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# Passport to Toledo: Cuno, the World Trade Organization, and the European Court of Justice

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### Recommended Citation

Avi-Yonah, Reuven S. "Passport to Toledo: Cuno, the World Trade Organization, and the European Court of Justice." *Tax Notes* 109, no. 13 (2005): 1661-8.

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## PASSPORT TO TOLEDO: *CUNO*, THE WORLD TRADE ORGANIZATION, AND THE EUROPEAN COURT OF JUSTICE

By Reuven S. Avi-Yonah

Reuven S. Avi-Yonah is the Irwin I. Cohn professor of law and director of the international tax L.L.M. program at the University of Michigan. He would like to thank Peter Enrich, Walter Hellerstein, and Rick Hills for their helpful comments. All errors are the author's.

The purpose of this article is to try to place the debate about *Cuno v. DaimlerChrysler* in a broader perspective by connecting it with the overall discussion of harmful tax competition. It discusses two hypothetical scenarios under which the city of Toledo, Ohio, is (a) a separate country and (b) a member state of the European Union. If the first hypothetical were true, the tax incentives offered by Toledo would violate the rules of the World Trade Organization; if the second hypothetical were true, the tax incentives would also violate the Treaty of Rome, as interpreted by the European Court of Justice. The reason for those outcomes is that tax incentives like those at issue in *Cuno* violate well established policies of both the WTO and the ECJ designed to prevent harmful tax competition from skewing trade and investment patterns. Thus, consideration of the two hypotheticals may shed some light on the policy issues at stake in *Cuno*, as well as on the desirable outcome if the Supreme Court were to decide *Cuno* on the merits.

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### I. Introduction

On September 27, 2005, the U.S. Supreme Court granted certiorari in *Cuno v. DaimlerChrysler*, a case involving interstate tax competition that has drawn numerous comments from academics and the bar.<sup>1</sup> The case is controversial for holding that some state tax incentives to business are a violation of the Commerce Clause. Because of that controversy and the ubiquitous prevalence of those incentives, it is widely expected that if the Supreme Court reaches the merits, it will reverse.

This article tries to place the debate about *Cuno* in a broader perspective by connecting it with the overall discussion of harmful tax competition. Specifically, the article will address two (admittedly highly unlikely) hypotheticals: First, suppose (like the London borough of Pimlico in the classic British film *Passport to Pimlico*) the city of Toledo, Ohio, seceded from the United States and became a separate country? Second, suppose, in addition, that the new country of Toledo somehow became a member state of the European Union?

The reason those hypotheticals are interesting is because it is clear that if the first hypothetical were true, the tax incentives offered by Toledo<sup>2</sup> (which were at issue in *Cuno*) would violate the rules of the World Trade Organization; and if the second hypothetical were true, the tax incentives would also violate the Treaty of Rome, as interpreted by the European Court of Justice. Moreover, the reason for those outcomes is that tax incentives like those at issue in *Cuno* violate well-established policies of both the WTO and the ECJ that are designed to prevent harmful tax competition from skewing trade and investment patterns. Thus, consideration of the two hypotheticals may shed some light on the policy issues at stake in

<sup>1</sup>*Cuno v. DaimlerChrysler, Inc.*, 386 F.3d 738, Doc 2004-17647, 2004 TNT 174-3 (6th Cir. 2004), petition for cert. granted sub nom. *DaimlerChrysler Corp. v. Cuno* (No. 04-1704) and *Wilkins v. Cuno* (No. 04-1724) (Sept. 27, 2005). For the debate on *Cuno*, see, e.g., Edward Zelinsky, "Ohio Incentives Decision Revisited," *State Tax Notes*, Sept. 19, 2005, p. 859, and articles cited therein.

<sup>2</sup>One of the incentives (a personal property tax exemption) was offered by Toledo (under state law), and the other incentive (an investment tax credit against the state corporate franchise tax) was offered by Ohio. For ease of exposition (and because it makes no difference to the analysis in this article), the ensuing discussion will assume that both incentives were offered by Toledo.

*Cuno*, as well as on the desirable outcome if the Supreme Court were to decide *Cuno* on the merits.

This article is divided into six parts. After this introduction, Part II describes the *Cuno* case as decided by the Sixth Circuit. Part III discusses from a broad policy perspective some of the issues raised by state tax competition. Parts IV and V are the heart of the report and discuss the two hypotheticals laid out above: how the WTO rules would apply to the *Cuno* facts if Toledo were a country, and how the ECJ would rule if Toledo were a member of the EU. Finally, Part VI concludes by arguing that given the policy issues at stake, the U.S. Supreme Court should reach the merits and affirm *Cuno*, as a way of spurring Congress to regulate harmful state tax competition.

## II. The *Cuno* Case

In 1998 DaimlerChrysler entered into an agreement with the city of Toledo to construct a new vehicle-assembly plant near the company's existing facility, in exchange for various tax incentives. DaimlerChrysler estimated that it would invest about \$1.2 billion in the project, which would provide the region with several thousand new jobs. In return, the city and two local school districts agreed to give DaimlerChrysler a 10-year 100 percent property tax exemption, as well as an investment tax credit of 13.5 percent against the state corporate franchise tax for some qualifying investments. The total value of the tax incentives was estimated to be \$280 million.

