Unilateral Tax Policy for Attracting High-Skilled Individuals in a Globalized Economy

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＜要約＞

　本論文は，経済のグローバル化・デジタル化によって可動性を増す個人，とりわけ高技能労働者をめぐる租税競争を題材に，一国（単独）主義的な観点からどのような租税政策がありうるかを，経済学・法学双方の観点から分析したものである。

　近年，経済のグローバル化・デジタル化により，企業や資本だけでなく自然人，とりわけ高技能労働者についても可動性が増してきた。そして，高技能労働者の可動性の高まりは，労働所得課税を含む個人所得税をめぐる租税競争につながる。この問題は，租税政策論議において効率性を優先する人々にとっても重要である。個人直接税の最適な課税ベースに関する文献では，法人所得を含む資本所得への非課税は十分に正当化できるが、労働所得への逆進課税まで常に支持するものではない。しかし，高技能労働者をめぐる租税競争はまさにそのような結果をもたらしうる。

　そこで，本論文では，高技能労働者をめぐる租税競争環境下で，多国間協調が存在しない場合に主権国家がとりうるアプローチについて分析した。具体的には，欧州と日本の状況から，新規居住者のみを対象として税制優遇措置を与えるアプローチ（アプローチ１）と，形式的には既存居住者を含むすべての居住者に税制優遇措置を及ぼすものの，その便益を受ける者が事実上高技能・高所得労働者に限定されるような形で税制優遇措置を与えるアプローチ（アプローチ２）に類型化し（chapter 4.2），いずれがより害悪が少ないかを経済学・法学双方の観点から検討した。

　経済分析では，シンプルなゲーム理論に基づく分析の結果，自国の税収最大化の観点から，①とりわけ規模の大きく，既存居住者の可動性が低い前提の下では，アプローチ１がアプローチ２より害悪が少ないこと，②規模が同等の国の間では，互いに租税競争に従事しないよう協調することで囚人のジレンマ状況から脱することができるが，国の規模が異なれば，小国にとっては大国と協調するよりも，むしろ租税競争に従事することによって税収最大化を図ることができること，③大国が小国に協調してもらうためには，小国が協調することによる税収減への補償金の支払いが必要となること，といった含意を導いた（chapter 4.3）。

　法的分析では，まず，アプローチ１は，主として市民で構成される既存居住者と非市民で構成される新規居住者との間の対立を惹起する一方，アプローチ２は，高所得者と中低所得者との間の対立を惹起すると整理した。そのうえで，いずれがより害悪が少ないかを，民主主義国家の構成員（member）の視点から考察した。そして，構成員の判断基準として，①居住を基準とする立場，②国籍・市民権を基準とする立場，に大別して主な論者の見解を取り上げ，両アプローチへの評価を推論した。

　具体的には，①OECD の「有害な税の競争」レポートで問題視された ring-fencing に着目すると，アプローチ１は問題が大きいが，アプローチ２は BEPS 行動計画５のネクサスアプローチの下で正当化されうると推論した。②居住者性を基準に構成員を判断する

Dietsch & Rixen の考え方からは，構成員の一部にのみ税制優遇を与えるアプローチ1は正統性がなく，アプローチ2については，他国の税収を損ない集合的に最適な水準を下回る税収しか確保できなくなる点で正統性を失う，と推論した。③Dagan の考え方からは，構成員の可動性に着目して税制上の取扱いを異ならせ，担税力に基づく税負担の決定を困難にするため，アプローチ1は，各構成員を「平等な敬意と配慮（equal respect and concern）」をもって取り扱わないことになるので拒絶されることになり，アプローチ2も，その事実上の受益者が高所得・高技能者に限定されることが意図され，結果的に逆進的な課税につながるのであれば拒絶される，と推論した。その一方で，④市民権の有無により構成員を判断する Schön の考え方によれば，民主的政治過程を経て非市民に税制優遇措置を与えることへの憲法的制約はほとんどなく，アプローチ1は，新規居住者が非構成員によって占められている限りで正当となり，アプローチ2は，可動性の高い構成員を自国に引き留めておくことがより恵まれない他の構成員にとって望ましい限りにおいて正当性を有しうることになる，と推論した。

　筆者は Schön の考え方を支持した上で，民主主義にその正統性が立脚していることに鑑み，政治的顕示性は低いもののいったんそれが明るみになれば構成員（市民）間のより深い分断を招くアプローチ2よりも，構成員と非構成員との間の対立を惹起するものの政治的顕示性の高いアプローチ1の方が，導入されるのであれば法的に害悪が少ないと結論づけた。

Blueprint for Individual Income Taxation Reform in a Globalized World

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Chapter 4

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Takayuki Nagato*

4.1. Introduction

The advancement of technologies has significantly accelerated the globalization of the economy and increased the mobility of companies and capital, leading to tax competition between states over corporate and capital income taxation. It has long been warned that intensified tax competition threatens to undermine capital and corporate income taxation to fund modern welfare states.[1] Nevertheless, states have attempted to put some restraints on tax competition. Since the late 2000s, states have implemented a series of countermeasures to establish an international framework for sharing information on bank accounts among tax authorities to capture financial income.[2] Regarding corporate income taxes, the OECD's base erosion and profit shifting (BEPS) Project aimed at multilateral cooperation to curb profit shifting by exploiting the difference in tax rules between states with the concept of "value creation".[3] Moreover, OECD's Global Anti-Base Erosion (GloBE) rules are intended to set a floor for corporate tax competition via global minimum taxes that target the world's largest multinational enterprises (MNEs).[4]

1.   Avi-Yonah, R. S. (1999). Globalization, tax competition, and the fiscal crisis of the welfare state. *Harvard Law Review*, *113*(7), 1573–1676. https://doi.org/10.2307/1342445.
2.   OECD. (2014). *Standard for automatic exchange of financial account information in tax matters*. OECD. https://www.oecd-ilibrary.org/taxation/standard-for-automatic-exchange-of-financial-account-information-for-tax-matters_9789264216525-en; OECD. (2017). *Standard for automatic exchange of financial account information in tax matters* (2nd ed.). OECD. https://www.oecd-ilibrary.org/taxation/standard-for-automatic-exchange-of-financial-account-information-in-tax-matters-second-edition_9789264267992-en.
3.   OECD. (2015). *BEPS project explanatory statement: 2015 final reports*. OECD. https://www.oecd-ilibrary.org/taxation/beps-project-explanatory-statement_9789264263437-en.
4.   OECD. (2021). *Statement on a two-pillar solution to address the tax challenges arising from the digitalisation of the economy*. https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.pdf.

However, companies and capital are not the only things that increase their mobility. It has long been suggested that individuals are also increasing their mobility.[5] In particular, the increased mobility of high-skilled individuals leads to tax competition over individual income taxes, including labour income taxes. In Europe, the institutional premise of a single market oriented towards ensuring freedom of movement for EU citizens has led to intense tax competition to attract high-skilled labourers.[6]

This issue is problematic even for those who prioritize efficiency in tax policy analysis. While the literature on the optimal tax base for individual direct taxation can provide sound justification for not taxing capital income, including corporate income, it does not always support regressive taxation of labour income.[7] However, tax competition to attract high-skilled individuals results in this consequence.

Although competition over individual income taxes can be suboptimal, sovereign states cannot resolve this issue without multilateral cooperation. Tax competition over individual income taxes causes not only an economic issue of insufficient revenue raising for the provision of public goods and redistribution but also a legal issue of undermining the social contracts of democratic states through unequal treatment of its members.[8] To address this issue, it has been ambitiously proposed that the wealthiest individuals should be subject to global minimum taxes.[9] However, reaching an agreement on imposing global minimum taxes on the wealthiest individuals seems much more difficult than corporate taxes, given the number and variety of home states of the wealthiest individuals. An alternative proposal put forward is to bundle essential public goods and services with an appropriate level of tax payments as membership fees.[10] While it is crucial to explore multilateral cooperative measures to tackle this issue, it is equally imperative for a state to identify the least detrimental unilateral approach in the context of unrestricted tax competition.

In this regard, Japan (deliberately or not) has adopted a distinct, yet contentious approach. While numerous states typically provide preferential tax regimes for newly incoming residents, Japan endeavoured to attract foreign

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5.   Avi-Yonah, R. S. (2014). And yet it moves: Taxation and labor mobility in the twenty-first century. *Tax Law Review*, *67*(2), 169–184.
6.   *See* section 4.2.1.
7.   *See* section 4.3.1.
8.   *See* section 4.4.
9.   *See* section 4.3.2.1.
10.   *See* section 4.4.2.3.

high-skilled individuals into its financial industry by providing preferential tax treatment not limited to newly incoming residents but to all its residents who earn a specific category of income, namely, carried interest.[11]

From the experiences in European countries and Japan, we can categorize unilateral tax policies to attract high-skilled individuals into two approaches: a tax preference is provided only to newly incoming high-skilled residents; or a tax preference is provided to all residents, but its de facto beneficiaries are limited to high-skilled residents.

The latter approach has the advantage of lowering political salience and minimizing political conflict between existing resident citizens and incoming resident non-citizens. However, this approach presents economic and legal challenges. First, the provision of tax preferences through this approach is economically inefficient, as it grants these preferences to high-skilled resident citizens who are less mobile than high-skilled foreigners due to cultural, linguistic and familial factors. Second, it presents the problem of unequal treatment between high and low-skilled citizens and often between high and mid or low-income citizens.

The author hypothesizes that affording tax preferences solely to newly incoming residents (mainly non-citizens), even if it results in disparate taxation between resident citizens and non-citizens, would be a more suitable second-best unilateral tax policy for attracting high-skilled individuals than granting tax preferences to all residents who can earn a specific type of income to protect democratic states comprising citizens with voting rights in the political community.

The remainder of this chapter is organized as follows. Section 4.2. provides the background of the current state of tax competition over individual income taxes in Europe and Japan's uncommon approach to attract high-skilled individuals to its financial industry. These are categorized into two ideal types of approaches that sovereign states can adopt as a second-best unilateral tax policy to attract high-skilled individuals in a globalized economy in the absence of multilateral cooperation, namely (i) providing tax preferences only to newly incoming residents; or (ii) providing tax preferences to all residents. Section 4.3. reviews the economic literature on optimal labour income taxation, tax competition and preferential tax regimes to evaluate which approach is better from an economic perspective. Section 4.4. presents a legal analysis comparing the two approaches and

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11.   *See* section 4.2.2.

concludes that the former is less detrimental to protecting the social contract of a democratic political community. Section 4.5. provides a summary of this discussion.

