Charitable Giving, Tax Expenditures, and Direct Spending in the United States and the European Union

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**I. INTRODUCTION**

Imagine that a state in the United States or a Member State of the European Union is faced with a budget crisis. In order to cut spending, it stops providing grants to out-of-state businesses. Or it limits its tax breaks to in-state businesses. Or it allows charitable deductions only for donations to in-state organizations. Or it restricts its low-income tax credits to state residents. Can the state make any of these decisions? Or are they impermissibly discriminatory? In other words, can states in a federal system favor their residents through spending and taxing programs? What does it tell us if states favor one type of program over another? Do the limits on state support change with the type of entities that receive that support?

This Article considers these questions through a comparative lens, looking at the different approaches taken by the United States and the European Union. Both entities have nondiscrimination provisions that prohibit states and Member States from treating resident individuals and corporations more favorably than nonresidents. In the United States, the Dormant Commerce Clause plays this role; in the European Union, the Treaty guarantees of free movement do the same. And yet both the United States and the European Union have allowed certain discriminatory state-level laws and disparate treatments that result from these laws. This Article focuses on the different ways in which the United States and the European Union limit the ability of state-level entities to subsidize their own residents, whether through direct subsidies or through tax expenditures. In doing so, this Article identifies lessons about the form of fiscal federalism, useful for both the United States and the European Union.

This Article focuses primarily on charitable deductions as a lens through which to consider the different approaches taken by the United States and the European Union. This is because the Court of Justice of the European Union (previously the European Court of Justice and hereinafter the ECJ) recently decided four cases addressing charitable tax incentives, and these cases highlighted a trend that the court had been establishing over the last several decades. Since the charitable tax deduction is in many ways the ultimate example of tax expenditure, the ECJ’s case law in this area exemplifies its approach to tax expenditure cases more generally.

Part II of this Article introduces readers to the tax expenditure jurisprudence of the ECJ using the court’s recent charitable giving cases. This Part also outlines the responses of Member States to the ECJ’s charitable giving cases. Part III then assesses the costs and benefits of the court’s tax expenditure jurisprudence. It illustrates that while the ECJ’s tax expenditure jurisprudence may suggest a new and promising model for fiscal federalism, it may also have negative social policy implications. This Part also points out the court’s inconsistency in both its analysis and application. Despite their economic equivalence, the court considers direct spending and tax expenditures under different rubrics. Furthermore, the court’s differential treatment is not applied consistently, giving Member States and taxpayers little guidance as to how a provision will be interpreted.
Part IV then compares the ECJ's approach to state subsidies and tax expenditures to the approach taken by the U.S. Supreme Court. The Supreme Court analyzes discriminatory state spending provisions under the Dormant Commerce Clause doctrine, the confines of which are still unclear almost two centuries after the Court first explicitly acknowledged it.1 This Part compares the tests that the Supreme Court applies to subsidies and tax expenditures and shows that discriminatory state subsidies are much more likely to survive challenge than tax expenditures.

The comparative analysis in Part IV concludes that courts in both the United States and the European Union treat tax expenditures differently from direct spending, despite their economic equivalence. Unlike in the United States, however, discriminatory subsidies in EU Member States are required to be preapproved in order to survive, and the penalties for such subsidies are higher than in the United States. Furthermore, discriminatory tax expenditures in the European Union are not automatically struck down, as they are in the United States. The ECJ thus favors direct spending over tax expenditures, just as the U.S. Supreme Court does, but the ECJ's analytical framework means that more tax expenditures and fewer direct subsidies are likely to survive in the European Union than in the United States.

Based on the comparison to the United States, Part V asks whether the European Union's recent development in tax expenditure jurisprudence is normatively desirable. This Part concludes that although both the Supreme Court and the ECJ prioritize formalism over economic equivalence, the Supreme Court's approach to tax expenditures is more defensible than that of the ECJ due to the two jurisdictions' different federal structures.

Part VI concludes that the charitable giving cases raise important red flags about inconsistencies underpinning the ECJ's tax expenditure jurisprudence and argues that these inconsistencies must be addressed in the absence of an EU-level direct tax system.

II. THE CHARITABLE GIVING CASES OF THE EUROPEAN UNION

In the past several decades, the executive and legislative institutions of the European Union have been granted competency over an increasing number of areas. As the European Union has increased in size and Member States have grown more comfortable with their role in the Union, the Member States have ceded more power to both the Commission (the EU's executive body), the Council of the European Union, and the European Parliament (the EU's legislature). In ceding power, the Member States have moved away from requiring a unanimous vote of all twenty-eight Member States for many types of legislation and have instead adopted majority or "qualified majority" voting requirements in many areas.2

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Direct taxation is one of the few areas over which Member States retain individual veto power. Despite the fact that Member States have attempted to retain control over their fiscal policies, they have gradually been losing this control to the ECJ. Section A surveys the ECJ's direct tax jurisprudence and explains why many commentators have described the court as the engine of "negative harmonization." Section B then focuses on the four charitable giving cases that the court has recently decided, and Section C builds on these cases to introduce readers to the court's tax expenditure jurisprudence. Section D then outlines the responses of Member States to the charitable giving cases.

A. *Direct Taxation in the European Union*

The European Union has come a long way since its start as a coal and steel community in 1951. With a shared monetary policy among the Eurozone countries, borders eliminated between the twenty-eight Member States, and the concept of EU citizenship enshrined in the founding treaties, the current European Union has in many ways lived up to its early goal of becoming an "ever closer union." One area of law that has bucked this trend toward unification, however, is direct taxation. Even as the Member States have eliminated legislative hurdles to harmonization in other fields, direct taxation has been one of the last holdouts. Under Article 115 of the Treaty on the Functioning of the European Union (TFEU), no direct tax legislation may pass at the EU level without the unanimous consent of all twenty-eight Member States. In this way, each Member State retains veto power over any proposed direct tax meas-

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3. In the European Union, the term "direct taxation" refers to taxation of individuals and corporations. It is contrasted with indirect taxation, which refers to taxation of goods and is exemplified by the Value Added Tax (VAT). As opposed to direct taxation, which Member States have not agreed to harmonize, Member States have agreed to harmonize the VAT.

4. The current seventeen members of the Eurozone are Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia, and Spain.


6. See TFEU, supra note 2, art. 2(1) ("Every citizen of the Union shall have the right to move and reside freely within the territory of the Member States, subject to the limitations and conditions laid down in the Treaties and by the measures adopted to give them effect.").


8. Note that indirect tax policy has long been one of the areas of EU law that has been harmonized. See TFEU, supra note 2, art. 113.

9. Whenever possible, this Article will refer to the Articles of the TFEU. However, readers should note that the founding treaties of the European Communities and the European Union have gone through several stages of renumbering, and many of the Articles mentioned herein have themselves had different numbers throughout EU history. References to Article 115 of the TFEU thus also encapsulate references to Article 97 of the EC Treaty and its predecessors, all of which required unanimous consent for legislative regulation of direct taxation.

10. TFEU, supra note 2, art. 115.
The principle of subsidiarity also prevents tax legislation at the EU level if it would be more appropriate at the Member State level.

Because of the ability of each Member State to block any move toward fiscal harmonization, the direct tax measures that have gained unanimous approval have done little to lead to fiscal union. There have been six legislative directives that have been approved thus far under Article 115 of the TFEU and its predecessors. Although directives do not have immediate effect in the Member States, they set the ultimate policy objectives for Member States to achieve and often also the means for achieving them. While these directives signal that Member States share certain goals in the direct tax arena, they also highlight that fiscal policy is still far from unified across the twenty-eight Member States. And yet, despite this limited legislative authority in the direct tax arena, Member States have developed a form of fiscal coordination. This coordination has been orchestrated not by the legislative arm of the European

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11. Member States have recently approved enhanced cooperation for the EU-level financial transactions tax, which allows a smaller number of Member States to act separately from the rest. However, even this enhanced cooperation scheme requires that the smaller group of cooperating states acquire the unanimous approval of all twenty-eight Member States before they move ahead. TFEU, supra note 2, arts. 326-34.