The district court held that the investment tax credit and the property tax exemption did not violate the Commerce Clause because, although "an increase in activity in Ohio could increase the credit and exemption amount" under the two statutes, an increase in activity outside the state would not decrease the amount of the tax credit or exemption.<sup>3</sup>

On appeal, the plaintiffs' primary contention was that the Ohio statutes authorizing the investment tax credit and personal property tax exemption violate the Commerce Clause of the U.S. Constitution. The U.S. Constitution expressly authorizes Congress to "regulate Commerce with foreign Nations, and among the several States," and the "negative" or "dormant" aspect of the Commerce Clause, as construed by U.S. constitutional jurisprudence, implicitly limits a state's right to tax interstate commerce.<sup>4</sup> A tax provision satisfies the requirements of the Commerce Clause if (1) the activity taxed has a substantial nexus with the taxing state; (2) the tax is fairly apportioned to reflect the degree of activity that occurs within the state; (3) the tax does not discriminate against interstate commerce; and (4) the tax is fairly related to benefits provided by the state.<sup>5</sup>

In *Cuno*, the parties disagreed whether Ohio's method for encouraging economic investment by conferring in-

vestment tax incentives and property tax exemptions discriminated against interstate commerce under the third prong of the *Complete Auto* test.<sup>6</sup> The Sixth Circuit held that the investment tax credit was discriminatory, relying on a distinction first proposed by Profs. Hellerstein and Coenen.<sup>7</sup> The court stated:

Although the investment tax credit at issue here is equally available to in-state and out-of-state businesses, the plaintiffs nevertheless maintain that it discriminates against interstate economic activity by coercing businesses already subject to the Ohio franchise tax to expand locally rather than out-of-state. Specifically, any corporation currently doing business in Ohio, and therefore paying the state's corporate franchise tax in Ohio, can reduce its existing tax liability by locating significant new machinery and equipment within the state, but it will receive no such reduction in tax liability if it locates a comparable plant and equipment elsewhere. Moreover, as between two businesses, otherwise similarly situated and each subject to Ohio taxation, the business that chooses to expand its local presence will enjoy a reduced tax burden, based directly on its new in-state investment, while a competitor that invests out-of-state will face a comparatively higher tax burden because it will be ineligible for any credit against its Ohio tax.<sup>8</sup>

That, the court held, was discriminatory, rejecting the defendants' argument that the effect of the credit is similar to a subsidy, which the Supreme Court has generally upheld:

Although the defendants liken the investment tax credit to a direct subsidy, which would no doubt have the same economic effect, the Court has intimated that attempts to create location incentives through the state's power to tax are to be treated differently from direct subsidies despite their similarity in terms of end-result economic impact. The majority in *New Energy* noted in dicta that subsidies do not "ordinarily run afoul of [the Commerce Clause]" because they are not generally "connected with the State's regulation of interstate commerce." . . . Thus, the distinction between a subsidy and a tax credit, in the constitutional sense, results from the fact that the tax credit involves state regulation of interstate commerce through its power to tax. In short, while we may be sympathetic to efforts by the City of Toledo to attract industry into its economically depressed areas, we conclude that Ohio's investment tax credit cannot be upheld under the Commerce Clause of the United States Constitution.<sup>9</sup>

<sup>3</sup>*Cuno v. DaimlerChrysler, Inc.*, 154 F. Supp.2d 1196 (N.D. Ohio 2001).

<sup>4</sup>U.S. Const., Art. I, section 8, cl. 3.

<sup>5</sup>See *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279, 51 L. Ed. 2d 326, 97 S. Ct. 1076 (1977).

<sup>6</sup>*Cuno* at 743.

<sup>7</sup>Walter Hellerstein and Dan Coenen, "Commerce Clause Restraints on State Business Development Incentives," 81 *Cornell L. Rev.* 789 (1996).

<sup>8</sup>*Cuno* at 743.

<sup>9</sup>*Cuno* at 746 (citations and footnote omitted).

However, the Sixth Circuit held that the property tax exemptions were constitutional because "conditional exemptions raise no constitutional issues when the conditions for obtaining a favorable tax treatment are related to the use or location of the property itself," which the court held was the case in *Cuno*.<sup>10</sup>

The Supreme Court granted the defendants' petitions for certiorari to review the Sixth Circuit's decision striking down the investment tax credit and, *sua sponte*, requested the parties to brief the question whether the plaintiffs had standing in federal court to challenge the investment tax credit.<sup>11</sup>

### III. State Tax Competition and U.S. Welfare

#### A. The Problem of Tax Competition<sup>12</sup>

From its beginnings late in the 19th century, the modern state has been financed primarily by progressive income taxation. The income tax differs from other forms of taxation (like consumption or Social Security taxes) in that, in theory, it includes income from capital in the tax base, even if it is saved and not consumed. Because the rich save more than the poor, a tax that includes income from capital in its base is more progressive (taxes the rich more heavily) than a tax that excludes income from capital (for example, a consumption tax or a payroll tax). However, the ability to tax saved income from capital (that is, income not vulnerable to consumption taxes) is impaired if the capital can be shifted overseas to jurisdictions where it escapes taxation.