4.2. Background

4.2.1. Europe: Preferential labour income tax regimes for new residents

An empirical study demonstrates that from the mid-1990s to 2007, during which time globalization of the economy significantly progressed, the effective tax rates on labour income of the top 1% – who were presumed to be mobile – declined, whereas those of the median earners – who were presumed to be less mobile – slightly increased compared to the period of the preceding 14 years in the 65 biggest jurisdictions surveyed.[12] This finding is in line with the expectation that it is more efficient to tax the less mobile factors. However, due to the scarcity of suitable data on migration and credible tax variation, it is difficult for empiricists to provide direct evidence of the effect of individual income taxes on migration.[13] The limited literature on this topic focuses on a specific jurisdiction or occupation due to limited availability of data.[14] A recent study more generally examines the migration responses of the European top 10% earners to the changes in the top marginal tax rate of labour income, which serves as a plausible proxy for the average tax rate of those taxpayers, and finds that the elasticity of the net-of-tax rate computed for foreign residents is significantly larger than that of the top 10% in general.[15] This implies that foreign residents in the top

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12.   Egger, P. H., Nigai, S., & Strecker, N. M. (2019). The taxing deed of globalization. *The American Economic Review*, *109*(2), 353–390. https://doi.org/10.1257/aer.20160600.
13.   Kleven, H., Landais, C., Muñoz, M., & Stantcheva, S. (2020). Taxation and migration: Evidence and policy implications. *The Journal of Economic Perspectives*, *34*(2), 119–142. https://doi.org/10.1257/JEP.34.2.119.
14.   Kleven, H. J., Landais, C., & Saez, E. (2013). Taxation and international migration of superstars: Evidence from the European football market. *American Economic Review*, *103*(5), 1892–1924. https://doi.org/10.1257/aer.103.5.1892; Kleven, H. J., Landais, C., & Schultz, E. (2014). Migration and wage effects of taxing top earners: Evidence from the foreigners' tax scheme in Denmark. *The Quarterly Journal of Economics*, *129*(1), 333–378. https://doi.org/10.1093/qje/qjt033; Akcigit, U., Baslandze, S., & Stantcheva, S. (2016). Taxation and the international mobility of inventors. *American Economic Review*, *106*(10), 2930–2981. https://doi.org/10.1257/aer.20150237.
15.   Muñoz, M. (2023). *Do European top earners react to labour taxation through migration?* Google Docs. https://drive.google.com/file/d/1RtRhjMv8K4-2VJOcAi3DvaLqr0187x2Q/view.

10% are much more sensitive to the tax burden and mobile than domestic residents at the same income level.

In Europe, it is noteworthy that intense competition over individual income taxes is observed given the institutional premise of freedom of movement for EU citizens in a single market.[16] In European countries, the top statutory tax rates continued to decline between 1995 and the financial crisis of 2008. Throughout this 15-year-long period, the average top statutory rate in EU countries decreased from nearly 48% to less than 40%.[17] Following the financial crisis of 2008, to mitigate fiscal damage, EU countries switched to other forms of tax competition to attract individuals by using preferential tax regimes for newly incoming tax residents.[18] The EU Tax Observatory report summarizes three categories of preferential tax regimes for new residents: (i) special treatment of foreign sources or worldwide income; (ii) regimes targeting income earned while performing a certain economic activity in the host country; and (iii) regimes targeting pensioners.[19] Category (ii) has significant importance for the objective of this study, as it results in a regressive taxation of labour income. European countries that have already been equipped with preferential labour income tax regimes for newly incoming residents include Belgium, Denmark, Finland, Greece, Ireland, Italy, the Netherlands, Portugal, Spain and Sweden.[20] Despite the varieties and differences in these preferential regimes in their details, their common feature is that they provide preferential tax rates or special allowances for a specified period of time to the labour income of new residents who have not been residents of the host states for a specified period of time.[21] For instance, Portugal has a preferential tax rate of 20% and a duration of 10 years, and Spain has a rate of 24% and a duration of 6 years. In numerous instances, the effective tax rates for eligible residents can be less than half of the effective tax rates of ineligible top earners. An empirical study reports a large effect of these preferential tax regimes on the elasticity of eligible foreigners.[22] Although several countries restricted or shrunk their regimes

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16.   Articles 45-48 of the Treaty of the Function of the European Union.
17.   *See* Flamant, E., Godar, S., & Richard, G. (2021). *New forms of tax competition: An empirical investigation*. EU Tax Observatory. sec. 3.1 https://www.taxobservatory.eu/publication/new-forms-of-tax-competition-an-empirical-investigation/.
18.   Id. sec. 3.2.1.
19.   Id.
20.   *See* Krajcuska, F. (2024). The future of special individual income tax regimes for inward expatriates in the European Union. *European Taxation*, *64*(2/3). sec. 2.3., Journals IBFD.
21.   Id.
22.   *See* Kleven et al. (2013), at 1907-1914.

recently,[23] there is still an ongoing trend to provide preferential tax regimes for new residents' labour income.

It is certain that the tax preferences of category (i) also hold considerable significance in attracting high-skilled foreign workers. Indeed, the prevalence of non-dom status among high-skilled migrants in the UK finance industry provides a compelling illustration of this point.[24] However, the author confines his analysis to the tax preferences of category (ii).

4.2.2. Japan: A de facto tax preference for high-skilled residents

In contrast to European countries, Japan's preferential tax regime for incoming residents is relatively modest. There is no tax preference for incoming residents' labour income earned within its territory. It is true that there is a form of remittance-based taxation for non-permanent residents,[25] but Japan restricted the scope of eligible residents in 2006 to address abusive use by some nationals and foreigners.[26] However, Japan has recently endeavoured

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23. Belgium, Italy, the Netherlands and Portugal revised their preferential tax regimes in recent years (Krajcuska, 2024)*. See* Palmitessa, E. A. (2024). Italy's tightened tax rules for attracting human capital: A welcome change or a missed opportunity?. *Tax Notes International*, *113*, 1627-1633; Beretta, G., & Cipollini, C. (2024). The new Italian tax regime for inbound workers: Has the "Bel Paese" become less attractive for inward expatriates? *European Taxation*, *64*(4), Journals IBFD; Moniz, R. B. (2024). The New Portuguese Tax Incentive Regime for Expatriates. *European Taxation*, *64*(5), Journals IBFD; Offermanns, R. (2024). Overhaul of Dutch Special Regime for Inbound Expats. *European Taxation*, *64*(6), Journals IBFD.

24. Administrative data of the UK taxpayers revealed that share of migrants (many of which have claimed non-dom status at some point) in the top 1% of income distribution in the United Kingdom is 1.4 times higher than the share at the median, and 47% of top income to migrants comes from the finance industry, implying that they earn mainly labour income. *See* Advani, A., Koenig, F., Pessina, L. & Summers, A. (2024). Immigration and the top 1 percent. *Review of Economics and Statistics*. https://doi.org/10.1162/rest_a_01408; Advani, A. (2022). *The UK's 'non-doms': Who are they, what do they do, and where do they live?* https://policycommons.net/artifacts/3133845/the-uks-non-doms/3927076/. The UK government announced the abolition of the non-dom status in April 2025 and introduction of new preferential regimes from April 2025. *See* HM Treasury. (2024). *Spring budget 2024: Non-UK domiciled individuals policy summary*. GOV.UK. https://www.gov.uk/government/publications/spring-budget-2024-non-uk-domiciled-individuals-policy-summary/.

25. JP: Income Tax Act (*Shotokuzei-ho*), 1965 (amended 2024), art. 2-1(iv). *See* Ault, H. J., Arnold, B. J., & Cooper, G. S. (2020). *Comparative income taxation: A structural analysis* (4th ed.). Wolters Kluwer. p. 566.

26. *See* Ministry of Finance (2006). *Heisei 18 nendo zeiseikaisei no kaisetsu* [Explanation of the Tax Reform of 2006]. Ohkura-zaimukyokai. p. 452.

to attract foreign high-skilled individuals by offering preferential tax treatment not only to incoming residents but also to all its residents. In 2021, the Japanese government issued an administrative notice without legislation on the taxation of carried interest[27] earned by the managers of private equity funds to resolve interpretative uncertainty. The notice confirms that carried interest – when its profit distribution has economic rationality – is taxed not as labour income, which is subject to the top marginal tax rate of 55%, but as capital income, which is subject to a flat 20% tax rate under the existing law.[28] The stated purpose of the clarification is to attract foreign talent, businesses and investment to establish Japan's position as an international financial centre in Asia and the world.[29]

Whether carried interest should be taxed as capital income or labour income has been heavily discussed in other jurisdictions.[30] Several jurisdictions have adopted an interpretation of existing law that classifies carried interest as labour income. At the same time, these jurisdictions have introduced preferential tax regimes for carried interest that meet specific conditions.[31]

For instance, Hong Kong, which is in a rivalry relationship with Japan (Tokyo) for international financial hubs in Asia, introduced a special tax exemption for qualified carried interest in 2021 to attract international private equity funds. In Hong Kong, carried interest is considered as compensation received for the performance of services in connection with asset management activities, which is subject to salary tax with a top marginal

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27.　"Carried interest" refers to the certain share (in many cases, 20%) of profits other than the fixed management fee the managers of private equity funds receives as a profit-sharing right. *See* Fleischer, V. (2008). Two and twenty: Taxing partnership profits in private equity funds. *New York University Law Review*, *83*(1), 1–59. p. 8.

28.　The Financial Services Agency (2021). *Partial revision of the notice regarding the tax treatment of Carried Interest.* https://www.fsa.go.jp/en/news/2021/20210401.html.

29.　Ministry of Finance (2021). *Reiwa 3 nendo zeiseikaisei no kaisetsu* [Explanation of the Tax Reform of 2021]. Ohkura-zaimukyokai. p. 81.

30.　*E.g.* Fleischer, V. (2008); Weisbach, D. A. (2008). The taxation of carried interests in private equity. *Virginia Law Review*, *94*(3), 715–764; Kim, Y. R. (2018). Carried interest and beyond: The nature of private equity investment and its international tax implications. *Virginia Tax Review*, *37*(3), 421–484; Neidle, D. (2023). Carried too far'?: A challenge to the tax treatment of carried interest in the private equity industry. *British Tax Review*, *2023* (1), 45-67; Walker, M. (2023). Carried interest: A response, *British Tax Review*, *2023*(3), 251-261; Imparato, D. (2024). Private equity's byzantine tax stand: An untold and new story of carried interest, *British Tax Review*. *2024*(1), 104-132.

