, *Taxation as a Global Socio-Legal Phenomenon*, 14 ILSA J. INT'L & COMP. L. 303, 309-11 (2008).

97 *See, e.g., Avi-Yonah, Crisis, supra* note 2, at 1629.

binding international standard that required countries to impose the same tax rates such a standard would be ineffective without also standardizing the tax base.[98] Assuming that the relevant measure is an income tax, this would mean that all countries would need to adopt identical provisions for determining taxable income (e.g., what is included in gross income? Which deductions are permissible? What is the appropriate rate of depreciation for every type of asset? Under what circumstances can losses be deducted?) To put it in the starkest terms possible, harmonization would require either that the rest of the world adopt Title 26 of the United States Code (not a likely prospect) or that the United States scrap its own Internal Revenue Code and adopt in its place whatever code is agreed upon by international convention (also not a likely prospect). Moreover, even if a standard internal revenue code were adopted by every country on the planet, the task would still not be complete. If administrative or judicial interpretation of the code varied from country to country, the effective tax burden would not be the same.[99] Enforcement of the common norms would also need to be standardized.[100]

Because of the difficulties inherent in attempting to equalize international taxation and thereby remove tax as a factor in making international investment decisions, scholars and policy-makers tend to moderate their goals and instead focus on measures such as countering tax regimes that operate as "tax havens" or that are engaged in "harmful tax competition."[101] Nevertheless, these are usually viewed as compromise measures. Harmonization of tax regimes is ordinarily considered the (admittedly unattainable) Holy Grail of inter-jurisdictional taxation.[102]

My argument is that such a goal is misguided. Even if it were possible to adopt measures that would neutralize the effect of taxation on international investment so that investment patterns mimicked those that would have prevailed in a no-tax world, such measures would actually

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[98] Julie Roin, *Taxation without Coordination*, 31 J. LEGAL STUD. S61, S78 (2002) ("[T]ax rate harmonization has been accorded higher priority, despite widespread knowledge of the toothlessness of such proposals in the absence of tax base harmonization.").

[99] Jeffrey Owens, *The David H. Tillinghast Lecture Tax Competition: To Welcome or Not?*, 65 TAX L. REV. 173, 183-84 (2012).

[100] *See, e.g.*, Dean, *supra* note 7, at 139–40.

[101] *See, e.g.*, *Conclusions of the Ecofin Council Meeting on 1 December 1997 Concerning Taxation Policy*, 1998 O.J. (C 2/01) 1, 4 (EC); Dean, *supra* note 7, at 132-33; Kudrle & Eden, *supra* note 51, at 37–42, 46-47; Hedda Leikvang, *Piercing the Veil of Secrecy: Securing Effective Exchange of Information to Remedy the Harmful Effects of Tax Havens*, 45 VAND. J. TRANSNAT'L L. 293, 299 (2012); *Harmful Tax Competition*, *supra* note 33; Rosenzweig, *supra* note 2, 936–42.

[102] An alternative to harmonizing tax regimes is for home countries to impose an effective worldwide tax on their domestic corporations and on foreign corporations controlled by their domestic corporations and to permit a full credit for foreign taxes paid or incurred. Assuming that the domestic tax rate is no lower than the tax rate applicable in the countries in with the corporation operated, the effective tax burden will not be dependent upon the location of the corporation's investments. *See, e.g., OECD, Action 3, supra* note 6.

misallocate capital and reduce aggregate global welfare. In the inter-jurisdictional arena, it is not the pretax rate of return but rather the after-tax rate of return that is relevant for determining efficiency. In other words, in order to maximize aggregate global welfare, capital must flow to where the after-tax return is the highest.

As we saw in our discussion of taxation in the purely domestic sphere, the principle of neutrality is a response to the substitution effect of non-Pigouvian taxes. The principle posits that, all else being equal, the less the behavioral change precipitated by such taxes, the less the deadweight loss and the more efficient the tax. Therefore, if the pretax return from Investment A is higher than the pretax return from Investment B but the after-tax return from Investment B is higher than the after-tax return from investment A, then the anticipated flow of resources to Investment B likely constitutes an inefficient allocation of resources. Undertaking measures to encourage the flow of capital to Investment A and thereby recreating the investment pattern that would have occurred in a no-tax world could contribute to allocative efficiency.[103]