12. See Consolidated Version of the Treaty on European Union art. 5, Mar. 30, 2010, 2010 O.J. (C 83) 13 (stating that "[t]he use of Union competences is governed by the principles of subsidiarity and proportionality" and defining subsidiarity to mean that "in areas which do not fall within its exclusive competence, the Union shall act only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States, either at central level or at regional and local level, but can rather, by reason of the scale or effects of the proposed action, be better achieved at Union level").

13. See Ruth Mason, Common Markets, Common Tax Problems, 8 FLA. TAX REV. 599, 602 (2007) ("[T]he principle of 'subsidiarity,' which forbids action at the EU level except when the policy objective cannot be achieved at the state level, also suggests that the Member States will remain the principal actors for tax matters.").


15. TFEU, supra note 2, art. 249 ("A directive shall be binding, as to the result to be achieved, upon each Member State to which it is addressed, but shall leave to the national authorities the choice of form and methods.").

16. Another development in the direct tax area, which is not a legislative enactment but still took place based on a recommendation from the Commission, is the Code of Conduct for Business Taxation (the "Code of Conduct"). Conclusions of the Ecofin Council Meeting on 1 December 1997 Concerning Taxation Policy, 1998 O.J. (C 2) 1. Although the Code of Conduct is not binding on Member States, its mandate that Member States remove any forms of harmful tax competition has been widely respected. Tracy A. Kaye, The Gentle Art of Corporate Seduction: Tax Incentives in the United States and the European Union, 57 KAN. L. REV. 93, 109 (2008) ("The Code is not binding on the Member States, but those adopting it agree to reduce any existing tax measures that constitute harmful competition and to refrain from instituting any similar measures in the future.").
Union, but rather by its judicial arm.

The ECJ has jurisdiction over cases that challenge a Member State’s actions as violations of the treaties of the European Union.17 As the ECJ often writes, "although direct taxation falls within the competence of the Member States, the latter must none the less [sic] exercise that competence consistently with Community law."18 Although Article 115 of the TFEU requires the unanimous consent of the Member States for any EU-wide measure regulating direct taxation,19 all Member State laws may be challenged before the ECJ for violating the fundamental freedoms of the European Union. These fundamental freedoms include the so-called “four freedoms” of movement of goods, labor, capital and services, as well as the freedom of establishment.20 From an American perspective, this essentially means that the ECJ has nondiscrimination jurisdiction similar to the U.S. Supreme Court’s Dormant Commerce Clause jurisdiction.

For the first several decades of the ECJ’s jurisprudence, no cases challenged any direct tax measures as violations of the fundamental freedoms.21 In 1986, the ECJ upset any sense that direct cases were outside its jurisdiction when it decided Avoir Fiscal, which struck down a French tax credit that was permitted only to companies resident in France.22 As one commentator has noted, the effect of Avoir Fiscal “can be likened to the opening of Pandora’s Box.”23

After 1986, the number of direct tax cases before the ECJ blossomed

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17. See TFEU, supra note 2, art. 267 (“The Court of Justice of the European Union shall have jurisdiction to give preliminary rulings concerning: (a) the interpretation of the Treaties; (b) the validity and interpretation of acts of the institutions, bodies, offices or agencies of the Union . . . .”); id. art. 273 (“The Court of Justice shall have jurisdiction in any dispute between Member States which relates to the subject matter of the Treaties if the dispute is submitted to it under a special agreement between the parties.”).  
19. See TFEU, supra note 2, art. 115 (“[T]he Council shall, acting unanimously in accordance with a special legislative procedure and after consulting the European Parliament and the Economic and Social Committee, issue directives for the approximation of such laws, regulations or administrative provisions of the Member States as directly affect the establishment or functioning of the internal market.”) (emphasis added).  
22. Case 270/83, Comm’n v. France, 1986 E.C.R. 273; see, e.g., Alvin C. Warren, Jr., Income Tax Discrimination Against International Commerce, 54 TAX L. REV. 131, 166 (2001) (“Beginning in the 1980’s, the European Court of Justice has interpreted these various rights to provide protection against income tax discrimination among Member States. The first such case was Commission v. France [hereinafter Avoir Fiscal], in which France’s denial of integration credits to the French branch of a foreign insurance company that held shares of French companies was held to violate the freedom of establishment.”).  
23. de la Feria & Faust, supra note 14, at 15.
from zero to hundreds over the last decade.24 Direct tax cases now constitute almost two percent of the ECJ’s caseload, with tax cases in general making up approximately ten percent of the court’s cases.25 Many commentators, discussing the court’s increased role in adjudicating direct taxation measures, have reached a wide variety of conclusions regarding its impact. However, while commentators disagree about whether the court’s encroachment into this field is a positive or a negative development,26 most agree that the court’s activity in this field has limited the ability of Member States to shape their tax systems.27 In turn, both those who criticize the court’s entry into the direct tax arena and those who support it describe the effect of the court’s decisions as “negative harmonization.”28 This term captures the fact that, while the court is eliminating aspects of Member State tax regimes, the legislative arm of the European Union still lacks the authority to positively harmonize those regimes. The ECJ’s direct tax jurisprudence is thus hollowing out individual Member State tax regimes, but no EU-level entity yet has the ability to replace the provisions that the court has removed.

When the court decides direct tax cases, it generally follows a multipart analysis that permits restrictive or discriminatory provisions only upon further justification.29 This analysis of whether a provision is justified is sometimes

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25. See Philipp Genschel & Markus Jachtenfuchs, How the European Union Constrains the State: Multilevel Governance of Taxation, 50 EUR. J. POL. RES. 293, 301-02 (2011) (“[T]he relative share of direct tax cases grew from less than 10 per cent of all tax cases (1988-1997) to almost 25 per cent (1998-2007) . . . .”); Mason & Knoll, supra note 20, at 1018 (“[T]ax cases constitute about 10% of the [ECJ’s] caseload.”).

26. Compare Servaas van Thiel, The Direct Income Tax Case Law of the European Court of Justice: Past Trends and Future Developments, 62 TAX L. REV. 143, 188 (2008) (“The criticism that the CJEU’s approach is inconsistent . . . is based on a misunderstanding of the constitutional rules in the EU on the horizontal and vertical division of competences, which largely have been developed by the court itself.”), with Peter J. Wattel, Commentary: Judicial Restraint and Three Trends the ECJ’s Direct Tax Case Law, 62 TAX L. REV. 205, 207 (2008) (“I . . . generally welcome the court’s recent restraint, as I feel the court was overplaying its hand (its competence and its possibilities) in its activist years and had given us an intractable ball of unacceptably inconsistent case law, as the court was regularly backing out—without saying so—of consequences of its previous vigorous case law.”). The involvement of the ECJ has triggered debates in other related areas. See Graetz & Warren, supra note 20, at 1120-21; Suzanne Kingston, The Boundaries of Sovereignty: The ECJ’s Controversial Role Applying Internal Market Law to Direct Tax Measures, 9 CAMBRIDGE Y.B. EUR. LEGAL STUD. 287, 297-303 (2006) (charting “the three ‘eras’ in the court’s jurisprudence applying the fundamental freedoms to national direct tax rules”); Mason & Knoll, supra note 20, at 1014 (discussing whether the court has a cohesive view of taxation); Wattel, supra, at 205 (observing “a cyclical pattern [from] hesitance in the beginning (until 1994), followed by outright activism (1995-2004) [to] a return to judicial restraint and a certain deference to the fiscal sovereignty of the Member States (since 2005)”).