31.　*See* DLA Piper. (2023). *Carried interest: A multi-jurisdictional comparison*. https://www.dlapiper.com/en/insights/topics/carried-interest; Simmons & Simmons (2023). *Carried interest regimes: A European tax overview*. https://www.simmons-simmons.com/en/publications/clk9ifs3u011otpz03d1y00lr/carried-interest-regimes.

rate of 17%, but qualified carried interest is exempt from taxation.[32] This tax exemption regime has already undergone the peer review process of monitoring harmful tax practices as part of the BEPS Action 5.[33]

In Europe, France made a special amendment to the tax regime regarding carried interest taxation (the Holroyd Amendment) in 2018, to present Paris as an alternative to London after Brexit.[34] Although there is an existing tax regime for carried interest, known as the Arthuis Regime that characterizes carried interest not as labour income but as financial income to benefit from the flat 30% tax rate instead of the maximum applicable marginal personal income tax rate of 45% and the specific social security contribution rate of 30% to carried interest treated as employment income in France,[35] the Arthuis Regime is rarely applicable to carried interest in foreign funds.[36] Accordingly, the Holroyd Amendment introduced less stringent eligibility requirements for employees and managers of a foreign fund who newly transferred their tax residence to France than those in the Arthuis Regime.[37]

Unlike France, Japan's approach bypassed the discussion of whether to introduce a preferential regime for newly incoming residents in the private equity industry. This method of providing tax preference can be seen as problematic, considering that Fumio Kishida, who was the Prime Minister at the time, suggested (and soon abandoned) his plan to increase taxes on financial income out of his concern that high-income class taxpayers who earn a larger portion of their income from the sale of stocks and securities are often subject to a lower average tax rate than middle-income class workers.[38] The 2021 clarification of income tax treatment of carried interest entails a similar problem. This implies that only high-skilled individuals

32.   Yip, P. (2021). New tax policy to lure more private equity funds to Hong Kong. *Tax Notes International*, *103*, 705-714.
33.   Johnston, S. S. (2022). Hong Kong's carried interest tax break isn't harmful, OECD says. *Tax Notes International*, *105*, 593.
34.   *See* Tenore, M. (2024). What are the latest special tax regimes that boost the relocation of senior executives/high-net-worth individuals?. In S. V. Kostić, A. B. Moreno, V. Chand, & M. Tenore (Eds.), *Mobility of individuals and workforces: Tax challenges raised by digitalization*, sec. 6.2.3.2., Online Books, IBFD.
35.   *See* Simmons & Simmons (2023), at 3.
36.   Tenore (2024), at sec. 6.2.3.2.
37.   Id.
38.   *See* Kishida, F. (2020). *Kishida vision* [The Kishida vision]. Kodansha. *See also* Hoke, W. (2021, 13 October). Japan's prime minister lowers priority of capital gains tax hike. *Tax Notes Today International*.

who can earn labour income in the disguise of financial income[39] can enjoy the preferential tax rate.

In contrast to individual income taxes, the Japanese government adopted a different approach regarding inheritance taxes to eliminate impediments for foreign high-skilled individuals to come to Japan. It legislated to exempt property located outside Japan's territory from taxable property for inheritance tax purposes if the property is inherited by non-national residents who are residents of Japan for less than 10 years during the 15 years preceding the inheritance.[40] This approach suggests that only incoming non-national residents can enjoy the benefits of exemption.

Although Japan's approach to income taxation of carried interest is only one example of its tax policymaking, it is a good indication that a sovereign state can take an approach to attract high-skilled individuals of providing tax preferences to all its residents, but its de facto beneficiaries are limited to high-skilled individuals.

4.2.3. Summary

A sovereign state can adopt two approaches to attract foreign high-skilled individuals in a globalized economy. First, a tax preference is provided only to newly incoming high-skilled residents (Approach 1). Second, a tax preference is provided to all residents, but its de facto beneficiaries are limited to high-skilled residents (Approach 2). To evaluate these two approaches, further investigation from both economic and legal perspectives is required.

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39.   It is reported in the United Kingdom that carried interest (which is taxed at the rate of 28%) makes up almost 1/20 (4.3%) of realized capital gains by value and goes to a small minority of taxpayers (only 2,000 taxpayers per year), at an average gains of over GBP 1.2 million. *See* Advani, A., Lonsdale, A., & Summers Andrew. (2024). *Who would be affected by capital gains tax reform?* [Policy brief] https://warwick.ac.uk/fac/soc/economics/research/centres/cage/publications/policybriefings/2024/who_would_be_affected_by_capital_gains_tax_reform/.
40.   JP: Inheritance Tax Act (*Souzokuzei-ho*), 1950 (amended 2024), art. 1-3.

4.3. Economic analysis

4.3.1. Debate on ideal tax base of direct taxes for individuals

Both approaches adopt tax preferences for high-skilled individuals, who are presumed to have high earning ability. Therefore, tax preferences targeting high-skilled individuals are likely to lead to regressive labour income taxation. "Regressive" means that the average tax rate on labour income decreases as the income increases.

The optimal income tax literature often argues against the taxation of capital income because an ideal distribution to maximize social welfare can be achieved through labour income or consumption taxation, with an appropriate transfer system that minimizes the accompanying deadweight losses.[41] Accordingly, it is not difficult to justify the preferential tax treatment of capital income and economically equivalent wealth from the efficiency perspective.

In contrast, other justifications are required to offer tax preferences for labour income. It is well known that the optimal marginal tax rate should decline when we factor in the effect on the work incentives of high earners.[42] However, the progressivity of the entire structure of the tax and transfer system should be ensured in this model.[43] Available measures to achieve progressivity include not only cash demogrants but also in-kind public expenditure for public education and medical care, from which lower-income individuals benefit the most.

Put differently, if progressivity is not ensured on the transfer side, this argument does not necessarily support the preferential taxation of high earners. It is suggestive that several tax reform plans to switch from comprehensive income tax to only labour income tax aim to achieve progressivity on the tax side. Both the renowned flat tax and the X tax reform plans pursue rent tax

41.   *See* Atkinson, A. B., & Stiglitz, J. E. (1976). The design of tax structure: Direct versus indirect taxation. *Journal of Public Economics*, *6*(1), 55–75. https://doi.org/10.1016/0047-2727(76)90041-4; Bankman, J., & Weisbach, D. A. (2006). The superiority of an ideal consumption tax over an ideal income tax. *Stanford Law Review*, *58*(5), 1413–1456.
42.   *See* Mirrlees, J. A. (1971). An exploration in the theory of optimum income taxation. *The Review of Economic Studies*, *38*(2), 175–208. https://doi.org/10.2307/2296779; Bankman, J., & Griffith, T. (1987). Social welfare and the rate structure: A new look at progressive taxation. *California Law Review*, *75*(6), 1905–1968; Kaplow, L. (2008). *The theory of taxation and public economics*. Princeton University Press. pp. 74-77.
43.   *See* Kaplow, L. (2006). Taxation and redistribution: Some clarifications. *Tax Law Review*, *60*(2), 57–82.

at the business entity level via cash-flow taxation with deductible wage costs and progressive labour income tax structures at the individual level. The flat tax achieves progressivity by setting the exemption threshold high,[44] and the X tax directly introduces a progressive tax rate schedule at the individual level.[45] Considering the difficulty of precisely adjusting the transfer system to achieve the progressivity of distribution in real politics, regressive labour income taxation should be a concern.

In addition, recent optimal income tax literature, which emphasizes the connection between theory and empirical work,[46] even suggests an increasing marginal tax rate for top earners' labour income. According to Diamond and Saez, it exceeds 70% based on the low elasticity of US top earners estimated from statistical data.[47] Moreover, once deviating from the standard model and factoring in the rent-seeking behaviour of top earners (e.g. US CEOs), the optimal labour tax rate would be higher.[48] Furthermore, it is intriguing that Kaplow recently implied that it might be best to merge capital income and labour income of founders, specialized financiers such as venture capitalists and private equity fund managers to the extent that the current contrasting tax treatment is not optimal, because a substantial portion of these individuals' capital is invested in their own firms without diversification.[49]

However, if we factor in the positive spillover effect of innovation by entrepreneurs, who account for a substantial portion of top earners, the optimal labour income tax rate for these entrepreneurs is estimated to be much lower (even a negative rate).[50]

44.   *See* Hall, R. E., & Rabushka, A. (1995). *The flat tax* (2nd ed.). Hoover Institution Press.
45.   *See* Bradford, D. F. (2004). *The X tax in the world economy: Going global with a simple, progressive tax*. AEI Press; Carroll, R., & Viard, A. D. (2012). *Progressive consumption taxation: The X tax revisited*. AEI Press.
46.   *See* Piketty, T., & Saez, E. (2013). Optimal labor income taxation. In A. J. Auerbach, R. Chetty, M. Feldstein, & E. Saez (Eds.), *Handbook of Public Economics* (Vol. 5, pp. 391–474). Elsevier. https://doi.org/10.1016/B978-0-444-53759-1.00007-8.
47.   *See* Diamond, P., & Saez, E. (2011). The case for a progressive tax: From basic research to policy recommendation. *Journal of Economic Perspectives*, *25*(4), 165–190. https://doi.org/10.1257/jep.25.4.165.
48.   *See* Piketty, T., Saez, E., & Stantcheva, S. (2014). Optimal taxation of top labor incomes: A tale of three elasticities. *American Economic Journal: Economic Policy*, *6*(1), 230–271. https://doi.org/10.1257/pol.6.1.230.
49.   *See* Kaplow, L. (2024). Optimal income taxation. *Journal of Economic Literature*, *62*(2), 637-738. https://doi.org/10.1257/jel.20221647.
50.   *See* Jones, C. I. (2022). Taxing top incomes in a world of ideas. *Journal of Political Economy*, *130*(9), 2227–2274. https://doi.org/10.1086/720394.

In summary, there are good reasons to be concerned about regressive labour income taxation under certain conditions, even from the optimal tax theory perspective. Next, we explore whether regressive labour income taxation is inevitable in a tax competition environment.

4.3.2. Tax competition and preferential tax regimes

4.3.2.1. Game theoretical explanation of tax competition

The influence of tax competition is not considered in section 4.3.1. In a globalized economy, sovereign states cannot ignore other states' tax policies in designing their own tax policies. The economic literature on tax competition reveals that rational states that aim to maximize their tax revenue face a prisoner's dilemma under certain conditions in the absence of coordination.[51] It is estimated that tax competition over individual income taxes will lead to the out-migration of taxpayers at the top of the income distribution while increasing the in-migration of transfer recipients.[52] As a result, the optimal level of redistribution will be lower, meaning that the welfare of lower-income individuals will be significantly reduced, while that of the rich will improve.[53] Therefore, tax competition provides policymakers – who aim to keep the redistribution stable – with a good reason for bilateral and multilateral cooperation in substantive and procedural tax laws, including global minimum taxation, information exchanges and peer monitoring mechanisms to reduce negotiation costs and enhance the reliability of commitments among states.[54] The successful introduction of the GloBE rules motivated some progressive scholars to propose global minimum taxation for the wealthiest individuals.[55] It is also stressed that

51. *See* Keen, M., & Konrad, K. A. (2013). The theory of international tax competition and coordination. In A. J. Auerbach, R. Chetty, M. Feldstein, & E. Saez (Eds.), *Handbook of Public Economics* (Vol. 5, pp. 257–328). Elsevier. https://doi.org/10.1016/B978-0-444-53759-1.00005-4.