Two recent developments have dramatically augmented the ability of individuals and corporations to earn income overseas free of income taxation: the effective end of withholding taxation by developed countries and the rise of production tax havens in developing countries.<sup>13</sup> Since the United States abolished its withholding tax on portfolio interest paid to foreigners in 1984, no major capital importing country has been able to impose such a tax for fear of driving mobile capital elsewhere (or increasing the cost of capital for domestic borrowers, including the government itself).<sup>14</sup> The result is that individuals can generally earn investment income free of host-country taxation in any of the world's major economies.<sup>15</sup> Moreover, even developed countries find it exceedingly difficult to effectively collect the tax on the

foreign income of their individual residents in the absence of withholding taxes imposed by host countries, because the investments can be made through tax havens with strong bank secrecy laws.<sup>16</sup> Developing countries, with much weaker tax administrations, find that task almost impossible. Thus, cross-border investment income can largely be earned free of either host- or home-country taxation.<sup>17</sup>

For example, consider a wealthy Mexican who wishes to earn tax-free interest income from investing in the bonds of an American corporation. All he needs to do is set up, for a nominal fee, a Cayman Islands corporation to hold the bonds. The interest payments are then made to the Caymans corporation without any U.S. tax withheld under the so-called portfolio interest exemption.<sup>18</sup> The individual does not report the income to the Mexican tax authorities, and they have no way of knowing that the Caymans corporation is effectively an "incorporated pocketbook" of the Mexican resident. Nor are the exchange of information provisions of the Mexico-U.S. tax treaty of any help, because the IRS has no way of knowing that the recipient of the interest payments is controlled by a Mexican resident and therefore cannot report that to the Mexican authorities. As a result, the income is earned completely free of tax. (The Caymans, of course, impose no income taxes of their own.)

When we switch our attention from passive to productive investment, a similar threat to the taxing capacity of both home and host jurisdictions emerges. In the last decade, competition for inbound investment led an increasing number of countries (103 as of 1998) to offer tax holidays specifically geared to foreign corporate investors.<sup>19</sup> Given the relative ease with which an integrated multinational can shift production facilities in response to tax rates, those "production tax havens" enable multinationals to derive most of their income abroad free of host-country taxation.<sup>20</sup> Moreover, most developed countries (including the United States) do not dare impose current taxation (or sometimes any taxation) on the foreign-source business income of their resident multinationals for fear of reducing the competitiveness of those

<sup>10</sup>*Cuno* at 746.

<sup>11</sup>The Court has not ruled on the plaintiffs' petition for certiorari from the portion of the Sixth Circuit's decision sustaining the property tax exemption. It presumably will do so once it has disposed of the defendants' challenge.

<sup>12</sup>The following two sections are based in part on Reuven S. Avi-Yonah, "The WTO, Export Subsidies, and Tax Competition," in Michael Lang, Judith Herdin, and Ines Hofbauer (eds.), *WTO and Direct Taxation* (2005).

<sup>13</sup>Reuven S. Avi-Yonah, "Globalization, Tax Competition and the Fiscal Crisis of the Welfare State," 113 *Harv. L. Rev.* 1573 (2000).

<sup>14</sup>Edward H. Gardner, "Taxes on Capital Income: A Survey," in George Kopits (ed.), *Tax Harmonization in the European Community* (1992); Vito Tanzi, *Taxation in an Integrating World* (1995).

<sup>15</sup>Reuven S. Avi-Yonah and Linda Z. Swartz, "Virtual Taxation: Source Based Taxation in the Age of Derivatives," 2

(Footnote continued in next column.)

*Derivatives* 247 (1997); Edmund S. Cohen, "Individual International Tax Planning Employing Equity Derivatives," 4 *Derivatives* 52 (1998); Gregory May, "Flying on Instruments: Synthetic Investments and the Avoidance of Withholding Tax," *Tax Notes*, Dec. 9, 1996, p. 1225.

<sup>16</sup>Tanzi, *supra* note 14.

<sup>17</sup>Charles E. McLure Jr., "U.S. Tax Laws and Capital Flight From Latin America," 20 *U. of Miami Inter-Am. L. Rev.* 321 (1989); Chander Kant, "Foreign Direct Investment and Capital Flight," 80 *Princeton Studies in International Finance* 1 (1996).

<sup>18</sup>Section 871(h).

<sup>19</sup>Raymond Vernon, *In the Hurricane's Eye* (1998); United Nations, *World Investment Report* (1996).