27. See, e.g., Genschel & Jachtenfuchs, supra note 25, at 297 (“While Member States continue to levy taxes, EU institutions increasingly shape them.”).


referred to as the proportionality analysis, in which the court considers whether the restriction on free movement is proportionate to a permissible goal. Permissible justifications include "reasons of public policy, public security or public health," as well as preserving the fiscal cohesion of a Member State's tax system. The availability of administrative remedies and offsetting tax advantages are among the justifications that have been found to be impermissible. Notably, one justification that the court has consistently rejected in direct tax cases is the protection of Member State revenue. Thus, although one of the primary reasons that Member States have retained control over fiscal policy is so that they can protect their tax bases, the ECJ has declared that this very protection is not a sufficient justification for discriminatory or restrictive domestic tax provisions.

If the court finds that a Member State's tax provision impermissibly violated the fundamental freedoms, then the other Member States are required to eliminate or amend similar tax provisions to ensure that they do not discriminate based on residence or seat of establishment. Some Member States may respond by eliminating the problematic tax provision entirely, while others may extend the beneficial treatment of the provision to nonresident taxpayers or restrict the negative treatment that previously applied only to nonresident taxpayers.

From 1986 onwards, the ECJ has applied its direct tax analysis to all kinds of Member State tax provisions, including rate differentials, loss consolidation, and anti-avoidance rules. In 2006, the court’s direct tax jurisprudence considered another type of provision: incentives for charitable giving. Section B discusses the four cases that this Article refers to as the ECJ’s “charitable giving cases,” which address the legitimacy of restrictions on incentives for charitable giving.

B. The Charitable Giving Cases of the ECJ

Due to historical, religious, and cultural differences between the individual Member States, the charitable sectors within the European Union are extremely varied. The tax treatment of charitable organizations and charitable do-

(2012).
30. MASON, supra note 29, at 93 (internal quotations omitted).
31. Case C-204/90, Bachmann v. Belgium, 1992 E.C.R. I-00249, ¶ 21. For more on justifications that are permitted in certain limited circumstances, see Mason, supra note 29, at 101-08. Note that even permitted justifications can only support narrowly tailored Member State provisions; the fact that a justification has been accepted by the ECJ in the past does not guarantee that it will be accepted in a particular case.
32. MASON, supra note 29, at 108-14.
33. See, e.g., Case C-10/10, Comm’n v. Austria, 2011 E.C.R. I-05389, ¶ 40 (“[I]t is settled case-law that the need to prevent the reduction of tax revenues is neither among the objectives stated in Article 58 EC nor an overriding reason in the public interest capable of justifying a restriction on a freedom instituted by the Treaty.”).
35. See, e.g., Case C-446/03, Marks & Spencer v. Halsey, 2005 E.C.R. I-10866.
nations also vary by Member States. In some Member States, charitable giving incentives take a form similar to that taken in the United States: charitable organizations are exempt from income, property, estate, and other taxes, while donations to these organizations are deductible from income and estate taxes. Member States with these incentives vary in terms of their limitations, but the general shape of the incentives remains similar.\(^37\) Other Member States, however, retain charitable giving incentives in their tax systems, but they operate differently from the exemptions and deductions that may be familiar to readers. In the United Kingdom, for example, the most popular charitable giving incentive is Gift Aid; under this scheme, donations to charitable organizations are not deductible to donors, but instead are grossed up in the hands of the recipient organizations.\(^38\) In Italy and Spain, by contrast, after individuals calculate their personal income tax liability, they can choose on their tax returns to allocate a set portion to the Catholic Church or other qualifying organizations.\(^39\) Hungary had a similar rule until recently, allowing taxpayers to designate a charitable organization to receive 1\(^{\text{st}}\) of their tax owed.\(^40\)

\(^{37}\) See, e.g., Antoine Vaccaro, Chris Olivier & Edith Bruder, *France, in The State of Giving Research in Europe: Household Donations to Charitable Organizations in Twelve European Countries* 20, 21 (Pamala Wiepking ed., 2009) ("The deductibility rates of charitable giving in France have increased from 1995 to 2006. For donations to organizations of general interest, the deductibility evolved from 40% of the gift with a maximum of 5% of the income in 1995, to 60% with a maximum of 20% of the income in 2003, and to 66% of the gift in 2005. For charitable giving to organizations specialized in social care, the deductibility rate increased from 50% of the donation with a maximum of 1040 French Francs (€158) in 1995, to 66% with a maximum of €414 in 2003, and to 75% with a maximum of €470 in 2005."). The definition of qualifying charitable organizations also varies by Member State, although most Member States have overlapping definitions.

\(^{38}\) See *Giving to Charity Through Gift Aid*, HM Revenue and Customs, http://www.hmrc.gov.uk/individuals/giving/gift-aid.htm (last visited Oct. 24, 2013); see also Cathy Pharaoh, *United Kingdom, in The State of Giving Research in Europe: Household Donations to Charitable Organizations in Twelve European Countries* 71, 74 (Pamala Wiepking ed., 2009) ("Tax repaid to charities on giving through Gift Aid – the most popular tax-effective method in the UK which accounts for 90% of all giving – is worth around £850 million: tax repaid to donors is around £200 million.").

\(^{39}\) See Giuliana Gemelli, *Italy, in The State of Giving Research in Europe: Household Donations to Charitable Organizations in Twelve European Countries* 42, 45 (Pamala Wiepking ed., 2009) (describing the cinque per mille: government allocation of .5% of personal income tax. In 2006, this was €395 million, which "represents direct contributions from individuals who are free to give their personal share of taxes to their favorite NPO or research institution."); see also Marta Ray Garcia, *Spain, in The State of Giving Research in Europe: Household Donations to Charitable Organizations in Twelve European Countries* 52, 58 (Pamala Wiepking ed., 2009) ("The amount of household giving indirectly raised under the 0.7% of the Tax on Individual Income ruling (0.52% until fiscal year 2006) is published every year. This differential subsidization mechanism allows individuals to voluntarily devote 0.7% of their total tax liability . . . to charitable purposes. In their tax statement, taxpayers can choose to devote that amount to either the Catholic Church . . . to NGOs active in social action and cooperation . . . to match it and share it among the two with no additional cost . . . or to mark neither of the two options, thus leaving the amount to the State for general purposes.").

\(^{40}\) See David Moore, *The Fiscal Framework for Corporate Philanthropy in CEE and NIS*, 6 INT’L J. NOT-FOR-PROFIT L. 2 (2004) ("One of the more innovative tax incentives in the region in recent years has become known as the 1% Law." Pioneered in Hungary in 1996, the 1% Law allows private individuals to designate 1% of their tax liability to an NGO and 1% to a church. To be entitled to receive 1% contributions, a foundation or association must carry out public benefit activities. State museums and other state cultural institutions are also eligible recipients. Hungary’s 1% Law, through which $15.76 million was designated for NGOs in 2001 alone, has served as a model for similar tax designation legislation now enacted in Slovakia, Lithuania, and most recently, Poland.")
Despite these differences, the tax treatments of charitable giving and charitable organizations in Member States had one similarity. Until 2006, the majority of Member States limited their charitable giving incentives to charitable organizations located within their individual borders. Under this limitation, the only charitable organizations that were exempt from income or property tax were domestic organizations, and the only charitable donations that qualified for tax deductions were those to domestic organizations. This qualification, commonly known as the "landlocked" or "water’s edge" principle, was not novel to Member States of the European Union. It has been common amongst the many countries worldwide that offer charitable giving incentives in their tax systems, including the United States. Although the landlocked principle had generated much debate amongst commentators in recent years, Member States appeared set on maintaining this restriction prior to 2006.

The ECJ addressed this state of affairs in 2006, when it decided its first charitable giving case. In Walter Stauffer, the court considered whether Germany could limit its charitable tax exemption to domestic nonprofit organizations. Under the German tax provisions in question, Italian foundations such as the Centro di Musicologia Walter Stauffer were not exempt from taxation on any income earned in Germany because they, as foreign institutions, were only subject to limited tax liability in Germany. The ECJ held that this practice of restricting tax exemption to domestic nonprofits violated the free movement of capital.