On the other hand, we have seen that even within the domestic sphere, the principle of neutrality does not apply to Pigouvian taxation. When taxpayers modify their behavior in order to avoid a properly constructed Pigouvian tax, the substitution effect does not produce a deadweight loss, but actually promotes economic efficiency. In other words, with regard to Pigouvian taxation it is the after-tax return and not the pretax return that determines allocative efficiency. If the pretax return from Investment A is higher than that from Investment B but (after the introduction of a property designed Pigouvian tax) the after-tax return from Investment B is higher than that from Investment A, then the anticipated flow of resources to Investment B will promote aggregate social welfare.[104]

Analytically, why is the principle of neutrality applicable to non-Pigouvian taxation but not to Pigouvian taxation? In other words, why does the relative pretax return reflect allocative efficiency in the former case, while in the latter it is the relative after-tax return that reflects efficiency? I would posit that the applicability of the principle of neutrality to a given type of tax depends upon the relationship between the tax in question and the market. Non-Pigouvian taxes do not reflect either consumer preferences or the availability of resources. Whereas taxpayers' pretax behavior is their considered response to supply and demand as expressed in the price structure (how much the market values what they have to offer and how much it values the resources that they desire), their after-tax behavior is skewed by the non-market effect of the tax. Consequently, the tax might dissuade taxpayers (whether acting in their capacity as suppliers of goods and services or in their capacity as consumers) from engaging in a course of

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[103] *See supra* text accompanying notes 18-21.

[104] *See supra* Part II.B.

action that would otherwise entail an efficient use of resources. This change of behavior — the substitution effect — is what produces the deadweight loss.[105]

With regard to Pigouvian taxation, the situation is reversed. Because the market operating on its own does not account for externalities, pretax prices do not fully reflect consumer preferences or the availability of resources and, consequently, may encourage behavior that is sub-optimal from a societal perspective. By modifying prices to reflect the true cost of taxpayers' behavior, a properly constructed Pigouvian tax forces taxpayers to respond to the actual supply of and the demand for resources. Thus, I would argue, the question of whether pretax return or post-tax return is the appropriate benchmark for determining efficiency is a function of whether the tax itself reflects supply and demand. If it does not, then pretax behavior is optimal. If it does, then after-tax behavior is optimal from a societal perspective.

Intranational taxation is the price charged by host countries for access to their territory and their markets.[106] The amount that they can successfully charge is a function of what they have to offer relative to alternative venues and what foreign investors need. The more the demand for what they have to offer and the less the supply, the higher the price that they can charge. Furthermore, the more the host country desires the investment the less tax it will demand (indeed it may adopt a negative tax - a subsidy or a grant - to attract the investment), while the less desirous it is of the investment the more it will demand as the price of access. The interplay between the needs, the desires, and the resources that each party brings to the table will determine the tax that the host country will be able to collect from foreign investors. Because intranational taxation reflects supply and demand, the pretax return represents an incomplete picture of global resources and preferences. Consequently, an investment pattern that responds to pretax return will not necessarily best promote global welfare. Efficiency requires that investment be allowed to flow to the place offering the highest after-tax return.

As an example, assume that a corporation is considering establishing a manufacturing plant in one of two countries. Country P is a wealthy country with a developed economy. The pretax return from investing in Country P is 12%. However, the proposed manufacturing plant and its attendant activities will burden Country P's infrastructure and lower the quality of life of its residents. Consequently, Country P is unwilling to allow the corporation to operate in its territory unless it pays a tax equal to 50% of its projected pretax profits. In contrast, Country Q is a relatively poor country with an underdeveloped economy and a primitive infrastructure. The

[105] *See supra* notes 15-17 and the accompanying text.

[106] As already noted, from an economic perspective intranational taxes are not taxes but fees. *See supra* Part III.B.

proposed manufacturing plant would provide much-needed jobs that would stimulate the local economy, relieve social unrest, and release the government from some of its obligation to provide a social safety net. It would provide job-training and managerial experience for local residents and exposure to world markets. Furthermore, in order to be able to ship raw materials into and finished products out of the plant, the corporation will need to invest funds in developing the physical infrastructure in the plant's vicinity. Given these advantages, Country Q is willing to allow the corporation to operate in its territory without paying any tax whatsoever.[107] Of course, Country Q would prefer collecting tax revenue from the corporation, but it is aware that should it set its price too high the corporation may go elsewhere and Country Q will lose the opportunity to host what for it is a very beneficial investment. Assume that the corporation's investing in Country Q will produce a return of 8%.[108]