<sup>20</sup>James R. Hines Jr. and Eric M. Rice, "Fiscal Paradise: Foreign Tax Havens and American Business," 109 *Quarterly Journal of Economics* 149 (1994); Rosanne Altshuler and T. Scott Newlon, "The Effects of U.S. Tax Policy on the Income Repatriation Patterns of U.S. Multinational Corporations," in Giannini et al. (eds.), *Studies in International Taxation* (1993).



multinationals against multinationals of other countries.<sup>21</sup> If they did, new multinationals could be set up as residents of jurisdictions that do not tax that foreign-source income.<sup>22</sup> Thus, business income can also be earned abroad largely free of either host- or home-country taxation.

For example, Intel Corp., a top 10 multinational, has operations in more than 30 countries around the globe. The company states that “an Intel chip developed at a design center in Oregon, might be manufactured at a wafer fabrication facility in Ireland, packaged and tested in Malaysia, and then sold to a customer in Australia. Another chip might be designed in Japan, fabricated in Israel, packaged and tested in Arizona, and sold in China.”<sup>23</sup> Specifically, outside the United States, Intel has major manufacturing facilities in Puerto Rico, China, Malaysia, the Philippines, Ireland, and Israel.<sup>24</sup> Thus, outside the United States, all of Intel’s manufacturing facilities are located in countries granting tax holidays. Nor does Intel pay current U.S. tax on its income from those foreign operations, because, under U.S. law, active income earned by foreign subsidiaries of U.S. multinationals is not taxed until it is repatriated in the form of dividends, which Intel can delay for many years.<sup>25</sup> Thus, the effective tax rate on Intel’s foreign-source income is far below the nominal U.S. corporate rate of 35 percent.

If income from capital can escape the income tax net, the tax becomes, in effect, a tax on labor. Several empirical studies have suggested that in some developed jurisdictions the effective tax rate on income from capital approaches zero, and tax rates on capital have tended to go down sharply since the early 1980s (when exchange controls were relaxed).<sup>26</sup> As a result, countries that used to rely on the revenues from the income tax are forced to increase relatively regressive taxes. The two fastest growing taxes in OECD member countries in recent years have been consumption taxes (from 12 percent of total revenues in 1965 to 18 percent in 1995) and payroll taxes (from 19 percent to 27 percent), both of which are more regressive than the income tax.<sup>27</sup> Over the same period, the personal and corporate income taxes have not grown as a percentage of total revenues (the personal income tax accounted for 26 percent of total revenues in 1965 and 27 percent in 1995, while the figures for the corporate income tax are 9 percent and 8 percent, respectively).<sup>28</sup> The total tax revenue as a percentage of gross domestic product in developed countries went up sharply during

the same period (from an average of 28 percent in 1965 to almost 40 percent in 1994), and that increase is accounted for largely by the rise of consumption and payroll taxes.<sup>29</sup> Moreover, there is evidence that as the degree of openness of an economy in OECD member countries increases, taxes on capital tend to go down while taxes on labor go up (the income tax is imposed on both capital and labor, so that its stability may mask this trend).<sup>30</sup>

The same trends can be observed in developing countries as well. In non-OECD-member countries (outside the Middle East), total government revenues as a share of GDP rose from an average of 18.8 percent in 1975-1980 to 20.1 percent in 1986-1992.<sup>31</sup> That growth was financed primarily by the growth of revenues from the VAT in the same period (from 25.5 percent of total revenues to 31.8 percent). At the same time, revenues from both the individual and the corporate income tax were flat or declined.<sup>32</sup>

A recent study by Keen and Simone illustrates both the extent of that problem and its effect on developing countries.<sup>33</sup> Keen and Simone show that from 1990 to 2001, corporate tax rates declined in both developed and developing countries. However, while in developed countries that decline in the rates was matched by a broadening of the tax base, so that no decline in revenues can be observed,<sup>34</sup> in developing countries, the same period witnessed a decline of corporate tax revenues by about 20 percent on average. That decline is particularly important in light of the larger share of tax revenues produced by the corporate tax in developing countries (average of 17 percent, as opposed to 7 percent for developed countries). Keen and Simone attribute most of that decline to the spread of targeted tax incentives for multinational enterprises. From 1990 to 2001 the percent of developing countries granting tax holidays to MNEs grew from 45 percent to 58 percent, and similar trends can be seen for tax breaks for exporters (32 percent to 45 percent), reduced corporate rates for MNEs (40 percent to 60 percent), and free trade zones (17.5 percent to 45 percent).<sup>35</sup> Those figures are particularly important because a companion paper by Altshuler and Grubert shows that the evolution of country effective tax rates in the period between 1992 and 1998 seems to have been driven by tax competition, and that U.S. manufacturers

<sup>21</sup>Robert J. Peroni, “Back to the Future: A Path to Progressive Reform of U.S. International Income Tax Rules,” 51 *U. Miami L. Rev.* 975 (1997).

<sup>22</sup>James R. Hines Jr., “The Flight Paths of Migratory Corporations,” 6 *Journal of Accounting, Auditing and Finance* 447 (1991).

<sup>23</sup><http://www.intel.com/intel/intelis/sites.htm> (1998).

<sup>24</sup>*Intel Annual Report* (1999).