This finding was striking in its effect from the perspective of Member States. Although the court had addressed geographic limits on personal deductions earlier in Schumacker, this was the first case to address charitable giving incentives directly. Limiting tax exemptions to domestic charitable organizations was hardly unique to Germany, but after Walter Stauffer, Germany and all other Member States that had limited tax exemptions to domestic nonprofits were presented with two options. They could either exempt all nonprofits from the twenty-eight Member States from tax, or they could deny tax exemptions to.

43. See, e.g., 26 U.S.C. § 170 (2006). Note that this limitation is less onerous in practice in the United States because the United States allows "friends of" organizations, which are U.S. charitable organizations that are "friends of" established non-U.S. organizations. See Rev. Rul. 63-252, 1963-2 C.B. 101. The "friends of" exception, however, still requires non-U.S. charities to establish a U.S. charitable organization, while U.S. charities do not need to create a separate conduit organization. For sources questioning the wisdom of the continued water’s edge limitation, see generally Eric M. Zolt, Tax Deductions for Charitable Contributions: Domestic Activities, Foreign Activities, or None of the Above, 63 HASTINGS L.J. 361 (2012) (arguing that alternative charitable deduction regimes should be considered); Pozen, supra note 42 (arguing that the water’s edge limitation is problematic under all deduction theories); and Harvey P. Dale, Foreign Charities, 48 TAX LAW. 655 (1995) (arguing that the current regime is unreasonably complex and inconsistent).
45. Id. at I-8239. The income in question was rental income from property owned in Germany.
46. Id. at I-8247.
47. Case C-279/93, Finanzamt Köln-Altstadt v. Schumacker, 1995 E.C.R. I-00249 (holding that personal deductions cannot be categorically prohibited to non-residents if they earn all or almost all of their income in Germany).
all nonprofits, including domestic organizations that had previously had tax-exempt status. Member States thus lost the ability to limit their exemption regime to their domestic charitable sectors.

Walter Stauffer dealt with a nonresident charitable organization that was prohibited from taking advantage of a charitable tax exemption that would be permitted to a resident charitable organization. In 2009, the court considered a different scenario in a case called Hein Persche v. Finanzamt Lüdenscheid, whether a resident donor could be prevented from taking a charitable deduction just because the donee was a nonresident charitable organization. Persche dealt with Germany's charitable tax deduction. As with many other Member States, Germany had limited the deduction for charitable donations to donations that were given to domestic charitable organizations. In 2003, Mr. Persche, a German tax adviser with a second home in Portugal, donated “a gift in kind of bed-linen and towels, and also Zimmer frames and toy cars for children” to the Centro Popular de Lagoa in Portugal, a retirement home with an attached children's home near Persche's Portugal residence. Persche valued this donation at €18,180, and he deducted this amount from his German income tax. In order to substantiate this deduction, Persche provided a receipt showing that Centro Popular was “registered as a private social solidarity body with the General Directorate of Social Services and that it was accordingly entitled to all exemptions and tax benefits conferred by Portuguese law on bodies recognised as charitable.” The ECJ accepted that this certificate was “sufficient under Portuguese law to entitle him to a deduction for tax purposes.”

The German tax authorities, however, disallowed the deduction, both because Centro Popular was not a German charitable organization and because the receipt provided by Persche was not in the form required by German law for substantiating documentation. The German court sent the case to the ECJ for a preliminary ruling and the court was thus presented with two threshold questions. First, do the donations in question fall within the treaty prohibition on free movement of capital? Second, if so, does a residency restriction on deductions for such donations constitute an impermissible restriction on free movement of capital?

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49. Case C-318/07, Hein Persche v. Finanzamt Lüdenscheid, 2008 E.C.R. 1-00359 (Opinion of Advocate General Mengozzi), ¶ 10; see also Persche, 2009 E.C.R. 1-00359, ¶ 6 (noting that German law provides that exemptions on corporation tax apply only to charitable bodies established in Germany).
50. Persche, 2008 E.C.R. 1-00359 (Opinion of Advocate General Mengozzi), ¶ 16; Persche, 2009 E.C.R. 1-00359, ¶ 2, 12. For American readers, "Zimmer frames" are the British term for "walkers."
52. Id. ¶ 17.
55. Note that the Advocate General presented these as three questions, with the third question being whether Member States are obligated to obtain assistance from another Member State to determine if a charitable organization meets the latter Member State's requirements. The Grand Chamber combined the second and third questions into one. Id. ¶ 1.
The ECJ held that charitable donations, including in-kind gifts, did fall under the treaty guarantee of the free movement of capital and that restricting charitable deductions to domestic recipients was an impermissible restriction on the free movement of capital. The ECJ thus disallowed absolute territorial restrictions on charitable deductions; resident donors must be able to receive a deduction if they can show that the foreign recipient organization would have been permitted to receive deductible donations had it been a domestic organization.

The Persche holding is significant because of both its limitations and its wide-ranging impact. In terms of limitations, the ECJ placed the burden on taxpayers to provide evidence that a donation to the foreign charitable organization would qualify for a tax deduction were that donation made to a domestic organization. In other words, Member States were permitted to limit their deduction to donations to qualified organizations, but nationality could not be one of the qualifications for a deduction. Furthermore, placing the burden on taxpayers allows Member States to continue to treat donations to domestic and foreign organizations differently, if only in terms of the hurdles faced by taxpayers. So long as the Member State does not categorically refuse to allow deductions for any donations to foreign organizations, Member States may still require taxpayers to acquire all necessary substantiation and reject such documentation if it does not comport with Member State requirements. As will be seen in Part III, this limitation may have created enough of a loophole to permit some Member States to avoid, at least in the short term, the actual holding of Persche. However, the number and frequency of Member State responses suggest that Member States themselves do not believe that this substantiation requirement is sufficient to erase the effect of the ECJ’s holding in Persche. Furthermore, the Commission’s responses to Member State laws also establish the limits of this apparent loophole.

57. Id.
58. See, e.g., id. ¶ 48 ("[i]t is not a requirement under Community law for Member States automatically to confer on foreign bodies recognised as having charitable status in their Member State of origin the same status in their own territory .... In those circumstances, they are free to define the interests of the general public that they wish to promote by granting benefits to associations and bodies which pursue objects linked to such interests in a disinterested manner and comply with the requirements relating to the implementation of those objects.").
59. Id. ¶ 72 ("Article 56 EC precludes legislation of a Member State by virtue of which, as regards gifts made to bodies recognised as having charitable status, the benefit of a deduction for tax purposes is allowed only in respect of gifts made to bodies established in that Member State, without any possibility for the taxpayer to show that a gift made to a body established in another Member State satisfies the requirements imposed by that legislation for the grant of such a benefit.").
60. See id. ¶ 70 ("As regards charitable bodies in a non-member country, it must be added that it is, as a rule, legitimate for the Member State of taxation to refuse to grant such a tax advantage if, in particular, because that non-member country is not under any international obligation to provide information, it proves impossible to obtain the necessary information from that country .... ").
61. To the extent that this substantiation requirement does limit the effect of Persche, it may make it harder for smaller charitable organizations to benefit from cross-border giving, since larger charitable organizations may be able to apply for charitable status in the Member States from which they are likely to receive donations, while smaller charitable organizations will have to rely on donors to provide substantiation to their countries of residence.
62. See infra Section II.D.
In terms of wide-ranging impact, the effect of Persche was to require most Member States to make fundamental changes to the tax incentives they provided for charitable giving. After Persche, the Member States that provided charitable giving incentives in the form of deductions had two choices. They could either eliminate their incentives for charitable giving entirely, meaning that donors would not benefit from the incentive regardless of the residence of the recipient organization, or they could extend the incentive to cover donations to charitable organizations in other Member States that met the requirements—other than residency—for qualified recipients of charitable organizations. As will be shown in Part II, the Member States responded to this requirement in a variety of ways.