52. *See* Muñoz, M. (2023). *How much are the poor losing from tax competition?*. NBER *Working Papers*, Article 31920. https://doi.org/10.3386/w31920.

53. Id.

54. *See* Keen & Konrad (2013), at 287, 307.

55. *See* EU Tax Observatory. (2023). *Global Tax Evasion Report 2024.* ch. 5 https://www.taxobservatory.eu//www-site/uploads/2023/10/global_tax_evasion_report_24.pdf; OECD. (2024). *OECD Secretary-General Tax Report to G20 Finance Ministers and Central Bank Governors, G20 Brazil.* p. 11. https://www.oecd.org/tax/oecd-secretary-general-tax-report-g20-finance-ministers-brazil-february-2024.pdf; Zucman, G (2024). *A blueprint for a coordinated minimum effective taxation standard for ultra-high-net-worth individuals.* https://www.taxobservatory.eu/publication/a-blueprint-for-a-coordinated-minimum-effective-taxation-standard-for-ultra-high-net-worth-individuals/.

internationally coordinated regulation of preferential tax regimes for incoming high-skilled individuals is necessary.[56] However, analysing the unilateral actions that each state can adopt is also urgent in the absence of such multilateral cooperation.

4.3.2.2. Targeted or general tax preference

4.3.2.2.1. *Scenario 1: Low-mobility scenario*

As Keen proves, a state under tax competition pressure can mitigate its harm by differentiating the tax rates applied to each tax base if the elasticities of each tax base differ and are observable.[57] How can we use this finding regarding preferential tax regimes to analyse tax policy for attracting high-skilled individuals?

Here is a simple numerical example.[58] In this example, sovereign States A and B are the only states and have symmetric size of initial labour income tax bases of 100 each and are competing for high-skilled individuals. States A and B aim to maximize their own tax revenue for the provision of public goods and redistribution. The aggregate amount of the tax base is fixed (i.e. 200). This assumption implies that the spillover effects of high-skilled immigrants are negligible. The effect of tax burden on investment decisions and work effort is also put aside. There are two types of workers in each state: Mobile and Immobile. Mobile is defined as mobile workers, who leave their home state if the after-tax income is higher in a host state. Immobile is defined as immobile workers, whose choice of resident state is not affected by the difference in tax rates between the two states. Scenario 1 is a low-mobility scenario, in which the tax base of 20 is from Mobile and the remaining 80 is from Immobile in each state. Each state has three strategies for taxing workers: (i) doing nothing to attract high-skilled individuals; (ii) Approach 1, in which a tax preference is provided only to newly incoming high-skilled residents; and (iii) Approach 2, in which a tax preference is provided to all residents. In both states, the standard and preferential tax rates are assumed to be 50% and 20%, respectively. The assumed high standard rate of 50% implies that we are dealing mainly with high-skilled

56. *See* Piketty & Saez (2013), at 431.
57. *See* Keen, M. (2001). Preferential regimes can make tax competition less harmful. *National Tax Journal*, *54*(4), 757–762. https://doi.org/10.17310/ntj.2001.4.04. *See also* Keen & Konrad (2013), at 304-306.
58. In this chapter, the author intends to exemplify – not provide – formal proofs of discussed propositions.

(high-earning) residents in our examples. Therefore, de facto beneficiaries
of Approach 2 are limited to high-skilled residents.

Table 4.1. summarizes the tax revenue that each state can raise from each
strategy in Scenario 1. This illustrates that a set of choices of (ii) Approach
1 in both states is the Nash equilibrium,[59] where a state's own tax rev-
enue is maximized given the other state's choice of strategy for both states.
However, the equilibrium is not a Pareto optimum[60] because each state can
maximize its revenue simply by (i) doing nothing to attract high-skilled
individuals. This shows the need for cooperation between sovereign states
if the total tax revenue is suboptimal.[61] Moreover, it is intriguing that (iii)
Approach 2 is strictly dominated by both (i) and (ii) for both states, mean-
ing (iii) Approach 2 always gives less tax revenue than the other two strat-
egies.[62] Accordingly, it is irrational for a state that aims to maximize its tax
revenue to choose (iii) Approach 2 without any changes to the assumption
in Scenario 1.

Table 4.1. Low-mobility scenario (Scenario 1)

A \ B	(i) Do nothing	(ii) Approach 1	(iii) Approach 2
(i) Do nothing	(50, 50) [Pareto optimum]	(40, 54)	(40, 24)
(ii) Approach 1	(54, 40)	(44, 44) [Nash equilibrium]	(40, 24)
(iii) Approach 2	(24, 40)	(24, 40)	(20, 20)

4.3.2.2.2. *Scenario 2: High-mobility scenario*

However, the Nash equilibrium is found in another set of strategies when the
mobile population increases. In Scenario 2, it is assumed that tax bases from
Mobile and Immobile account for 80 and 20, respectively, in both states.

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59.   The Nash equilibrium is "the combination of strategies that players are likely to
choose is one in which no player could do better by choosing a different strategy given
the ones the others choose". *See* Baird, D. G., Gertner, R. H., & Picker, R. C. (1994).
Game Theory and the Law. Harvard University Press. p. 310.
60.   A solution to a game is "Pareto optimum" when there is no other set of strategies
in which one of the players is better off and the other players are no worse off. Id. at 311.
61.   *See* Keen & Konrad (2013), at 287.
62.   A dominant strategy is a strategy that is a best choice for a player in a game for
every possible choice by the other player. One strategy is "dominated by" another strategy
when it is never better than that strategy and is sometimes worse. When one strategy is
always worse than another, it is "strictly dominated" (*see* Baird et al. (1994), at p. 306).

Table 4.2. illustrates a set of choices of (iii) Approach 2 in both states is the Nash equilibrium, which is different from Scenario 1. This equilibrium is not a Pareto optimum. Moreover, (iii) Approach 2 is no longer strictly dominated by (ii) Approach 1 in Scenario 2. This difference is due to the change in our assumption of the share of Mobile in each state. From this analysis, it can be inferred that (ii) Approach 1 is superior to (iii) Approach 2 when the share of Mobile in a state is not very high. If a substantial proportion of existing taxpayers (or high-skilled workers) in a state is Mobile, the state would be forced to provide tax preferences for these taxpayers for retention purposes.

Table 4.2. High-mobility scenario (Scenario 2)

B A	(i) Do nothing	(ii) Approach 1	(iii) Approach 2
(i) Do nothing	(50, 50) [Pareto optimum]	(10, 66)	(10, 36)
(ii) Approach 1	(66, 10)	(26, 26)	(10, 36)
(iii) Approach 2	(36, 10)	(36, 10)	(20, 20) [Nash equilibrium]

4.3.2.2.3. *Policy choices depending on the share of the mobiles*

The targeting of tax preferences in Approaches 1 and 2 is summarized in Table 4.3. The gray cells are the targets of the tax preferences in each approach. Although Approach 1 is suitable for granting preferential tax regimes to newly incoming mobile residents, it is not capable of offering the same to potential mobile emigrants. In contrast, since Approach 2 provides all its residents who are presumed to be high earners with tax preferences, it gives unnecessary tax preferences to immobile high earners[63] while appropriately providing tax preferences to mobile potential emigrants.

Depending on the existing share of Mobile and Immobile among high-earning residents in a state's population, a desirable approach for the state will differ. For states where the share of the mobile population among high-earning residents is relatively small (typically large states,[64] including Japan

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63.   If immobile high-income workers can earn that level of income domestically because their productivity at home and host is different, these workers can earn "information rents" through the provision of tax preferences to them. *See* Wilson, J. (2009). Income taxation and skilled migration: The analytical issues. In J. Bhagwati & G. Hanson (Eds.), *Skilled immigration today: Prospects, problems, and policies*. Oxford University Press. p. 294.
64.   *See* Kleven et al. (2020), at 136.

and the United States), it is rational for such states to adopt Approach 1, although such states may suffer slight losses in tax revenue and positive spillovers from emigrating high-skilled individuals.[65] For states where the share of mobile high-skilled residents (potential emigrants) is relatively large (typically small states), it may be worth considering introducing tax preferences for both mobile existing residents (mainly citizens) and new residents (mainly non-citizens). From a distributional perspective, the elimination of potential emigration by high-skilled residents can maintain a level of redistribution.[66]

Table 4.3. Targeting of tax preference

	Approach 1		Approach 2	
Existing residents (mainly citizens, nationals)	Mobile	Immobile	Mobile	Immobile
Incoming residents (mainly non-citizens, foreigners)	Mobile	Immobile	Mobile	Immobile

To discourage potential emigrants from leaving their home states, they can also adopt an approach of taxing emigrants. Ways of taxing emigrants include exit taxes, expansion of unlimited tax liabilities for extended periods and recapture of tax benefits enjoyed previously,[67] although mutual assistance in tax administration between states is indispensable for effective enforcement.

4.3.2.2.4. *Approach 1.5 and inability of governments to observe mobility*

What happens if a state provides a tax preference only to newly incoming residents and mobile existing residents (potential emigrants)?[68] We refer to this approach as Approach 1.5. In Scenario 2.5, in which the assumptions are the same as in Scenario 2, States A and B have four choices of strategies: (i) doing nothing; (ii) Approach 1; (iii) Approach 1.5, in which a tax preference is provided only to newly incoming high-skilled residents and mobile existing residents (potential emigrants); and (iv) Approach 2.

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65.   *See* Wilson (2009), at 294-295; OECD. (2011). *Taxation and employment*. OECD. sec. 4.2 https://www.oecd-ilibrary.org/taxation/taxation-and-employment_9789264120808-en.
66.   *See* Wilson (2009), at 296.
67.   *See* de Broe, L. (2002). General report. In *IFA Cahiers 2002—Volume 87b. The tax treatment of transfer of residence by individuals.*, Online Books IBFD. Recently, Flamant et al. (2021), at sec. 5.2 proposed that expatriates should be subject to unlimited tax liability of home states for a specified number of years after their departure.
68.   The author thanks Ivan Lazarov for suggesting to incorporate Approach 1.5 into the analysis.

Table 4.4. summarizes the tax revenue that each state can raise. If a state has a strategy of Approach 1.5, the Nash equilibrium is found in a set of strategies of (iii) Approach 1.5 in both states, although this is not a Pareto optimum. It should be noted that states can avoid choosing (iv) Approach 2, even in a high-mobility scenario, because Approach 2 is strictly dominated by Approach 1.5 for both states. Therefore, Approach 1.5 is a good alternative to Approach 2 in the high-mobility scenario if it is implementable.