<sup>25</sup>Reuven S. Avi-Yonah, “International Taxation of Electronic Commerce,” 52 *Tax L. Rev.* 507 (1997).

<sup>26</sup>Jeffrey Owens and Jacques Sasseville, *Emerging Issues in Tax Reform* (1997); Dani Rodrik, *Has Globalization Gone Too Far?* (1997).

<sup>27</sup>Owens and Sasseville, *supra* note 26.

<sup>28</sup>*Id.*

<sup>29</sup>World Bank, *Tax Policy Handbook* (1994).

<sup>30</sup>Enrique G. Mendoza, Assaf Razin, and Linda L. Tesar, “Effective Tax Rates in Macroeconomics: Estimates of Tax Rates on Factor Income and Consumption,” 34 *Journal of Monetary Economics* 297 (1994); Enrique G. Mendoza, Gian Maria Milesi-Ferretti, and Patrick Asea, “On the Ineffectiveness of Tax Policy in Altering Long-Run Growth,” Centre for Economic Policy Research Discussion Paper 1378 (1996).

<sup>31</sup>World Bank, *supra* note 29.

<sup>32</sup>*Id.*

<sup>33</sup>Michael Keen and Alejandro Simone, “Is Tax Competition Harming Developing Countries More Than Developed?” *Tax Notes Int’l*, June 28, 2004, p. 1317.

<sup>34</sup>Rachel Griffith and Alexander Klemm, “What Has Been the Tax Competition Experience of the Last 20 Years?” *Tax Notes Int’l*, June 28, 2004, p. 1299.

<sup>35</sup>Keen and Simone, *supra* note 33.

are becoming increasingly sensitive to tax considerations in determining the location of their investments.<sup>36</sup>

## B. State Tax Competition

So much for tax competition among countries. What about tax competition among states in a federal country like the United States?

States are different from countries in one obvious way: People are free to move in and out of them at will. On that basis, Charles Tiebout famously defended the efficiency of state tax competition as reflecting the wishes of state residents for a larger or smaller public sector. An enormous amount of literature exists examining and reexamining the Tiebout hypothesis in this context.<sup>37</sup> However, the issue is not relevant to the kind of tax competition described above, which does not involve setting general tax rates, but rather specific tax rates for particular companies. That type of tax competition is rarely an election issue, and does not involve individual voters' choice of the desirable size of their state government in the way general tax competition does.

Thus, state tax competition for business involves other issues, relating to the desirability of states offering those incentives. The standard advice by economists to "small open economies" is that they should refrain from taxing foreign investors, because those investors cannot be made to bear the burden of any tax imposed by the capital importing country.<sup>38</sup> Therefore, the tax will necessarily be shifted to less-mobile factors in the host country, like labor or land, and it is more efficient to tax those factors directly. That argument presumably applies to states as well as countries, because they are generally small open economies in the economic sense (that is, they have no power to set tariffs or influence the terms of trade). But while that argument seems quite valid as applied to portfolio investment, it seems less valid regarding foreign direct investment (FDI) for two reasons. First, the standard advice does not apply if a foreign tax credit is available in the home country of the investor, which frequently would be the case for FDI.<sup>39</sup> Second, the standard advice assumes that the host country (or state) is small. However, an extensive literature on multinationals suggests that they typically exist to earn economic rents.<sup>40</sup> In that case, the host country or state is no longer "small" in the economic sense. That is, there is a reason for the investor to be there and not elsewhere. Therefore, any tax imposed on those rents (as long as it is below 100

percent) will not necessarily drive the investor to leave even if it is unable to shift the burden of the tax to labor or landowners.

That argument clearly holds in the case of rents linked to a specific location, like natural resources or a large market. But what if the rent can be earned in a large number of potential locations?<sup>41</sup> In that case, the host country will not be able to tax the rent if the multinational can credibly threaten to go elsewhere, although once the investment has been made, the rent can be taxed. That situation, which is probably the most common, would require coordinated action to enable all host countries (or states) to tax the rent earned within their borders.

That relates to a second argument, which is that host countries (or states) need to offer tax incentives to be competitive. An extensive literature has demonstrated that taxes frequently play an important role in determining investment location decisions, after other factors like labor costs and infrastructure have been taken into consideration.<sup>42</sup> But all of those studies emphasize that tax incentives are crucial *given the availability of those incentives elsewhere*.<sup>43</sup> Thus, it can be argued that given the need for tax revenues, states would in general prefer to refrain from granting tax incentives, if only they could be assured that no other state would be able to grant them.<sup>44</sup>

### **Restricting the ability of states to compete in granting tax incentives does not truly restrict their autonomy or counter their interests.**

Thus, restricting the ability of states to compete in granting tax incentives does not truly restrict their autonomy or counter their interests. That is the case whenever they grant the incentive only for fear of competition from other states and would not have granted it but for that fear. Whenever competition from other states drives the tax incentive, eliminating the competition does not hurt the state and may aid its revenue-raising efforts (assuming it can attract investment on other grounds, which is typically the case).