Persche was not the ECJ’s last word on charitable giving or nonprofit institutions. In 2011, the court decided both Missionswerk and Commission v. Austria. In Missionswerk, the ECJ extended the Walter Stauffer holding beyond personal and corporate income tax regimes. Under Belgian law, beneficiaries of bequests were required to pay succession duties—or estate taxes—at a rate of up to 80%. This marginal rate was reduced to 7% if the beneficiary was a nonprofit organization, but only if the organization was either in Belgium or in the benefactor’s actual place of work or residence. Ms. Renardie had bequeathed a gift to Missionswerk, a religious organization in Germany, and Belgium taxed this gift at a marginal rate of 80% because the benefactor had neither lived nor worked in Germany. The ECJ held that this restriction on the the reduced rate for succession duties violated Article 63 of the TFEU.

After Missionswerk, Member States thus face the same decision in the estate tax realm that they faced after Walter Stauffer and Persche in the income tax realm. They must either eliminate charitable tax incentives entirely, or they must extend them to otherwise qualifying organizations in other Member States.

The most recent charitable giving case was also decided in 2011. Although Commission v. Austria was not about a charitable deduction per se, because Austria had not implemented such a deduction until 2009, it focused on what was effectively a deduction for charitable giving. Under the Austrian income tax regime, Austria provided that certain gifts could be deducted as “operating expenses,” and these gifts included gifts out of operating capital to

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63. Although some commentators incorrectly interpreted Persche as requiring the latter choice, see Karla W. Simon, International Non-Governmental Organizations and Non-Profit Organizations, 44 INT’L LAW. 399, 410 (2010) (“This decision is an important one for all of Europe, holding as it does that cross-border donations within Europe must be made deductible under domestic law”). The ECJ only required that Member States not discriminate based on residence, so they had the option described here.

67. Id. ¶ 8.
68. Id. ¶ 5.
69. Id. ¶ 9.
70. Id. ¶ 37.
71. Case C-10/10, Comm’n v. Austria, 2011 E.C.R. I-05389, ¶ 5 (holding that an Austrian law violated Article 40 of the EEA Agreement by referring exclusively to institutions established in Austria).
educational institutions that were established in Austria. The Commission in 2005 challenged this limitation, first in two letters of formal notice and then in a reasoned opinion. In 2010, the Commission brought this case before the ECJ, and the court decided that Austria had violated the free movement of capital provisions under both the founding treaties and the European Economic Area (EEA) Agreement by limiting its deduction to recipients established in Austria. That the court reached this holding under both the treaties and the EEA Agreement means that the deduction in question must be extended to all European Free Trade Association (EFTA) member states. The charitable sectors that can benefit from the charitable giving cases thus now include those throughout the EFTA as well as the European Union. In other words, Member States in the European Union must not only extend their charitable giving incentives to the other twenty-seven Member States of the Union, but also to Iceland, Liechtenstein, Norway, and Switzerland.

C. Charitable Giving Cases as an Example of the ECJ's Tax Expenditure Jurisprudence

Upon first reading, it may appear that the charitable giving cases are no different than the ECJ's earlier direct tax cases referenced in Section A. In many ways, this is correct. The court applied the analysis that it generally uses in direct tax cases. The court found, as it has in many other direct tax cases, that the provisions in question were impermissible restrictions on free movement. This finding led the court to hold that Member States must either eliminate these restrictive provisions or extend them to similarly situated beneficiaries in other Member States.

While these cases were decided consistently with previous direct tax jurisprudence, the cases highlight a larger development in the ECJ—the court's recent tax expenditure jurisprudence. This is particularly true of Persche and Commission v. Austria, which dealt with charitable deductions.

Governments have two primary options for providing monetary support to their citizens: they can either pay money directly to individuals and corporations, or they can reduce their citizens' taxes. The former option is achieved through direct expenditures, and the latter through tax expenditures. The charitable deductions in question are in many ways the paradigmatic example of tax expenditures, and this Article uses the charitable giving cases as illustrations

72. Id. ¶¶ 5-8.
73. Id. ¶¶ 7-14.
74. Id. ¶ 44.
75. See id. ¶ 2 (quoting Article 40 of the EEA Agreement as preventing "restrictions between the Contracting Parties on the movement of capital belonging to persons resident in [EU] Member States or [EFTA] States").
76. Just because the cases were decided consistently with previous direct tax jurisprudence does not mean that they could not also have come out the other way. See Graetz & Warren, supra note 20, at 168 (pointing out the lack of any general overarching theme in the ECJ's direct tax jurisprudence).
78. See, e.g., Daniel Halperin, Is Income Tax Exemption for Charities a Subsidy?, 64 Tax L.
of the ECJ’s broader tax expenditure jurisprudence.

Although direct spending and tax expenditures are often approved through different political processes, they are generally accepted in the tax and economics literature as being economically equivalent. Both represent revenue forgone by the government and both are methods by which the government can target spending to specific recipients. Both are, in other words, subsidies.

Because charitable deduction is often held up as a prime example of tax expenditure, I use the cases addressing charitable deduction here as an example of those tax expenditure cases that preceded it. Furthermore, as will be discussed further in the next Part, its link to social policy highlights many of the downsides of the ECJ’s tax expenditure jurisprudence that might not be as evident in other cases.

The court’s tax expenditure jurisprudence, however, expands well beyond cases considering charitable deduction. Although readers may disagree on the appropriate definition of a tax expenditure, the ECJ’s tax expenditure jurisprudence could arguably include all cases considering revenue-reducing tax provisions, including the ECJ cases that considered provisions regarding tax refunds, shareholder credits or deductions on distributed profits, accurate measurement of income, application of lower rates to certain taxpayers or

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79. See, e.g., Alvin C. Warren, Jr., Income Tax Discrimination Against International Commerce, 54 TAX L. REV. 131, 143-44 (2001) (discussing the historical treatment of tax subsidies in the General Agreement on Tariffs and Trade (GATT) and adding that “the Uruguay Round yielded a new Subsidies Code, which defines a subsidy as a ‘financial contribution by a government or any public body’ including forgone revenue, such as a tax credit, that confers a benefit”); Arizona Christian Sch. Tuition Org. v. Winn, 131 S.Ct. 1436, 1450 (2011) (Kagan, J., dissenting).


81. For a summary of other tax expenditure (or tax incentive, to use the authors’ terminology) cases, see Edoardo Traversa & Barbara Vintras, The Territoriality of Tax Incentives within the Single Market, in ALLOCATING TAXING POWERS WITHIN THE EUROPEAN UNION 171, 172-74 (Richelle et al. eds., 2013).


83. See, e.g., Case C-175/88, Biehl v. Administration des Contributions du Grand-Duché de Luxembourg, 1990 E.C.R. I-1779 (holding that Luxembourg’s limit on refunds for overpaid taxes to full-time residents was inconsistent with the Treaty freedoms).

84. See, e.g., Case C-270/83, Comm’n v. France, 1986 E.C.R. 00273 (holding that France’s limit on the shareholder tax credit on dividends to resident taxpayers was inconsistent with the Treaty freedoms).