Table 4.4. Approach 1.5 (Scenario 2.5)

B A	(i) Do nothing	(ii) Approach 1	(iii) Approach 1.5	(iv) Approach 2
(i) Do nothing	(50, 50) [Pareto optimum]	(10, 66)	(10, 42)	(10, 36)
(ii) Approach 1	(66, 10)	(26, 26)	(10, 42)	(10, 36)
(iii) Approach 1.5	(42, 10)	(42, 10)	(26, 26) [Nash equilibrium]	(26, 20)
(iv) Approach 2	(36, 10)	(36, 10)	(20, 26)	(20, 20)

Providing a tax preference to high-skilled individuals, who are also high earners, is justifiable by the assumption that high-skilled individuals are generally more mobile than low-skilled individuals because they can find high-paying jobs in other states. The OECD suggests that one indirect and covert way of retaining potential emigrants is to use tax preferences for income types that are more likely to be earned by high-skilled individuals than by other individuals (e.g. employee stock options).[69] Japan's stance on individual taxation of carried interest can be understood as the indirect approach, and Approach 1.5 is also suitable for retaining potential emigrants.

However, it is questionable whether existing high-skilled residents in not only Japan but also other states are so much more mobile. According to several recent empirical studies on the mobility of top earners, Scenario 1 is more realistic than Scenario 2, and nationality or citizenship is a good proxy for low mobility. These studies indicate that the international mobility elasticity to personal income taxes of domestic resident top earners is close

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69. OECD (2011), at 131 and 142.

to zero, while that of foreigners exceeds one[70] – even in a small state such as
Denmark.[71] Therefore, states facing a prisoner's dilemma under the pressure
of tax competition can find a less detrimental way of providing preferential
tax regimes only to newly incoming high-skilled resident foreigners, who
are presumed to be mobile. It is also reasonable to use the requirement of
returning to their home state as a proxy for the high mobility of citizens to
allow access to preferential tax regimes, as in many European countries.

At the same time, the empirical fact that high income does not always
mean high mobility for domestic citizens implies the difficulty of externally
observing the mobility of domestic residents. Although some occupations
can be good proxies for mobility, it is extremely difficult for the govern-
ment to differentiate the applicable tax rates depending on the elasticity
of income earned by each occupation. This implies Approach 1.5 is not a
practical policy choice.

4.3.3. Other considerations

The analysis described in section 4.3.2. was based on simple examples
under the assumption that states have similar sizes; tax competition is a
zero-sum game; and there is no agglomeration economics. However, a more
realistic analysis necessitates consideration of these omitted factors.

4.3.3.1. Size of states

4.3.3.1.1. *No prisoner's dilemma*

The portrayal of tax competition as a prisoner's dilemma is altered when
considering the difference in the size of states. Table 4.5. presents a numer-
ical example of the game between a large State L and a small State S
(Scenario 3). The mobility of high-skilled workers is assumed to be low
in State L and high in State S. The initial tax base of existing high-skilled
residents in State L is 1,000, which consists of 200 from Mobile and 800
from Immobile. In State S, the initial tax base is assumed to be 100, which
consists of 80 from Mobile and 20 from Immobile. It is also assumed that
states, including State S, can accommodate newly incoming residents

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70. *See* Kleven et al. (2013); Kleven et al. (2014); Akcigit et al. (2016); Muñoz (2024).
71. *See* Kleven et al. (2014), at 367.

without deteriorating productivity.[72] States have three strategies, as shown in Scenarios 1 and 2. In this game, the Nash equilibrium is reached when State L chooses (ii) Approach 1 and State S chooses (iii) Approach 2. This equilibrium is not a Pareto optimum because State S can increase its revenue by choosing (ii) Approach 1 without deteriorating the revenue of State L when State L chooses (i) doing nothing. Interestingly, moving to a set of strategies for choosing (i) by both States S and L is not Pareto improving in Scenario 3, unlike Scenarios 1 and 2. For State S, (i) is strictly dominated by (iii) and weakly dominated by (ii). Therefore, it is inevitable for rational State S to engage in tax competition. On the other hand, for State L, (iii) is strictly dominated by (ii), and (i) is weakly dominated by (ii).

If states hope to maximize the total pie of their tax revenue (550), adequate compensation (i.e. more than 40 in Scenario 3) should be paid from State L to State S.[73] Intuitively, there is no prisoner's dilemma, and differences in the size of states make cooperation difficult because small states are worse off by cooperation, and they can maximize their revenue through tax competition.[74]

Table 4.5. Different state size scenario (Scenario 3)

S / L	(i) Do nothing	(ii) Approach 1	(iii) Approach 2
(i) Do nothing	(500, 50)	(400, 90) [Pareto optimum]	(400, 60)
(ii) Approach 1	(516, 10)	(416, 50)	(400, 60) [Nash equilibrium]
(iii) Approach 2	(216, 10)	(216, 10)	(200, 20)

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72. In contrast to capital income, capacity of a host state to absorb the immigrants' workforce and keep their productivity would be a strong constraint condition. These small states are not considered a "tax haven" in a traditional meaning. *See* Keen & Konrad (2013), at 311.

73. We can see the Qualified Domestic Minimum Top-up Tax (QDMTT) in Pillar Two functions as the compensation from large states to small states like investment hubs for their cooperation of agreeing with the minimum tax regime, although the author has a negative view on the QDMTT. *See* Nagato, T. (2023). Pillar 2 as a De Facto New Revenue Allocation Mechanism. *Tax Notes International*, *112*(1), 23-37.

74. On the tax or untax scenario, id. at 274-277, 288; Bucovetsky, S. (1991). Asymmetric tax competition. *Journal of Urban Economics*, *30*(2), 167–181. https://doi.org/10.1016/0094-1190(91)90034-5; Rixen, T. (2008). *The political economy of international tax governance*. Springer. pp. 44-46; Dietsch, P. (2015). *Catching capital: The ethics of tax competition*. Oxford University Press. pp. 56-57 https://doi.org/10.1093/acprof:oso/9780190251512.001.0001.

4.3.3.1.2. *Approach 1.5 and the difference in size of states*

Again, we factor in Approach 1.5 in Scenario 3.5, in which states can externally distinguish Mobile from Immobile. In Scenario 3.5, State L can minimize the harm of tax competition. In Table 4.6., the Nash equilibrium is reached when (iii) Approach 1.5 is chosen by both States L and S; (iv) Approach 2 is strictly dominated by (iii) Approach 1.5 for both states, and a set of strategies of (i) doing nothing in both states is a Pareto optimum. Therefore, State L does not need to pay compensation to State S to incentivize S to cooperate. However, it is difficult for states to distinguish mobile and immobile existing residents in practice as discussed in section 4.3.2.2.4.

Table 4.6. Different state size and Approach 1.5 (Scenario 3.5)

L \ S	(i) Do nothing	(ii) Approach 1	(iii) Approach 1.5	(iv) Approach 2
(i) Do nothing	(500, 50) [Pareto optimum]	(400, 90)	(400, 66)	(400, 60)
(ii) Approach 1	(516, 10)	(416, 50)	(400, 66)	(400, 60)
(iii) Approach 1.5	(456, 10)	(456, 10)	(440, 26) [Nash equilibrium]	(440, 20)
(iv) Approach 2	(216, 10)	(216, 10)	(200, 26)	(200, 20)

4.3.3.2. Externalities

It is generally considered that a state is eager to attract high-skilled individuals because of their net positive externalities. The externalities that high-skilled immigrants bring into host states are both positive and negative. One of the positive externalities is knowledge related.[75] Knowledge can be shared among colleagues when skilled immigrants impart their expertise, thereby improving the productivity of the local workforce.[76] Fiscal gains are also included in positive externalities.[77] Negative externalities include

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75.   OECD (2011), at ch. 4.3.
76.   Id. One economic model implies that infinitely elastic high-skilled immigrants should not be taxed because a drop in the immigrant population would lead to a reduction in the wages of the unskilled population under the assumption that the increase in the proportion of high-skilled immigrants to unskilled workers will enhance the productivity of unskilled workers. *See* Wilson (2009).
77.   *See* OECD (2011), at ch. 4.3.

congestion costs of providing additional public goods to incoming residents. If it is assumed that the social welfare objective depends only on domestic residents, then the optimal influx of foreigners is determined entirely by the externalities they bring to the domestic residents. The optimal tax rate for foreigners is governed by the Laffer curve[78] under the assumption that states respond appropriately to non-fiscal externalities on the expenditure side.[79] To the extent that additional revenue and positive spillover effects outweigh negative externalities, it is justifiable to provide a preferential tax regime only for high-skilled immigrants.[80]

4.3.3.3. Agglomeration economics

If a jurisdiction (or a city, in practice, rather than a state) possesses an agglomeration economy, the jurisdiction of the city can mitigate the impact of tax competition for high-skilled individuals.[81] Agglomeration economics is a positive spillover effect derived from physically agglomerating individuals and businesses. These spillover effects include the reduced transport of goods, people and ideas.[82] Due to the location-specific rent derived from agglomeration economies, it is possible for that jurisdiction to attract high-skilled individuals without being engaged in tax competition to the extent that after-tax labour income outweighs rivalry jurisdictions that do not bring such agglomeration benefits.

The effect of the proliferation of remote working on agglomeration economics requires careful consideration. If remote working becomes more widespread, jurisdictions may need to engage in more intense tax competition to attract not only elite workers who can work from home[83] but also a new type

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78.   The Laffer curve, named after its originator, is a curve showing the relation between tax rates and revenue raised. If any activity is taxed, revenue starts from zero with a zero tax rate and rises as the rate is increased. The tax tends to discourage the activity, however, so that at some point the total revenue raised turns down. This tendency is accentuated by the effect of higher tax rates in promoting tax evasion. These properties of the Laffer curve have been used to justify tax cuts as a means of increasing tax revenue. *See* Hashimzade, N., Myles, G., Black, J., Hashimzade, N., Myles, G., & Black, J. (2017). *A Dictionary of Economics* (Fifth Edition). Oxford University Press.
79.   *See* Kleven et al. (2020), at 134-135.
80.   Id. at 135.
81.   *See* Wilson (2009), at 306; Keen & Konrad (2013), at 301.
82.   *See* Glaeser, E. L. (1998). Are cities dying?. *Journal of Economic Perspectives*, *12*(2), 139–160. https://doi.org/10.1257/jep.12.2.139.
83.   It was observed that mobile elite workers who have few ties to a place migrate from high-tax states to low-tax states during the COVID-19 pandemic in the United States. *See* Young, C. & I. Lurie. (2022). *How incentives and embeddedness shape millionaire tax flight.*

of mobile workers, such as digital nomads,[84] as has already been observed globally.[85] Furthermore, if remote working diminishes the advantages of agglomeration and leads to a decline in productivity, this could result in lower revenue for jurisdictions owing to reduced wages for their residents.[86]

4.3.4. Summary

In section 4.3., the author reviewed the economic literature on optimal labour income taxation, tax competition and preferential tax regimes to attract high-skilled individuals. If adequate transfers are not institutionalized, the standard optimal labour income tax theory cannot justify regressive labour income taxation. Moreover, recent optimal labour income tax literature argues that the optimal marginal rate for top earners exceeds 70%.