In a tax-free world, the corporation would prefer investing in Country P (pretax return of 12% versus a pretax return of 8% in Country Q). However, given the tax differential, the corporation will likely invest in Country Q (after-tax return of 8% versus an after-tax return of 6% in Country P). Much of the international tax literature castigates this violation of neutrality and argues that, from a global perspective, resources are being used in an inefficient manner.[109] The idea behind this argument is that in a competitive market, a higher pretax return is indicative of a more efficient use of resources. By directing resources away from that country in which the market return is the highest, the international tax structure produces inefficiency and reduces aggregate global welfare.

The problem with this argument is its failure to recognize that intranational taxation is part and parcel of the market pricing mechanism. The amount that a country can charge international actors for access to its territory reflects the supply of and the demand for international investments and international investment venues. Therefore, with regard to intranational taxation it is the relative *after-tax* return, not the relative *pretax* return that determines market efficiency. In our example above, if we consider the benefits that the residents of Country Q would expect to reap and the cost that the residents of Country P would expect to bear from hosting the investment, we can see that establishing the plant in Country Q will better promote aggregate global welfare. Our source of information for this conclusion is the fact that, after both countries have signaled to the market - via their intranational tax regimes - the cost or benefit from the perspective of their own residents of hosting the investment, the after-tax return from

[107] Country Q might be willing to provide grants or subsidies (i.e., to impose a negative tax) in order to attract the investment. In such a case the after-tax return would be higher than the pretax return.

[108] As Corporation C is not subject to tax, its pretax and after-tax return will be the same.

[109] *See, e.g., supra* notes 1, 2, 7, and 34.

investing in Country Q is greater than the after-tax return from investing in Country P.[110] Any inter-jurisdictional attempt to restore, in the name of neutrality, the investment pattern that would have prevailed in the absence of taxation would not only fail to promote aggregate global welfare but would actually be counterproductive in this regard.

As was the case with regard to intranational taxation,[111] it is not that neutrality is a principle that ideally would be respected in inter-jurisdictional taxation but must be abandoned when it conflicts with other principles.[112] There is not even a prima facie reason to presume that an inter-jurisdictional tax regime that respects neutrality is preferable to one that does not. Neutrality is simply not a proper goal of inter-jurisdictional taxation.

In more universal terms, let us define the terms Y_x and C_x as follows:

(1) Y_X = the expected pretax income from investing in Country X,

[110] The text intentionally ignores international externalities and implicitly assumes either that the investment will not significantly affect the welfare of those living outside the host country or that it will produce the same effect regardless of its location. Of course, it is possible that, in our example, investment in Country Q will produce a greater negative international externality than will investing in Country P, or that investing in Country P will produce a greater positive international externality than will investing in Country Q, and, as a consequence, investing in Country P will better promote global welfare than will investment in Country Q. However, this is a fact-specific circumstance and in no way undermines the thesis of this sub-Part, namely that neutrality is inapplicable in inter-jurisdictional taxation. True, if it could be shown that investments in countries offering a higher pretax return produce fewer negative international externalities or more positive international externalities than do investments in countries offering a higher after-tax return, this would lend a modicum of support to the argument that pretax return is a relevant consideration in promoting global welfare. However, to the best of my knowledge, no one has suggested that such is the case. Indeed, it appears highly unlikely that there is any meaningful correlation between relative pretax return and the extent of international externalities. Thus, while it is possible that, in a specific instance, investing in a country offering a higher pretax return but a lower after-tax return might constitute a more efficient use of global resources, it is much more likely that, over the long run, a large series of investments in countries offering the highest after-tax return will promote aggregate global welfare better than a large series of investments in countries offering the highest pretax rate of return. In any case, if the international community is interested in overcoming international externalities, the proper means of doing so would be supranational regulation or, even better, a supranational Pigouvian tax. It is important to note that the term, "international externalities," like its domestic counterpart, does not include all effects on third parties, but only those effects that the market mechanism does not take into account. Thus, the fact that investing in one country may deprive another country of the opportunity to host the investment is not an externality, but is rather an effect that is fully taken into consideration by the market. As we have seen, if the package of taxes and incentives that a country can offer is insufficient to attract the investment (*i.e.*, if the highest after-tax return that a country can offer is less than the after-tax return available elsewhere), then investing in that country will most likely not increase aggregate global welfare as much as investing in the country that was actually chosen to host the investment.