85. It should be noted that there is significant debate over what provisions are necessary for accurate measurement of income. Although business expenses are deductible, many commentators agree that the deduction for business expenses is not a tax expenditure but rather a necessary provision to ensure that only net income is taxed. See Fleming & Peroni, supra note 82, at 142 (“[T]he section 162 deduction for business expenses is not a tax expenditure, even though it benefits taxpayers by reducing their taxable income, because the deduction is a normative element in the definition of the base of a net
transactions,\textsuperscript{86} purchase of insurance, pensions, and other savings vehicles,\textsuperscript{87} and for investment incentives.\textsuperscript{88}

Even readers with a much narrower definition of tax expenditures would likely view cases addressing tax provisions that encourage home ownership and education to contribute to the ECJ’s tax expenditure jurisprudence. In a host of such cases, the ECJ has eliminated residence restrictions, just as it did in the charitable giving cases. The court has required Member States to expand tax benefits to nonresidents in the context of interest rate subsidies for housing construction,\textsuperscript{89} capital gains exemptions for reinvestment in owner-occupied housing,\textsuperscript{90} accelerated depreciation for real property,\textsuperscript{91} and provisions explicitly described as “subsidies” for owner-occupied housing.\textsuperscript{92} In the context of education, the ECJ again eliminated territorial limitations on Member State deductions for educational expenses by professionals,\textsuperscript{93} deductions for private school fees,\textsuperscript{94} deductions for payments to state educational institutions,\textsuperscript{95} and exemptions for income received for teaching.\textsuperscript{96} Thus, the charitable giving cases illustrate a much broader trend in tax

\textsuperscript{86} E.g., Case C-311/97, Royal Bank of Scotland v. Dimosio, 1999 E.C.R. 1-02651 (holding that the higher rate imposed by Greece on foreign banks was inconsistent with the Treaty freedoms).

\textsuperscript{87} E.g., Case C-136/00, Danner, 2002 E.C.R. 1-08147 (considering the fact that Finland only allowed a deduction for contributions to voluntary pension insurance contracts offered by Finnish insurers and holding that this limitation was inconsistent with the Treaty freedoms).


\textsuperscript{89} Case C-484/93, Svensson v. Ministre du Logement et de l’Urbanisme, 1995 E.C.R. I-3971.

\textsuperscript{90} Case C-345/05, Comm’n v. Portugal, 2006 OJC 281; Case C-104/06, Comm’n v. Sweden, 2007 OJC 96.

\textsuperscript{91} Case C-35/08, Fernandez v. Finanzamt Stuttgart-Kopierschaften, 2008 OJC 92.

\textsuperscript{92} Case C-152/05, Comm’n v. Germany, 2005 OJC 132. Note that this list, as with the rest of this discussion of revenue-reducing tax provisions, focuses solely on income taxes throughout the European Union. The ECJ has also considered cases dealing with incentives for home ownership in other tax systems. See Case C-11/07, Eckelkamp v. Belgium, 2008 (holding that Belgium’s limit on the inheritance tax deduction of the amount of mortgage debt from the value of an estate to resident decedents was inconsistent with the Treaty freedoms); see also Case C-155/09, Comm’n v. Greece, 2011 (holding that Greece’s limit on the transfer tax exemption for first purchases of real property to Greek residents and buyers of Greek origin was inconsistent with the Treaty freedoms); Case C-250/08, Comm’n v. Belgium, 2011 (holding that the Flemish Region’s limit on the offset of property registration duties to purchases of property in the Flemish Region was inconsistent with the Treaty freedoms).

\textsuperscript{93} Case C-55/98, Skatteministeriet v. Vestergaard, 1999 E.C.R. 1-7657, (Danish rebuttable presumption that educational expenses in foreign tourist resorts were not deductible).

\textsuperscript{94} Case C-76/05, Schwarz v. Gladbach, 2007 E.C.R. I-6879 ¶ 99; Case C-318/05, Comm’n v. Germany, 2007 E.C.R. I-6962 ¶ 139.

\textsuperscript{95} Case C-56/09, Zanotti v. Agenzia delle Entrate, 2010 E.C.R. I-4520 ¶ 78.

\textsuperscript{96} Case C-281/06, Jundt v. Finanzamt Offenburg, 2007 E.C.R. I-2246 ¶ 88.
Charitable Giving, Tax Expenditures, and Direct Spending

expenditure cases. The ECJ has struck down territorial limitations, leaving Member States with a choice: they could either eliminate subsidies to their domestic institutions or residents, or subsidize the institutions and residents of other Member States on equal terms. Faced with this choice, what option did Member States choose? As the next Section shows, in the wake of the charitable giving cases, the vast majority of Member States preferred to expand their charitable tax incentives to other Member States rather than eliminate them entirely.

D. Member State Responses to the Charitable Giving Cases

Member States were not unaware that the ECJ’s decisions in the charitable giving cases could lead them to subsidize one another’s charitable sectors. Austria argued in Commission v. Austria:

An extension of . . . deductibility to institutions established in Member States other than the Republic of Austria . . . would have the consequence that part of the gifts in question . . . would benefit institutions which pursue objectives that are not in the public interest of the Republic of Austria, which would reduce correspondingly the means of institutions established in that Member State.97

Also, even before these cases were being argued, the Commission had been actively discouraging Member States from placing territorial limits on their charitable giving incentives.98

The Member States thus had fair warning, and, in the wake of both the ECJ’s rulings in the charitable giving cases and the Commission’s efforts to end discriminatory tax incentives for charitable giving, the majority of Member States amended their tax codes. Although the Member States vary widely in the speed and impact of their amendments, most of them now allow donations to charitable organizations in other Member States to qualify for tax incentives.99


98. This was true even before the charitable giving cases. See Oonagh B. Breen, EU Regulation of Charitable Organizations: The Politics of Legally Enabling Civil Society, 10 INT’L J. NOT-FOR-PROFIT L. 50, 71 (2008) (“Before and particularly since the decision in Stauffer, the Commission has actively encouraged complaints regarding alleged Member State discrimination against foreign charities in the area of tax exemption.”). The Commission increased its challenges in the wake of the Walter Stauffer decision, and, by 2008, the Commission had opened multiple investigations against Member States for discriminatory tax provisions that limited the beneficiaries based on the residence of the recipient charitable organization. Id. at 72; Press Release, Eur. Comm’n, Commission Requests the U.K. to End Discrimination of Foreign Charities (July 10, 2006); Press Release, Eur. Comm’n, Com’n Requests Ireland and Poland to End Discrimination of Foreign Charities (Oct. 17, 2006); Press Release, Eur. Comm’n, Comm’n Requests Belgium to End Discrimination Against Foreign Charities (Dec. 21, 2006).

99. See Koele, supra note 41, at 413 (“As a result of the Commission’s activity, 12 Member States have resolved elements of their landlocked legislation referring to cross-border philanthropy: Poland, Slovenia, the Netherlands, Denmark, the Czech Republic, Luxembourg, Bulgaria, Latvia, Greece, Belgium, Germany and France.”); Charles R. Ostertag, We’re Starting To Share Well with Others: Cross-Border Giving Lessons from the Court of Justice of the European Union, 20 TUL. J. INT’L & COMP. L. 255, 270 (2011) (noting that after Persche, “most countries in the EU have changed their laws to allow donors to claim deductions for gifts to qualifying foreign organizations that reside in other Member States within the EU”); id. at 270 n.98 (“These countries include Austria, Bulgaria, Belgium, the Czech Republic, Denmark, Estonia, France, Germany, Greece, Ireland, Italy, Latvia, Luxembourg,
While most Member States have chosen expansive systems, thereby deciding in favor of subsidizing foreign nonprofits rather than eliminating tax incentives for charitable giving altogether, there have been some contractive changes. In other words, some Member States have limited (if not entirely eliminated) the types of donations to which their tax incentives would apply.

This Section charts Member State charitable tax incentives along a spectrum from contractive to expansive. The most contractive provisions are those that eliminate the charitable giving incentive entirely, while the most expansive provisions are those that extend charitable giving incentives to any qualifying organization, regardless of residence. In between are deductions for donations to EU Member States, member states of the European Economic Area (EEA), members of the European Free Trade Association (EFTA), and other states as defined by treaty provisions or other agreements.