In the absence of cooperation between states, they fall into a tax competition game to attract high-skilled individuals. Through an in-depth examination, it is concluded that Approach 1, which provides a tax preference only to newly incoming high-skilled residents, is an economically less detrimental second-best tax policy for states, based on recent empirical studies' finding that the mobility elasticity of foreigners is high, while that of domestic residents is low. However, Approach 1 fails to provide tax preferences to potential emigrants when states cannot observe the differences in mobility among existing residents. On the other hand, Approach 2 covers these potential emigrants while providing redundant tax preferences to immobile existing residents. For states where the share of potential emigrants is relatively small, it is rational for such states to adopt Approach 1 while, for states where the share of potential emigrants is relatively large, it may be worth considering adopting Approach 2 or Approach 1.5 (if available).

Washington Centre for Equiable Growth Working Paper series. https://equitablegrowth.org/working-papers/taxing-the-rich-how-incentives-and-embeddedness-shape-millionaire-tax-flight/.
84.   It is possible for digital nomads to be taxed nowhere under current residence and source rules for employment and service income. *See* Kostić, S. V. (2019). In search of the digital nomad: Rethinking the taxation of employment income under tax treaties. *World Tax Journal*, *11*(2), Journals IBFD.
85.   *See* Pignatari, L. T. (2023). The taxation of 'digital nomads' and the '3 W's': Between tax challenges and heavenly beaches. *Intertax*, *51*(5), 384–396. https://doi.org/10.54648/TAXI2023033; Casi, E., Mardan, M., & Stage, B. M. B. (2023). *Citizenship/residence by investment and digital nomad visas: The golden era of individual tax evasion and avoidance?*. https://openaccess.nhh.no/nhh-xmlui/handle/11250/3086543.
86.   *See* Agrawal, D. R. & Stark, K. J. (2022). Will the remote work revolution undermine progressive state income taxes?, *Virginia Tax Review*, *42*(1), 47-152. pp. 117-120.

Moreover, considering the difference in size between states, small states – whose existing residents are likely to be more mobile – have good reasons to engage in tax competition and refuse to cooperate without receiving sufficient compensation from large states, while large states benefit from cooperation.

Factoring in the externalities from immigrants, states can justify providing a preferential tax regime only for high-skilled individuals to the extent that additional revenue and positive spillover effects outweigh the negative externalities. Finally, jurisdictions with agglomeration economies may be relieved from the pressure of tax competition, whereas agglomeration benefits may be reduced by the recent proliferation of remote work.

4.4. Legal analysis

In this section, the author liberates himself from the constraints of economic analysis and conducts legal analysis in a wider sense, which is grounded in political philosophy. Our criteria for evaluating tax policy extend beyond welfarism to encompass non-welfarism, which is often employed in legal analysis. First, the author shows the conflicts brought about by Approaches 1 and 2, respectively. Next, several assumptions are made to evaluate each approach. The author then delves into the debate on which approach is less detrimental for attracting high-skilled individuals by referring to several commentators' arguments on tax competition. Consequently, the author concludes that Approach 1 is less detrimental than Approach 2.

4.4.1. Agenda and assumptions for legal analysis

4.4.1.1. Agenda

Table 4.7. summarizes the beneficiaries of tax preferences in Approaches 1 and 2, respectively. In Approach 1, states introduce a preferential tax regime only for newly incoming high-skilled (in many cases, high-income) residents, who mainly consist of non-citizens and foreigners, although returning citizens are also eligible for the regime in several states. Accordingly, a conflict arises between existing resident citizens (both high-income and mid or low-income citizens) and incoming high-income resident non-citizens. On the other hand, in Approach 2, a tax preference such as preferential tax rates only applicable to a specific category of income – mainly earned by high-skilled individuals – is a de facto discriminatory

tax treatment between high-income individuals and mid or low-income individuals, regardless of citizenship. In this situation, we should be more concerned about a conflict between high-income and mid or low-income individuals (especially between citizens). The author analyses these conflicts in the following sections.

Table 4.7. Beneficiaries

	Approach 1		Approach 2	
Existing residents (mainly citizens, nationals)	High	Mid, Low	High ⟷ Mid, Low	
Incoming residents (mainly non-citizens, foreigners)	High ↓	Mid, Low	High	Mid, low

4.4.1.2. Assumptions

Several assumptions and clarifications are made before analysing and comparing the two approaches. First, the author takes a statist or internationalist position rather than a globalist one. This is not because the author has a strong opinion on the debate on global justice[87] and international tax justice.[88] Rather, the author's main interest lies in considering what a sovereign state should do to design its own domestic tax policy when multilateral cooperation is unavailable. This is a pragmatic approach considering the current situation of international tax policymaking processes as other commentators usually take.[89] Therefore, it should be noted that the author does not intend to undervalue the importance of pursuing multilateral cooperation to accomplish desirable global justice in the field of international taxation.

Second, even if the statist or internationalist position is taken, it is necessary to define who the "members" of the democratic society[90] are to justify impo-

87.   *See* Ronzoni, M., & Valentini, L. (2020). Global justice and the role of the state: A critical survey. In *The Oxford Handbook of Global Justice*. The Oxford University Press.
88.   *E.g.* Stark, J. (2022). Tax justice beyond national borders: International or interpersonal? *Oxford Journal of Legal Studies*, *42*(1), 133–160. https://doi.org/10.1093/ojls/gqab026.
89.   *E.g.* Rixen, T. (2011). Tax competition and inequality: The case for global tax governance. *Global Governance*, *17*(4), 447–467. pp. 456-458 https://doi.org/10.1163/19426720-01704004456-458; Dietsch, P. & Rixen, T. (2019). Debate: In defence of fiscal autonomy: A reply to Risse and Meyer. *Journal of Political Philosophy*, *27*(4), 499–511. pp. 501-502 https://doi.org/10.1111/jopp.12184; Christians, A., & Apeldoorn, L. van. (2021). *Tax cooperation in an unjust world*. Oxford University Press.
90.   *See* Bauböck, R. (2017). Political membership and democratic boundaries. In A. Shachar, R. Bauböck, I. Bloemraad, & M. P. Vink (Eds.), *The Oxford Handbook of Citizenship*. Oxford University Press; Shachar, A. (2017). Citizenship for sale? In A. Shachar, R. Bauböck, I. Bloemraad, & M. P. Vink (Eds.), *The Oxford Handbook of Citizenship*. Oxford University Press.

sition of tax, in particular, unlimited tax liability.[91] Although it is a matter for each society to decide which measure is appropriate connecting factors between taxpayers and society,[92] there are mainly two criteria to define a group of individuals as "members". One is to decide on members based on citizenship.[93] This criterion stresses on the formal democratic process. In modern democratic states, voting rights to decide on the political affairs of a state are exclusively entitled to citizens or nationals at the national level, although some states allow resident non-citizens to vote at the sub-national level. Another is to decide on members based on their continuous physical presence, such as residence.[94] This criterion dominates in the field of international taxation because of the decision to use economic allegiance instead of political allegiance as a nexus for residence taxation in the League of Nations report authored by four respected economists in the 1920s.[95] In many jurisdictions' tax rules, members of a society – in particular, residents – owe unlimited tax liability based on the ability-to-pay principle,[96] while non-members (non-residents) owe only limited tax liability based on the benefit principle.[97] The criteria used in evaluating Approaches 1 and 2 will lead to different results, as discussed in the following sections.

4.4.2. Evaluation

4.4.2.1. OECD: Ring-fencing

Based on the current international tax policymaking discourse in the OECD and European Union, Approach 2 would be preferred to Approach 1. The OECD explicitly pointed out that "ring-fencing" is one of the four key factors of harmful preferential tax regimes in the 1998 report.[98] The four key factors are (i) no or low effective tax rates; (ii) "ring-fencing" of regimes;

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91.   *See* Shaviro, D. (2016). Taxing potential community members foreign income. *Tax Law Review*, *70*(1), 75–110. pp. 89-97; Garavan, C. (2023). The membership theory of taxation. *Intertax*, *51*(4), 290-308. https://doi.org/10.54648/taxi2023025.
92.   Id. at 305.
93.   *See* section 4.4.2.4.
94.   *See* sections 4.4.2.2. and 4.4.2.3.
95.   *See* Garavan (2023), at 299-300. Theoretically, the concepts of residents and non-residents should not necessarily be binary. *See* Elkins, D. (2022). A scalar conception of tax residence. *Virginia Tax Review*, *41*(2), 149–202.
96.   *See* Garavan (2023), at 298-301. Regarding the recent criticism on the justification of residence-based taxation, *see* Brauner, Y. (2024). *Taxing people, not residents*, http://dx.doi.org/10.2139/ssrn4723636.
97.   *See* Garavan (2023), at 306.
98.   OECD. (1998). *Harmful tax competition: An emerging global issue*. OECD. https://www.oecd-ilibrary.org/taxation/harmful-tax-competition_9789264162945-en.

(iii) lack of transparency; and (iv) lack of effective exchange of information.[99] In the 1998 report, several forms of "ring-fencing" were presented, including (i) regimes that restrict the benefits to non-residents; and (ii) investors who benefit from the tax regime are explicitly or implicitly denied access to domestic markets.[100] Preferential tax regimes that ring-fenced are considered potentially harmful because "the country offering the regime may bear little or none of the financial burden of its own preferential tax legislation" and, at the same time, "taxpayers within the regime benefit from the infrastructure of the country providing the preferential regime without bearing the cost incurred to provide that infrastructure".[101]

In BEPS Action 5, although it was noted that "current concerns may be less about traditional ring-fencing but instead relate to across the board corporate tax rate reductions on particular types of income", ring-fencing continued to be one of the four key factors in identifying harmful tax practices.[102]

Preferential tax regimes to attract high-skilled individuals are provided only to newly incoming *residents*; therefore, strictly speaking, they may not satisfy the ring-fencing factor. However, preferential tax regimes based on Approach 1 are almost ring-fenced because they restrict benefits only to newly incoming residents, who are supposed to use the infrastructure of the host state, incurring a much smaller burden than existing residents who earn similar levels of income.