Three additional points need to be made from a state tax perspective. The first concerns the question of tax incidence. Because the tax competition that is most relevant to states concerns the corporate income tax, it is

<sup>36</sup>Rosanne Altshuler and Harry Grubert, "Taxpayer Responses to Competitive Tax Policies and Tax Policy Responses to Competitive Taxpayers: Recent Evidence," *Tax Notes Int'l*, June 28, 2004, p. 1349.

<sup>37</sup>See, e.g., Roderick M. Hills Jr., "Compared to What? Tiebout and the Comparative Merits of Congress and the States," in *Constitutional Federalism* (2005), and articles cited therein.

<sup>38</sup>Assaf Razin and Efraim Sadka, "International Tax Competition and Gains From Tax Harmonization," *37 Economics Letters* 69 (1991).

<sup>39</sup>Timo Viherkentta, *Tax Incentives in Developing Countries and International Taxation* (1991).

<sup>40</sup>Jean-Francois Hennart, "The Transaction Cost Theory of the Multinational Enterprise," in Pitelis and Sugden (eds.), *The Nature of the Transnational Firm* (1991).

<sup>41</sup>John Dunning, *Explaining International Production* (1988).

<sup>42</sup>Eric Bond, "Tax Holidays and Industry Behavior," 63 *Review of Economics and Statistics* 88 (1981); Michael J. Boskin and William G. Gale, "New Results on the Effects on Tax Policy on the International Location of Investment," in Martin Feldstein (ed.), *The Effects of Taxation on Capital Accumulation* (1987); James R. Hines Jr., "Lessons From Behavioral Responses to International Taxation," 52 *National Tax Journal* 305 (1999).

<sup>43</sup>Stephen E. Guisinger and Associates, *Investment Incentives and Performance Requirements* (1985).

<sup>44</sup>Peter Enrich, "Saving the States From Themselves: Commerce Clause Constraints on State Tax Incentives for Business," 110 *Harv. L. Rev.* 377 (1996); Hellerstein and Coenen, *supra* note 7; Zelinsky, *supra* note 1.

important to attempt to assess the incidence of that tax in evaluating the effects of collecting it on the welfare of the state. Unfortunately, after decades of analysis, no consensus exists on the incidence of the corporate tax. While the older studies have tended to conclude that the tax is borne by shareholders or by all capital providers, more recent studies have suggested that the tax is borne to a significant extent by consumers or by labor.<sup>45</sup> Another possibility is that the tax on established corporations was borne by those who were shareholders when the tax was imposed or increased, because thereafter it is capitalized into the price of the shares.<sup>46</sup> Yet a third possibility, articulated by Charles McLure, is that the state corporate income tax — and its economic incidence — should be analyzed as a tax on the factors that are used to apportion income to the state (namely, property, payroll, and sales, in various proportions).<sup>47</sup> It is unlikely that the debate will be decided anytime soon (in fact, the incidence may be shifting over time, especially as globalization may enable corporations to shift more of the tax burden to labor). However, from the perspective of a state deciding whether to collect taxes from a multinational, three out of the four possible alternatives for incidence (current shareholders or capital providers, old shareholders, and consumers) are largely the residents of other jurisdictions, and therefore, from a state welfare perspective, the state gains by collecting the tax. And even if some of the tax is shifted to labor in the state, it can be argued that as a matter of tax administration it is more efficient (as well as more politically acceptable) to collect the tax from the multinational than to attempt to collect it from the workers.

Second, it should be noted that a state may want to collect taxes from multinationals even if in general it believes that the private sector is more efficient in using the resources than the public sector. That is because, in the case of a foreign multinational, the taxes that the state fails to collect may indeed be used by the private sector, but in another jurisdiction, and therefore not benefit the state. One possible solution, which is in fact employed by states, is to refrain from taxing multinationals while they reinvest domestically, but tax them on remittance of the profits abroad. However, that taxation of dividends and other forms of remittance is subject to the same tax competition problem that we discussed above. Thus, it would appear that overcoming the tax competition problem is in most cases in the interest of states, and the question remains how to do so in the face of the collective-action problem described above.

Finally, restricting state tax competition is in the interest of the United States as a nation. From a U.S. national perspective, once a multinational has decided to

invest somewhere in the United States, state tax competition involves a pure welfare loss and a windfall gain to the MNE, because the benefits to the United States are the same wherever the investment takes place.<sup>48</sup> Thus, from a national perspective, state and local tax competition to attract MNEs, of the sort engaged in by Toledo, is undesirable.

#### IV. What if Toledo Were a Country?

##### A. The WTO Rules

There are two articles of the General Agreement on Tariffs and Trade that bear directly on taxation. GATT Article III provides that “internal taxes . . . should not be applied to imported or domestic products so as to afford protection to domestic production.” Because of the reference to products, that provision has generally been understood as referring only to indirect taxes (that is, excise taxes or consumption taxes like the VAT). However, even if the article is interpreted as referring to direct taxes as well, it seems unlikely that the income tax in particular can be used as an instrument for protecting domestic production, because of the difficulty of designing income tax provisions that will apply only to foreign production.