E. Contractive Responses

The most contractive response to the charitable giving cases has been the complete elimination of tax incentives for giving. One country that has taken this approach is Hungary, which no longer provides any tax incentives for charitable giving in the wake of Persche. The second most contractive response has been the ostensible expansion of tax incentives to nonresident organizations while retaining a restrictive definition of “qualifying organizations” that has the probable effect of limiting tax incentives geographically. Two countries that appear to have taken this approach are France and Germany. Prior to legislation at the end of 2009, France limited its charitable deductions to donations made to charitable organizations engaged in activity domestically or French organizations directing humanitarian activities abroad. In 2009, in response to the ECJ decisions discussed above, France’s law was changed to eliminate this residence requirement and extend the deduction to organizations established in the other twenty-seven Member States, as well as member states of the EEA that had mutual assistance agreements with France. The change potentially allows French tax authorities to require that the activities take place in France or benefit France. If France interprets this requirement to limit the activities to those that take place in France, the Commission could challenge such a limitation. If this requirement does stand, then France gets the benefit of appearing to be expansive in its response to Persche while still effectively limiting its subsidization of foreign charitable sectors. A similar situation exists in Germany, where the previous version of the charitable deduction challenged in Persche required that activities be “suitable for upholding Germany’s international

the Netherlands, Poland, Slovenia, and the United Kingdom.”).

100. See Koele, supra note 41, at 414.


102. France’s change in law was also spurred by its national court deciding cases in light of the charitable giving cases. Id.

103. Id. at 15.
reputation.”

After Persche, Germany did change its charitable deduction to encompass charitable organizations anywhere in the world, but kept the requirement that the activities support German permanent residents or benefit Germany’s reputation. Although some commentators have argued that this limitation is not in fact contractive since all charitable activities benefit Germany’s reputation, others have declared this new limitation “more subversive than an across-the-board lack of incentives” because, under the new requirement, Persche would not be permitted a deduction for his donation to Centro Popular.

Depending on how their definitions of qualifying organizations are interpreted, France and Germany may thus not have charitable giving incentives that are as expansive as they first appear. If it does turn out that France retains its activity/benefit limit and Germany’s reputational requirement continues to be read narrowly, then neither France nor Germany appears to have charitable giving incentives that are sufficient to pass muster under Persche. The Commission will likely challenge these limitations if such narrow readings are upheld by the French and German domestic revenue authorities.

F. Expansive Systems

Among the expansive charitable tax incentives, the spectrum varies depending on the number of countries whose charitable organizations may receive deductible donations. The least expansive approach permits deductions only for donations to Member State organizations. Although this approach is the one envisioned by the ECJ in Persche and its predecessors, no Member State appears to have this limitation. This is partly due to the ECJ’s expansive holding in Commission v. Austria, to include the EEA with three countries that are not members of the European Union.


105. Ostertag, supra note 99, at 271; see also Koele, supra note 41, at 414.

106. See Koele, supra note 41, at 414 (“In the author’s opinion, [a]ny purpose that serves the pluralism of German society, in its broadest sense [sic] would have a positive impact on that society.”). Although this idealized view of the world is appealing, it seems unlikely that Germany would add a restriction on the benefits provided by a charitable organization if that restriction had no actual restrictive effect.


108. The EEA Agreement was signed in 1992, and the EEA was established in 1994. Currently, the EEA consists of the EU Member States, Iceland, Liechtenstein, and Norway, and the Agreement provides the latter three members with the benefits of the EU’s internal market while requiring them to adopt related EU legislation. See Agreement on the European Economic Area, May 2, 1992, 1994 O.J. (L 1) 3. The European Free Trade Association (EFTA) predates the EEA. It was established by the Stockholm Convention in 1960, and its current members are Iceland, Liechtenstein, Norway, and Switzerland. While the former three members are members of the internal market by way of EEA membership, Switzerland’s involvement in the internal market takes place through bilateral agreements with the EU. See Consolidated Version of the Convention Establishing the European Free Trade Association, Jan. 4, 1960, Preamble (Sept. 20, 2010), http://www.efta.int/media/documents/legal-texts/efta-convention/efta-convention-texts/efta-convention- consolidated.pdf. Austria extended the holding to the EEA countries because the ECJ decided the case under both the TFEU and the EEA Agreement and found that Austria’s geographic restriction was a violation of both. See Case C-10/10, Comm’n v. Austria, 2011 E.C.R. I-5389, ¶ 42 (stating that “the provisions of Article 40 of the EEA Agreement have
Many EU Member States have slightly expanded the beneficiaries of their charitable giving incentives by including the EEA (i.e., the twenty-eight Member States plus Iceland, Liechtenstein, and Norway) or EFTA countries (i.e., the EEA plus Switzerland). The degree to which charitable organizations in these countries can benefit from deductible donations, however, varies widely across the Member States. Some Member States, such as Austria and the United Kingdom, have extended their charitable deductions to organizations in the European Union and all countries in the EEA—so long as those countries have sufficient mutual assistance agreements with the Member State in question. The effect of this requirement is to exclude Liechtenstein, which does not yet have a sufficient mutual assistance or information-sharing agreement, while also emphasizing the recent focus in international tax policy on information-sharing.

The next degree of expansiveness adds Liechtenstein to the list by allowing charitable organizations in all members of the EEA to receive deductible donations. Member States that have taken this approach include Belgium, Denmark, and Poland. One further step in the direction of expansiveness is the same legal scope as the substantially identical provisions of Article 56 EC and thus concluding that all considerations in the context of the TFUE "may, in circumstances such as those of the present case, be transposed mutatis mutandis to Article 40 (of the EEA Agreement)."

In the United Kingdom, Finance Act 2010 changed the definition of charitable organizations such that qualifying organizations were no longer limited to the United Kingdom. Mark Bowler Smith, Rotterdam Congress National Reports: Taxation of Charities, United Kingdom, EUR. ASS'N OF TAX L. PROFESSORS 5 (June 2012), http://www.eatlp.org/uploads/public/Reports%20Rotterdam /National%20Report%20UK.pdf. As of now, however, this extension is only to EU Member State organizations and organizations in EEA member states where "sufficient information exchange and collection of tax arrangements are in place to ensure the reliefs can be administered properly." Clive Cuthill et al., Income Tax Cap – Update and Frequently Asked Questions, MONDAQ, http://www.mondoag.com/x /174920/Charities+Non-Profits/Income+Tax+Cap+Update+And+Frequently+Asked+Questions (last updated May 2, 2012) ("Following the introduction of Finance Act 2010, eligible organisations in the EU, Norway and Iceland may receive donations from UK taxpayers which are relieved under Gift Aid and other charitable tax reliefs"); see also Smith, supra, at 5 (concluding that Lichtenstein at the time had not yet satisfied the information exchange requirement and that thus, donations to Lichtenstein would not qualify for U.K. tax deductions). For the expansiveness of Austrian charitable giving incentives, see Christoph Urtz, Rotterdam Congress National Reports: Taxation of Charities, Austria, EUR. ASS'N OF TAX L. PROFESSORS (June 2012), http://www.eatlp.org/uploads/public/Reports %20Rotterdam/National%20Report%20Austria.pdf. If France's activity/benefit limitation is not allowed to stand, so too does France's claimed expansion extend its charitable tax relief to donations to qualifying charitable organizations in other Member States and the EEA, so long as the relevant EEA state has signed a bilateral treaty with France for mutual assistance with regards to tax fraud or tax evasion. See Koele, supra note 41, at 413 n.27; see also supra notes 101-104 and accompanying text for an explanation of why this may only be "claimed."