[111] *See supra* Part III.B.

[112] *Cf.* text accompanying note 26 *supra*.

while

(2) C_X = the expected pretax net cost to Country X of hosting the investment.

The pretax net cost of hosting an investment is the totality of the pretax costs that the host country expects to incur minus the totality of the pretax benefits that it expects to obtain from hosting the investment. If benefits exceed cost (i.e., if there is a positive pretax net benefit), then C_x will be negative.

The over-all contribution of the investment to aggregate global welfare is equal to the pretax income that the investor expects to derive from the investment - a figure that represents consumer demand for the goods that it produces, the availability of labor and capital, and so forth - minus the costs that the host country will incur in hosting the investment. Thus,

(3) $(Y_X - C_X)$ = the contribution to aggregate global welfare of selecting Country X as an investment venue.[113]

As we have noted, the minimum tax that a rational country will agree to accept in order to host an international investment is equal to the net cost of hosting the investment (if the net cost is negative then the minimum tax will also be negative, *i.e.*, the maximum that it would agree to pay would equal the net benefits that it expects to obtain from hosting the investment). Thus,

(4) C_X = the minimum tax that Country X will demand to host the investment.

Seeing as Y_X is the expected pretax income from investing in Country X, while C_x is the minimum tax that Country X will demand:

(5) $(Y_X - C_X)$ = the maximum possible after-tax income from investing in Country X.

Applying statement (3), we know that for any two countries P and Q:

(6) If $(Y_Q - C_Q) > (Y_P - C_P)$, then the contribution to aggregate global

[113] Alternatively, we can define B_X as the expected pretax net benefit (benefits minus costs) of hosting the investment. As $B_x = -C_x$, the contribution to aggregate global welfare can be described as. Mathematically, the two expressions ($Y_X - C_X$ and $Y_X + B_x$) are identical. For the sake of consistency, the text will simply use the term C_X, which can take either positive or negative values.

welfare of investing in Country Q is greater that the contribution to aggregate global welfare of investing in Country P.

Furthermore, applying statement (5), we know that for any two countries P and Q:

(7) If $(Y_Q - C_Q) > (Y_P - C_P)$, then the maximum possible after-tax income from investing in Country Q is greater than the maximum possible after-tax income from investing in Country P.

Comparing statements (6) and (7), we can see that the country able to offer the higher *after-tax* return is the investment venue that would better promote aggregate global welfare. In contrast, the fact that $Y_P > Y_Q$ offers no indication that $(Y_P - C_P) > (Y_Q - C_Q)$. In other words, the fact that one country is able to offer a higher *pretax* return offers no indication that investing in that country will constitute a more efficient allocation of resources.[114]

[114] The text does not consider the distribution of the efficiency bonus that arises from the choice of Country Q as an investment venue. The thesis of this subpart is that an efficient allocation of global resources requires capital to flow to those venues offering the highest after-tax rate of return, not to those offering the highest pretax rate of return. The question of who will benefit from the efficiency bonus is beyond the parameters of our current discussion. However, in very encapsulated terms, let us assume that

(8) $(Y_Q - C_Q) > (Y_P - C_P) > (Y_R - C_R)$, where R represents any venue other than Country P and Country Q.

In other words, Country Q has to potential to offer the highest after-tax return and Country P has the potential to offer the second highest rate of return. In such a case, the most that the investor will be willing to pay to Country Q is the amount that would make the after-tax return in Country Q equal to the after-tax return from investing in Country P. Algebraically, the most that the investor would be willing to pay Country P is

(9) $Y_Q - (Y_P - C_P)$.

To see why this is so, recall that the pretax income in Country Q is Y_Q. If the tax imposed by Country Q is $Y_Q - (Y_P - C_P)$, then the after-tax return would be $Y_Q - [Y_Q - (Y_P - C_P)]$. This equals $Y_P - C_P$, which is the after-tax return in Country P, the next best alternative. In other words, the investor's indifferent point is when Country Q tax is $Y_Q - (Y_P - C_P)$. Any higher and the investor will prefer Country P; any less and the investor will prefer Country Q.