GATT Article XVI provides in general for notification procedures in the case of any “subsidy . . . which operates directly or indirectly to increase exports of any product from, or to reduce imports of any product into, [a contracting party’s] territory.” The article also expressly prohibits the use of any subsidy “on the export of any product . . . which subsidy results in the sale of such product for export at a price lower than the comparable price charged for the like product to buyers in the domestic market.” A note clarifies that the exemption of an exported product from taxes borne by the like product when destined for domestic consumption (like zero rating exports for the VAT) “shall not be deemed to be a subsidy.”

Article XVI was significantly expanded by the Subsidies Code included in the 1994 version of GATT. The Subsidies Code defines “subsidy” as including cases where “government revenue that is otherwise due is foregone or not collected.” To be actionable under GATT, a subsidy must be “specific to an enterprise or industry or group of enterprises or industries.” Also, a specific subsidy is prohibited only if it is “contingent, in law or in fact . . . upon export performance” or “upon the use of domestic over imported goods.” Annex I to the Subsidies Code includes an “illustrative list of export subsidies” that includes “the full or partial exemption, remission, or deferral specifically related to exports of direct taxes . . . paid or payable by industrial or commercial

<sup>45</sup>Joseph A. Pechman, *Federal Tax Policy* (1987); U.S. Treasury, *Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once* (1992).

<sup>46</sup>Pechman, *supra* note 45.

<sup>47</sup>See Charles E. McLure Jr., “The State Corporate Income Tax: Lambs in Wolves’ Clothing,” in Henry J. Aaron and Michael J. Boskin, (eds.), *The Economics of Taxation* 327 (1980); Charles E. McLure Jr., “The Elusive Incidence of the Corporate Income Tax: The State Case,” 9 *Pub. Fin. Q.* 395 (1981).

<sup>48</sup>It is plausible to assume that a multinational like Daimler-Chrysler would decide to locate its production in the United States rather than in, for example, Canada or Mexico, because of transportation costs and regulatory factors, even in the absence of tariffs. See, e.g., Daimler’s decision to produce SUVs in Alabama rather than in Mexico was because of transportation costs that more than overcome any Mexican labor cost advantage.



enterprises." However, a footnote clarifies that the language "is not intended to limit a Member from taking measures to avoid the double taxation of foreign-source income earned by its enterprises."

Importantly, the Subsidies Code applies only to goods, not to services. Services are addressed in the General Agreement on Trade in Services (GATS). Because services frequently involve FDI, in this case the line between trade and investment is particularly blurred. Therefore, the United States inserted provisions in GATS that prevent it from overriding domestic tax legislation and income tax treaties applicable to FDI. In particular, the provision of national treatment for service providers can be avoided if "the difference in treatment is aimed at ensuring the equitable and effective imposition or collection of direct taxes." In addition, most favored nation (MFN) treatment can be avoided if the difference in treatment follows from a tax treaty. GATS does not include a provision on subsidies.

### B. Application to Toledo

If Toledo were an independent country, the tax incentives granted to DaimlerChrysler would clearly violate the Subsidies Code. First, they would have been a subsidy, because Toledo refrains from collecting revenue that it would otherwise have collected (and does collect from other, similar businesses). Second, they would clearly have been "specific to an enterprise" because they were negotiated with DaimlerChrysler. Third, because very few of the cars assembled in Toledo are in fact sold in that city, the incentives would have been "contingent . . . in fact . . . upon export performance." Thus, if another country were to launch a complaint in the WTO's dispute resolution body, Toledo would presumably lose. The WTO could also warn Toledo that it was violating the Subsidies Code through its trade policy review mechanism.<sup>49</sup>

Toledo is not a country, and therefore its tax incentives probably are not a violation of GATT. GATT does in fact apply to subnational taxes,<sup>50</sup> and it could be argued that the term "export" in the Subsidies Code refers to export outside the jurisdiction granting the subsidy. However, I believe the better view is that "export" refers only to international exports, because that is the type of trade addressed by GATT. Thus, because most or all of the cars manufactured by DaimlerChrysler in Toledo are sold in the United States, the tax incentive is not a violation of GATT.

Still, as a policy matter, it is important to note that the type of incentives granted by Toledo are contrary to established WTO rules on export subsidies. We will return to this issue in the conclusion.

<sup>49</sup>See Michael Daly, "The WTO and Direct Taxation," WTO Discussion Paper No. 9 (June 2005).

<sup>50</sup>See Charles E. McLure and Walter Hellerstein, "Does Sales-Only Apportionment Violate International Trade Rules?" *Tax Notes*, Sept. 9, 2002, p. 1513.