In Action 5, the nexus approach was employed to address harmful tax regimes more effectively. The nexus approach emphasizes the significance of a substantial activity factor, which was one of the eight other factors alongside the four key factors identified in the 1998 report for determining harmful preferential tax regimes.[103] It was predicted that the nexus approach would be effective in regulating tax competition for paper profits, but it would accelerate tax competition for real activity.[104] According

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99.   Id. at 27.
100. Id. at 28.
101. Id. at 26.
102. *See* OECD. (2015). *Countering harmful tax practices more effectively, taking into account transparency and substance, Action 5 — 2015 final report*. OECD. ch. 1 https:// www.oecd-ilibrary.org/taxation/countering-harmful-tax-practices-more-effectively-taking-into-account-transparency-and-substance-action-5-2015-final-report_9789264241190-en.
103. Id. at ch. 4.
104. Hebous, S. (2021). Has tax competition become less harmful? In R. A. de Mooij, A. D. Klemm, & V. Perry (Eds.), *Corporate income taxes under pressure: Why reform is needed and how it could be designed* (pp. 87-105). International Monetary Fund. https:// doi.org/10.5089/9781513511771.071.

to a recent survey on income-based tax incentives (IBTIs), including IP boxes, 21 out of the 48 jurisdictions surveyed were equipped with IBTIs in 2015; 20 jurisdictions modified or refurbished their IBTIs to satisfy the nexus requirement in Action 5; and 27 jurisdictions have IBTIs in 2022.[105] Recently, Japan[106] and Hong Kong[107] decided to introduce IP box regimes. The current effective average tax rate for intangible income qualifying IP box regimes in European countries is estimated to be less than 10%.[108] If it is possible to infer that the OECD endorsed tax competition for real activity in Action 5,[109] preferential tax regimes for attracting high-skilled individuals based on Approach 2 would not be considered harmful because high-skilled individuals relocate to host states with substantial activity. In fact, Hong Kong's tax preference for carried interest has already passed the peer review process.[110] It is often proposed that preferential tax regimes for individuals should be within the scope of the EU Code of Conduct Group's monitoring.[111] However, without introducing new criteria for evaluating harmfulness, it would not be possible to effectively monitor preferential tax regimes for individuals. Considering these previous OECD positions on preferential tax regimes, Approach 2 would not necessarily be considered harmful.

4.4.2.2. Dietsch and Rixen: Membership and fiscal autonomy

The political philosophical analysis of tax competition by Dietsch and Rixen is informative for evaluating tax preferences for attracting high-skilled individuals. They argue that tax competition is considered illegitimate when it undermines a sovereign state's fiscal autonomy (fiscal self-determination).[112]

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105. Cabral, A. C. G., Appelt, S., Hanappi, T., Galindo-Rueda, F., O'Reilly, P., & Bucci, M. (2023). *A time series perspective on income-based tax support for R&D and innovation*. OECD. https://doi.org/10.1787/dae3cd5c-en.

106. JP: Act on Special Measures Concerning Taxation (*Sozeitokubetsusochi-ho*), 1957 (amended 2024), art. 59-3.

107. Hoke, W. (2024). Hong Kong proposes tax hikes on high earners, lower stamp duties, *Tax Notes International, 113*, 487-488.

108. *See* Cabral et al. (2023), at 30-32; Müller, J. M., Spengel, C., & Steinbrenner, D. (2022). IP box regimes and multinational enterprises: Does nexus pay off? *World Tax Journal*, *14*(1), sec. 5.1., Journals IBFD.

109. It is not impossible to evaluate that the GloBE rules override the nexus approach in Action 5, although the GloBE rules allow Substantial-based Income Exclusion. However, the OECD keeps silent on the relationship between the GloBE rules and the nexus approach.

110. *See* section 4.2.2.

111. *E.g.* Beretta, G. (2019). Cross-border mobility of individuals and the lack of fiscal policy coordination among jurisdictions (even) after the BEPS project. *Intertax*, *47*(1), 91–112. https://doi.org/10.54648/TAXI2019006; Flamant et al. (2021), at sec 5.1.

112. *See* Dietsch, P., & Rixen, T. (2014). Tax competition and global background justice. *Journal of Political Philosophy*, *22*(2), 150–177. https://doi.org/10.1111/j.1467-9760.2012.00419.x.

The legitimacy of a state rests on its democratic form of government, and it is essential that the state is granted autonomy over its institutions, including fiscal self-determination.[113] In a fiscal context, a democratic state should be allowed autonomy regarding the size of the public budget (level of revenues and expenditures) and the relative benefits and burdens among its members (extent of redistribution).[114] However, as seen in section 4.2., rational states engage in tax competition, which endangers each other's fiscal autonomies. Fiscal autonomy is endangered because a state under the pressure of tax competition cannot decide its level of revenue, expenditure and redistribution in accordance with the needs of its members.[115]

Dietsch and Rixen provide two global background tax justice criteria to render tax competition ethically illegitimate: the membership principle (MP) and the fiscal policy constraint (FPC).[116] The MP is formulated as "natural and legal persons should be liable to pay tax in the state of which they are a member".[117] The MP renders tax competition for capital income and paper profits illegitimate because investors and MNEs who exploit tax arbitrage opportunities are not liable to tax in the state that they are beneficiaries of public goods and services.[118] Although the MP would effectively curtail "poaching", which means states intend to attract portfolio capital and paper profits without substantial activity, "luring" – which is defined as a type of tax competition through which states intend to attract real investments – would not be restricted by the MP.[119] Dietsch and Rixen argue that some sort of "luring" can be rendered problematic by the application of the FPC when it produces a collectively suboptimal level of tax revenue *and* the intention behind the luring is strategic.[120] The FPC originates from their thought that the fiscal autonomy of a state should be restricted when the aggregate extent of fiscal autonomy across states is reduced.[121]

Although Dietsch cautiously makes a reservation in another article that his analysis on luring focuses exclusively on the luring of corporate capital and brackets his analysis on the luring of individuals,[122] it is possible for us to

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113.   Id. at 152.
114.   Id. at 152-153.
115.   Id. at 155-156.
116.   Id. at 157.
117.   Id. at 158.
118.   Id. at 157-158.
119.   Id. at 160-161.
120.   Id. at 161-162.
121.   Id. at 162.
122.   Dietsch, P. (2016). Whose tax base?: The ethics of global tax governance. In P. Dietsch & T. Rixen (Eds.), *Global tax governance: What is wrong with it and how to fix it*. ECPR Press. p. 241.

apply their analytical framework to evaluate tax preferences for high-skilled individuals.

Approach 1 will be rendered illegitimate by the application of the MP. According to Dietsch and Rixen's definition of "membership", "individuals and companies should be viewed as members in those countries where they benefit from the public services and infrastructure".[123] They explicitly state that their "definition of membership is distinct from citizenship" and "temporary resident aliens, even though they generally do not have a democratic voice in state decisions, should be [members]".[124] In the case of preferential tax regimes for high-skilled individuals based on Approach 1, users of the regime physically relocate to and reside in the host state for a while to be eligible for the regime. Therefore, preferential regimes based on Approach 1 are considered illegitimate by the application of the MP because the users of the regimes pay much smaller amounts of individual income tax while benefiting from public services and infrastructure in the host state.[125]

How about Approach 2? The MP cannot render tax preferences based on Approach 2 illegitimate because all members can equally access the tax preferences. However, Approach 2 can be considered illegitimate by the application of the FPC when the collective tax revenue across states is reduced and each state strategically introduces such tax preferences like the case of general corporate tax rate reduction in Ireland, as Dietsch and Rixen exemplify,[126] and the scenarios showed in section 4.3. Although it is possible that Approach 2 is not considered illegitimate from the FPC, if it goes too aggressive, it will be regarded as illegitimate because it erodes the fiscal autonomy of *other* states.

However, there is good reason to cast doubt on the rationale of the FPC. Risse and Meyer criticize that states owe no obligation to care about fiscal autonomy of *other* states if we take a position that each state has its own fiscal autonomy without adopting the globalist position.[127] If Risse and

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123. Dietsch & Rixen (2014), at 158.
124. Id. at 158, n. 22.
125. However, it should be noted that those new residents enjoy the benefit of public services to a lesser extent compared to existing residents because those new residents are not likely to receive benefits from public services, such as public education.
126. Dietsch & Rixen (2014), at 161-163.
127. *See* Risse, M., & Meyer, M. (2019). Tax competition and global interdependence. *The Journal of Political Philosophy*, *27*(4), 480–498. pp. 489-490 https://doi.org/10.1111/jopp.12185.

Meyer's criticism is accepted, Approach 2 may survive scrutiny and be less detrimental for small states, in particular.

4.4.2.3. Dagan: Resident non-citizens as members

Dagan also connotes resident non-citizens are included in the members of political communities and is concerned that states offering preferential tax regimes degrade the social contract of *other* states; thereby, all states may find it difficult to promote distributive justice via the tax system.[128] Furthermore, Dagan argues that giving preferential tax treatment to mobile individuals is also harmful to the civic membership of the state's own political community.[129]

Dagan stresses that "tax is one of the most prominent manifestations of civic participation in democratic societies" and "being a member of the state usually imposes a duty to pay its taxes, and the duty to pay taxes is often an indication of taxpayers' membership in the national polity".[130] Therefore, residents subject to the coercive taxing power of the state, regardless of their citizenship, would be classified as members. However, in a tax competition environment, mobile existing resident citizens and non-citizens increase the value of their exit options over voices in the democratic process.[131] In particular, existing and prospective resident non-citizens can exert a great influence on tax policymaking processes, even without a formal voice in democracy.[132] Consequently, policymakers are no longer able to treat all members of a political community with equal respect and concern.[133] Dagan is concerned that a state may lose its legitimacy in exerting its coercive power to tax its members once the solidarity of the political community is severely undermined by tax policymaking for the mobiles. As a possible solution to this problem, she proposed that each state should bundle a minimal package of public goods and services with an appropriate level of tax payment through multilateral cooperation.[134] The appropriate level of tax

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128.   Dagan, T. (2024). Tax and globalisation: Toward a new social contract. *Oxford Journal of Legal Studies*, gqae010. https://doi.org/10.1093/ojls/gqae010.

129.   Dagan (2024), at sec 4. E.

130.   Dagan, T. (2018). *International tax policy: Between competition and cooperation.* Cambridge University Press 21-22.

131.   Id. at 40-41.

132.   Id. at 41.

133.   Dagan, T. (2022). Klaus Vogel lecture 2021: Unbundled tax sovereignty: Refining the challenges. *Bulletin for International Taxation*, *76*(7), Journals. IBFD.

134.   Id. at sec. 4.

payment should be determined by each member's ability to pay, rather than mobility and the use value of the package they consume.[135]

From this standpoint, the ring-fenced preferential tax regime based on Approach 1 is rejected because it undermines the equal treatment between mobile (newly incoming residents) and immobile (existing residents) members.[136]

Approach 1.5 is also likely to be rejected because it explicitly intends to provide tax benefits only to mobile existing residents. This is more so the case if the tax preference results in regressivity, considering the tendency of high-income individuals to be more mobile than mid or low-income individuals.

What about a tax preference that is seemingly open to all its members at face value, but whose de facto beneficiaries are limited to high-income residents, including immobile high-income individuals (Approach 2)? In this case, it is possible to infer that such a tax preference would be rejected if it amounts to the regressivity of the entire structure of the tax and transfer system because members' tax burden is not determined by the ability-to-pay principle; therefore, such a tax preference results in undermining the solidarity of the political community. For instance, the reduction in the top marginal rate, which all members can possibly enjoy and does not result in a regressive average tax rate, is justifiable if the progressivity of the entire tax and transfer system is sustained. On the other hand, a reduced rate for a specific category of income (e.g. carried interest) that is mainly earned by high-income individuals would be rejected because of its de facto regressivity. It should be noted that the government funds for redistribution will be reduced if the preferential tax treatment extends to immobile high-income individuals.