Consequently, Country Q's BATNA is C_Q, while the investor's BATNA is $Y_Q - (Y_P - C_P)$. *See supra* note 86 and the accompanying text. From (8), we know that $C_Q < Y_Q - (Y_P - C_P)$, meaning that the minimum tax Country Q will take is less than the maximum tax that the investor will pay. The area between those points represents the ZOPA. *See supra* note 85 at 23 and the accompanying text. Unless one or both parties incorrectly estimate the other side's BATNA or engage in an ultimately self-destructive game of chicken, a deal will be struck somewhere within that zone. The exact point within the ZOPA where the deal will be struck depends upon all of the facts and circumstances, including the negotiating skills of those representing the two sides, the political and economic pressures that both parties they face, and so forth.

V. CONCLUSION

The discourse with regard to international taxation is fraught with conceptual confusion. First, there is a tendency among scholars and policy-makers in the field of international taxation to rely upon concepts that were developed within the context of domestic taxation, without a thorough examination of their applicability to the international arena. Second, there is a tendency to lump together a number of very distinct types of tax regimes under the category of international taxation, which fails to recognize that the principles of tax theory relevant to each are also different.

One theorem underlying domestic tax theory is that allocative efficiency can be achieved only when capital flows to those investments offering the highest pretax return. When investments with a relatively low pretax return are able to offer a relatively high after-tax return, capital will be misdirected and resources will not be used in the most efficient manner. The principle of neutrality posits, therefore, that taxes should not change investment patterns and that those investment opportunities that would have attracted capital in the absence of taxation should continue to attract capital following the imposition of tax.

However, even within the domestic sphere, the principle of neutrality is not universally valid. With regard to Pigouvian taxes, it is not the pretax but rather the after-tax return that determines efficiency. If, following the imposition of a properly designed Pigouvian tax, investments that offer a relatively high pretax return now offer a relatively low after-tax return, the expected change in investment decisions will increase aggregate societal welfare. The fact that such investments offer a relatively high pretax return but a relatively low after-tax return merely indicates that the activity concerned imposes a cost on third parties, a cost for which the market operating on its own does not account.

Moving to the international arena, the principles that would apply to a hypothetical supranational tax are similar to those of domestic tax theory. Here, too, non-Pigouvian taxes should be designed to be as neutral as possible, while the principle of neutrality would inapplicable for Pigouvian taxes (such as a tax on carbon emissions). As in the domestic sphere, allocative efficiency is determined by pretax return in the case of non-Pigouvian taxes and by after-tax return in the case of Pigouvian taxation.

However, most of the discourse in the field of international law concerns not supranational taxation, but rather intranational and inter-jurisdictional taxation. Nevertheless, perhaps because it describes all three under the catchall phrase of international taxation, it fails to recognize that while the principles of domestic taxation would be applicable to a hypothetical supranational tax regime, they are inappropriate in the context of intranational and inter-jurisdictional taxation.

When designing its intranational tax regime, there is no reason for a host country to consider as its point of reference the international investments that it would have hosted in the absence of taxation and to attempt to duplicate that pattern in the after-tax world. Rather it will attempt to use its tax laws, among other measures, to attract investments that are likely to promote the interests of its constituents and to deter investments that are likely to be detrimental to those interests. Whether such investments would have occurred in a world without tax is not a relevant consideration. The principle that will guide countries in designing their intranational tax regime is the desire to maximize the total benefit (i.e., the non-tax benefit plus the tax revenue) from hosting international investments.

With regard to inter-jurisdictional taxation, the key point is that because intranational tax is in substance a fee that host countries charge for access to their territory, it is part and parcel of the market mechanism and reflects the supply of and the demand for international investments and international investment venues. Therefore, an efficient allocation of global resources requires that capital be directed to those investments that offer the highest after-tax return. An inter-jurisdictional tax regime that successfully neutralized the effect of intranational taxation in international investment decisions — a cherished goal of the international tax literature — would in fact create allocative efficiency and reduce aggregate global welfare.

If the international tax dialogue were focused on the design of a (non-Pigouvian) supranational tax regime, then neutrality would properly play a central role in the discourse. However, discussions of cross-country cooperation to establish a modern "international tax regime" are almost always concerned with inter-jurisdictional taxation. Here the principle of neutrality not only has no legitimate role to play but would, if implemented, be counterproductive to the very interests that it purportedly promotes.