## V. What if Toledo Were a Member of the EU?

### A. The EU State Aid Rules

Under articles 87-89 of the Treaty of Rome, a "state aid" is "incompatible with the common market" if it is an "aid" that is "conferred" in any form whatsoever (as long as there is a financial benefit) by a member state out of state resources, the aid is available only to some undertakings or products, and the aid distorts or threatens to distort intracommunity competition and trade.<sup>51</sup> Under that language, numerous targeted tax incentives have been struck down either by the European Commission or by the ECJ.<sup>52</sup>

### B. Application to Toledo

The tax incentive offered by Toledo would be a prohibited state aid if Toledo were a member state. It would have been an aid conferred out of state resources to a particular company, and under well-established ECJ precedents, it would distort intracommunity trade.<sup>53</sup> Thus, the commission would probably take action against it, and if necessary the ECJ would strike it down.

Of course, because Toledo is not a member state, the EC Treaty is inapplicable. But the view of tax competition embodied in it offers an interesting contrast to the view taken by the U.S. Supreme Court.

## VI. Conclusion: Why *Cuno* Should Be Affirmed

If the Supreme Court were starting from a clean slate, it could have used *Cuno* to adopt the same policy embodied in the EU and WTO rules: All targeted subsidies and tax incentives that distort trade and investment within the United States should be prohibited under the Commerce Clause. As explained above, that kind of targeted tax competition among the states is not in the best interest of the states themselves or of the United States.<sup>54</sup>

But the Court has refused to treat subsidies as prohibited by the Commerce Clause, and it is unlikely to change its mind.<sup>55</sup> Nevertheless, I believe *Cuno* offers the Court an opportunity to move forward on the issue, if it affirms the distinction advocated by Profs. Hellerstein and Coenen and adopted by the Sixth Circuit: Subsidies are OK, as are tax incentives granted to lure new business into the

<sup>51</sup>Article 87(1) EC. See generally Biondi, Eeckhout, and Flynn, *The Law of State Aid in the European Union* (2004); Raymond H.C. Luja, *Assessment and Recovery of Tax Incentives in the EC and WTO* (2003).

<sup>52</sup>See Luja, *supra* note 51. The EU also has a "soft law" code of conduct that requires member states to refrain from adopting new tax incentives and roll back existing ones, under threat of invocation of the "hard law" state aid provisions. See Avi-Yonah, "Globalization," *supra* note 13.

<sup>53</sup>See Luja, *supra* note 51.

<sup>54</sup>Note that this conclusion does not apply to the setting of generally applicable tax rates, or to differences in the tax base or the mix of taxes employed. The Commerce Clause does not require states to levy an income tax at all, or at any rate. See Avi-Yonah, "Globalization," *supra* note 13, for a defense of this distinction.

<sup>55</sup>See Hellerstein and Coenen, *supra* note 7; Zelinsky, *supra* note 1.



state, but tax incentives to existing businesses to prevent them from moving are discriminatory and coercive. That distinction is consistent with the Court's previous precedents and can be maintained without overruling settled law.<sup>56</sup>

The Court has three options in *Cuno*. It can reverse on the standing issue, in which case it will simply postpone the day until it addresses the issue on the merits, when a taxpayer with unquestioned standing petitions for review.<sup>57</sup> It can reverse on the merits, in which case harmful tax competition will flourish. Or it can affirm on the merits.

If the Court chooses to affirm on the merits, that will transfer the debate to the body empowered by the Constitution to make those judgments: Congress. Congress is

likely to take the matter up because affirming *Cuno* will lead to widespread doubts about the validity of other state tax incentives. The Sixth Circuit decision has already spawned proposed legislation, but a Supreme Court decision is likely to increase dramatically the relative importance of the issue on Congress's legislative agenda.<sup>58</sup>

There is a reason both the WTO and the EU have adopted a broad prohibition of the kind of tax incentive at stake in *Cuno*: Those incentives distort investment patterns, confer windfall gains on taxpayers, and force the states into a prisoner's dilemma. Congress, not the Supreme Court, is best positioned to assess those policy arguments. But the issue will receive congressional attention only if *Cuno* is affirmed. That is the fundamental reason why the Court should affirm the Sixth Circuit decision in *Cuno*.

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<sup>56</sup>Hellerstein and Coenen, *supra* note 7.

<sup>57</sup>For example, if the Supreme Court remanded *Cuno* to the state courts and the state courts ruled against DaimlerChrysler (adopting the Sixth Circuit's analysis), DaimlerChrysler would have standing in federal court to challenge the denial of a state tax benefit on federal constitutional grounds. Alternatively, a taxpayer that was denied the ITC because it failed to qualify for its benefits would clearly have standing to challenge the denial in federal court. *Cf. Westinghouse Elec. Corp. v. Tully*, 466 U.S. 388 (1984) (entertaining taxpayer challenge to discriminatory state tax incentive).

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<sup>58</sup>On the current proposed legislation, see Walter Hellerstein, "*Cuno* and Congress: An Analysis of Proposed Federal Regulation Authorizing State Economic Development Incentives (2005)," analyzing the Economic Development Act of 2005, S. 1066, 109th Cong., 1st Sess. (2005); H.R. 2471, 109th Cong., 1st Sess. (2005). As the article points out, Congress, in response to *Cuno*, has already approved a narrow state tax incentive limited essentially to taxpayers engaged in the production of electricity from coal mined in the state that employs scrubbers or other forms of clean coal technology.