4.4.2.4. Schön: Resident non-citizens as non-members

Although Dietsch, Rixen and Dagan separate membership from citizenship, membership can be defined differently if we place a high value on voting rights in a formal democratic process. Schön shows a different view on the membership of globally mobile individuals.[137] Based on his extensive study on historical development of the relationship between taxing power and democracy, he points out that "congruence", which is defined as "the

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135.   Id.
136.   Dagan (2024), at sec. 5.
137.   *See* Schön, W. (2019). Taxation and democracy. *Tax Law Review*, 72(2), 235–304.

overlap of the persons who determine democratic inputs, the persons who bear the burden of taxation, and the persons who enjoy the benefit of public expenditure" is being eroded by the increased domestic demand for redistribution and the globalization of the economy.[138] The former led to the rise of progressive taxation under the democratic procedures, which "work as tools for the (poor) majority within a society to appropriate the wealth of the (rich) minority".[139] In contrast, the latter exposed states to the pressure of tax competition for high-net-worth individuals and mobile high-skilled labour.[140] In particular, the latter provided rich mobile non-citizens with an opportunity to exert de facto influence[141] on host states' democratic tax policymaking, resulting in less progressive taxation through an exit option, notwithstanding they cannot "voice" in the national election.[142]

Schön understands that current technical concept of "residence" for tax purposes does not work as a good proxy for belonging to a stable political or social community.[143] Therefore, current taxation of resident non-citizens can only be justified based on the benefit principle.[144] Once his view on membership is accepted, there is seemingly little constitutional constraint on providing advantageous treatment in contrast to the disadvantageous one to resident non-citizens,[145] who are not members of the political community.[146] At the same time, Schön is against the direction of greater congruence by increasing the voices of resident non-citizens[147] because he considers that fiscal residence is not enough to deem a taxpayer to be integrated into the national political community and that national elections are not only about taxation and not only about the current year.[148]

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138.   Id. at 241-244. *See also* Lind, Y. (2020). Voting rights compared to income taxation and welfare benefits through the Swedish lens. *Florida Tax Review*, *23*(2), 713–742.

139.   *See* Schön (2019), at 242.

140.   Id. at 243-244.

141.   As for the indirect influencing taxpayers can exercise on tax and spending policymaking, *see* Lind, Y. (2020). Initial findings on how individual taxpayers may indirectly influence tax and spend in Sweden, Germany and the United States. *Intertax*, *48*(5), 482–497. https://doi.org/10.54648/TAXI2020045.

142.   *See* Schön (2019), at 295. Dagan (2022), at sec. 3.3. also evaluates this point favourably.

143.   *See* Schön (2019), at 286.

144.   Id. *See also* Schön, W. (2023). *Is everybody obliged to pay taxes somewhere?* (SSRN Scholarly Paper 4521472). https://doi.org/10.2139/ssrn.4521472.

145.   *See* Schön (2019), at 292-293.

146.   Id. at 302-303.

147.   On this direction, *see* Lind, Y. (2020). A critical analysis of how formal and informal citizenships influence justice between mobile taxpayers. In D. de Cogan & P. Harris (Eds.), *Tax justice and tax law: Understanding unfairness in tax systems*. Bloomsbury Publishing.

148.   *See* Schön (2019), at 287-288.

The most complicated case, Schön raises, is whether a state should be prevented from giving a tax preference to mobile resident members (citizens) in accordance with their exit options in order to increase the aggregate welfare of its members.[149] Approach 2 and Approach 1.5 (if available) involves this case because a majority of existing residents are citizens. His advice from a constitutional policy perspective is that it is justifiable if the tax preference to retain mobile members in its territory is the advantage of less fortunate members.[150] Schön suggests that this problem of undertaxation of mobile individuals is only solved at the supranational level or through multilateral cooperation.[151]

As a logical extension of this discussion, once a preferential tax regime for newly incoming resident non-citizens based on Approach 1 is introduced as a domestic tax policy decision, we cannot denounce it as undemocratic or unconstitutional – even if its introduction was due to the pressure of tax competition. At the same time, taxpayers who use such preferential tax regimes should not be morally blamed for their tax-minimizing behaviours.[152] If a preferential tax regime is also provided to newly incoming resident citizens, there is room for constitutional restrictions when it amounts to regressive taxation among resident citizens and does not "trickle down" to the less mobile members of society.[153]

Tax preferences based on Approach 2 are also legitimate as long as they are decided through a formal democratic process. They might be helpful in retaining mobile existing residents. However, it is questionable whether this is a sound policy for attracting and retaining high-skilled individuals. It is likely that the revenue loss for luring the same number of high-skilled mobile individuals is much larger than in the alternative approach (Approach 1), and that the additional benefit of retaining potential emigrants is smaller than the revenue loss from providing tax preferences to existing immobile residents. Although Approach 1.5, if available, can minimize the revenue loss, it cannot do so without the problem of giving tax preferences only to high-income mobile citizens. In Approaches 2 and 1.5, there might

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149. Id. at 300.
150. Id. Different from Schön's cases in mind, there is a risk of violating non-discrimination clause of the income tax treaty if a state gives a tax preference only to its resident nationals for retention or luring purposes. *See* Souza de Man, F. (2019). Tax measures to combat brain drain: (In)compatibility issues with double tax conventions and a potential way forward. *Annals of the Faculty of Law in Belgrade - International Edition*, *2019*, 249–282.
151. *See* Schön (2019), at 301-302; Schön (2023), at 28.
152. Id.
153. Schön (2019), at 300.

be constitutional constraints on unequal treatment between high-income and
mid or low-income resident citizens. Accordingly, Approach 2 (or Approach
1.5 if it does not lead to the benefits of less fortunate members) is evaluated
as a more detrimental tax policy for attracting and retaining high-skilled
individuals.

4.4.3. Political salience

The author basically supports Schön's view on membership and argues
that introducing a preferential tax regime for newly incoming resident
non-citizens (Approach 1) can be justified as a domestic tax policy, while
Dietsch, Rixen and Dagan would oppose it. Approach 1 may be politically
salient, and it may provoke a conflict between citizens and non-citizens.
However, Approach 2 involves the danger of eroding the solidarity of
political community more severely. This is because tax preferences based
on Approach 2 are likely to take the indirect form of offering tax benefits
only to a specific category of income that high-skilled mobile individuals
earn, when individuals' mobility is externally unobservable. This results
in implicit discrimination between high-income and mid or low-income
resident citizens. If a tax preference is allowed only for newly incoming
resident non-citizens, who are more likely to be mobile, it is easier to defend
such a preference because of the increase in tax revenue from those who
would not have moved to the state without the tax preference. By contrast,
if a tax preference is given to all residents, it is more likely that immobile
high-income citizens enjoy windfall gains at the cost of revenue loss.

Approach 1.5, which minimizes the revenue loss, would also be politically
salient in differentiating tax treatment between newly incoming and existing
residents like Approach 1, and it also entails the problem of discrimination
between high-income and mid or low-income members in differentiating
tax treatment among citizens.

The OECD suggests that a covert way of giving tax preferences that are
not necessarily targeted at high-skilled individuals, but will benefit many
of them, would be important in states where it is not politically accept-
able to have open inequality of tax treatment between foreign and domestic
workers or between high-skilled and less-skilled individuals.[154] Although
lowering political salience is not necessarily bad in itself in the absence

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154.   OECD (2011), at ch. 4.4.

of a commonly shared reference point,[155] at least regarding the evaluation of Approaches 1, 1.5 and 2, Approach 2 (and Approach 1.5 regarding the different treatment between mobile and immobile existing citizens) – especially when a tax preference is provided in a covert manner – should be criticized for its low political salience. It is unrealistic to assume that ordinary citizens and politicians can appropriately evaluate the complicated tax treatments of carried interest and stock compensation. Therefore, Approach 2 (and Approach 1.5) entails the danger of eroding the solidarity of members in a political community more severely than Approach 1 once ordinary citizens are aware of the de facto discriminatory tax treatment. The author concludes that using a preferential tax regime targeting newly incoming residents (mainly non-citizens) with clearly stated policy goals is less detrimental to the political community than using a general tax preference, whose de facto beneficiaries are intended to be mainly high-skilled, high-income residents.

4.5. Conclusion

As globalization of the economy has greatly enhanced the mobility of high-skilled individuals, sovereign states are forced to reconsider their tax policies to achieve the desired provision of public services and redistribution. In the tax competition game for high-skilled individuals, sovereign states have two choices in the absence of multilateral cooperation, namely (i) providing a tax preference only to newly incoming high-skilled residents (Approach 1); or (ii) providing a tax preference to all its residents, but its de facto beneficiaries are limited to high-skilled residents (Approach 2), under the assumption that the precise mobility of individuals is not externally observable (Approach 1.5 is unavailable).

An examination of the optimal labour income tax literature reveals that there are several causes to be concerned about regressive labour income taxation. However, it is rational for sovereign states to engage in tax competition in the form of Approach 1 when the share of mobile existing residents is low and Approach 2 when it is high.

When the precise mobility of individuals is unobservable for states, it is wise to use citizenship or transfer of residence as a proxy for mobility, according to empirical analyses. Even so, it should be noted that Approach 1 may

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155. *See* Gamage, D. & Shanske, D. (2011). Three essays on tax salience: Market salience and political salience. *Tax Law Review, 65*(1), 19-98. p. 80.

fail to retain mobile potential emigrants, while Approach 2 may provide an unnecessary tax windfall to immobile existing residents. The tax competition problem is exacerbated by the fact that small states with a large share of mobile residents lack the motivation to cooperate with other states unless they are compensated for their cooperation. While states with agglomeration economies are spared from tax competition pressure, the impact of the rise of remote work on agglomeration economies remains to be seen.

From a legal perspective grounded in political philosophy, a conflict arises between resident citizens and non-citizens in Approach 1, whereas it arises between resident high-income and mid or low-income citizens in Approach 2. Assuming that membership in the political community is determined by fiscal residency, Approach 1 should be rejected. Although a tax preference based on Approach 2 is available to all residents, it is possible to consider Approach 2 as illegitimate or unjust when it harms the fiscal autonomy of other states or results in regressivity among residents.

However, assuming that membership is determined by citizenship, Approach 1 is defensible as long as tax preferences are adopted through a formal democratic process. Although Approach 2 is also defensible if democratically introduced, it is questionable whether it is a sound policy when factoring in the much larger revenue loss and predicted erosion of solidarity among citizens once they become aware of its discriminatory feature. Accordingly, the author concludes that Approach 1 is a less detrimental unilateral tax policy for attracting high-skilled individuals in a tax competition environment.