111. Edoardo Traversa & Barbara Vintras, Taxation of Charities: Belgian Report, EUR. ASS'N TAX L. PROFESSORS 6 (May 2012), http://www.eatlp.org/uploads/public/Reports %20Rotterdam/National%20Report%20Belgium.pdf. Belgium, which was the target of Commission investigations as early as 2002, ultimately amended its relevant tax legislation to allow tax deductions for donations to qualifying organizations in other Member States as well as qualifying organizations in the EEA. See Koele, supra note 41, at 413. This change went into effect in 2010.


is to allow deductions for donations to organizations in selected countries beyond the EEA. Member States that have taken this approach include Ireland, the Netherlands, and Sweden. Sweden may arguably have made the most expansive change in that it created a tax incentive for charitable giving that did not previously exist. Prior to 2012, Sweden was one of the few countries that did not provide any charitable tax benefit whatsoever; as of January 1, 2012, Sweden now permits a 25% deduction for qualified charitable giving. This incentive applies to donations to organizations within the EEA as well as within any countries with which Sweden has a mutual assistance agreement.

Finally, the most expansive response to the charitable giving cases would be for a Member State to extend its charitable giving incentives to organizations worldwide. This approach, unsurprisingly, is not the most popular among Member States since it requires the subsidization of the charitable sectors of the

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114. In Ireland, donations to qualifying organizations within the EU and EFTA may be deductible. See Charities, REVENUE: IRISH TAX & CUSTOMS, http://www.revenue.ie/en/personal/charities.html (last visited Oct. 24, 2013). Note that while some commentators seem to think that Ireland does not have a charitable deduction, Ireland’s Revenue Office quite clearly advertises its deduction and the fact that this is permitted for organizations throughout the EU and EFTA. See, e.g., BRUCE BARTLETT, THE BENEFIT AND BURDEN: TAX REFORM - WHY WE NEED IT AND WHAT IT WILL TAKE 128 (2013) (citing Ireland as an example of a country that does not allow charitable deductions). Both the Netherlands and Sweden go further, and they extend the deduction to countries with which they have mutual assistance agreements. The Netherlands allows deductions for donations to organizations in the Kingdom of the Netherlands, the European Union, and states designated by the Ministry of Finance that have mutual assistance agreements with the Netherlands. Sigrid J.C. Hemels, Rotterdam Congress National Reports: Taxation of Charities – Netherlands, EUR. ASS’N TAX L. PROFESSORS 5 (May 2012), http://www.eatlp.org/uploads/public/Reports%20Rotterdam/National%20Report%20Netherlands.pdf. Furthermore, even entities from countries that do not qualify as designat- ed countries may receive deductible donations if they share certain information with Dutch tax authorities on an annual basis. Id. at 6. The Netherlands responded even more expansively than either Belgium or France and permitted charitable organizations in any country to register as qualifying charitable or- ganizations. See Koele, supra note 41, at 413. Note that this announcement in November 2008 came after the Netherlands became “the first country in the world to make gifts to foreign charities fully deductible for Dutch resident individual and corporate donors and provide for an equivalent exemption for gift and inheritance tax” in January 2008. Koele, supra note 41, at 413. This expansive change, however, was met with criticism by the Commission, which issued a formal request implying that the registration process for foreign charitable organizations was itself discriminatory. See, e.g., Koele, supra note 41, at 413. This formal request, filed by the Commission in March 2010, has been roundly criticized by comment- menters, who note that both foreign and domestic organizations are required to register under Dutch law. Koele, supra note 41, at 414 (“In the author’s opinion, this seems to be a flawed initiative of the Commission, since there is no discriminatory treatment between foreign and domestic charities in this regard under Dutch tax laws.”).

115. Sigrid J.C. Hemels, The European Foundation Proposal: An Effective, Efficient and Feasible Solution for Tax Issues Related to Cross Border Charitable Giving and Fundraising, EUR. ASS’N TAX L. PROFESSORS 4 n.10 (May 2012) http://www.eatlp.org/uploads/public/Reports%20Rotterdam/Thematic%20report%20Hemels%20(section%2006b).pdf (“Until 2012 no gift deduction was possible in Sweden . . . .”); Ostertag, supra note 99, at 270 (“Sweden remains an outlier by providing no tax benefits for charitable giving . . . .”). Note that this is a change from Sweden’s historic will- ingness to provide incentives for charitable giving. See Richard Arvidsson, Swedish National Report: Taxation of Charities, EUR. ASS’N TAX L. PROFESSORS 1 (May 2012), http://www.eatlp.org/uploads/public/Reports%20Rotterdam/National%20Report%20Sweden.pdf (“The first type of legal entity to be granted tax relief was the foundation, which obtained some relief as early as 1810. This was followed by the non-profit association, which did not obtain their first privileges until 1942.”).

116. Hemels, supra note 115, at 4 n.10 (“[A]s of 2012 individuals can claim a tax reduction of 25% on the value of donations to certain charities . . . .”).

117. Arvidsson, supra note 115, at 12.
most countries. Some countries, however, have such provisions, including Italy and, ostensibly, Germany.\footnote{118}{Fabrizio Amatucci, Taxation of Charities: Italian Report, EUR. ASS'N TAX L. PROFESSORS 9 (May 2012), http://www.eatlp.org/uploads/public/Reports%20Rotterdam/National%20Report%20Italy.pdf; Lampert & Jochum, supra note 104.} Italy’s charitable giving incentive, however, is quite limited in its benefit,\footnote{119}{Amatucci, supra note 118, at 14-15.} and it applied worldwide even before Persche,\footnote{120}{Zolt, supra note 43, at 378 (stating that Poland and South Africa also “allow charitable tax deductions without regard for fwhere the funds are used”).} and Germany’s deduction continues to be restricted by the reputational requirement.\footnote{121}{See supra notes 105-108 and accompanying text.} The Member States that have chosen the most facially expansive charitable tax incentives, may not, in practice, end up foregoing as much revenue as they may at first appear.

The Member States thus now have a wide variety of tax provisions in the wake of the charitable giving cases. At one extreme, at least one Member State has eliminated its charitable deduction entirely. At the other extreme, a few Member States do not consider geography at all, thus extending their deductions to charitable organizations worldwide. The majority of Member States, however, have extended their charitable tax incentives slightly beyond the limits of the European Union. Some have stayed within the lines of the EEA or EFTA, while others have focused more on the existence of mutual assistance agreements or other affiliations.

The fact that most Member States have responded by establishing charitable tax incentives that do not limit their benefits to resident individuals or organizations highlights the impact of the ECJ’s tax expenditure jurisprudence on Member State tax incentive policies. The following Part discusses the costs and benefits of this jurisprudence.

III. THE COSTS AND BENEFITS OF THE ECJ’S TAX EXPENDITURE JURISPRUDENCE

What are the ramifications of the ECJ’s tax expenditure jurisprudence? This Part discusses one benefit and several costs. The primary benefit of the court’s tax expenditure case law is that it creates a new model for fiscal federalism that achieves the benefits of centralization without losing the benefits of decentralization. The primary costs are regulatory and analytic inconsistency.

A. A New Model of Fiscal Federalism

The concept of fiscal federalism was first introduced by Wallace E. Oates, a professor of public and environmental economics, in the 1970s.\footnote{122}{WALLACE E. OATES, FISCAL FEDERALISM (1972).} Under the general theory of fiscal federalism, public goods should be provided at the most decentralized level that experiences the benefits and costs of their provision.\footnote{123}{See Wallace E. Oates, Fiscal and Regulatory Competition: Theory and Evidence, in 3 PERSPEKTIVEN DER WIRTSCHAFTSPOLITIK 377, 377-378 (2002).} Such decentralized provision of goods will achieve the most effi-
cient outcome.\textsuperscript{124} This is because decentralization itself provides a variety of benefits. Among others, decentralization allows local governments to respond to different political preferences across a federal jurisdiction, encourages intergovernmental competition, and fosters political participation.\textsuperscript{125}

This theory does not hold true, however, when the locally provided goods in question have significant spillovers.\textsuperscript{126} In the case of spillovers—in other words, when either costs or benefits are felt outside the immediate jurisdiction—decentralized locales will under- or over-provide.\textsuperscript{127} It is thus more efficient in the face of spillovers to provide public goods at a more centralized level that can account for the total costs and benefits.\textsuperscript{128}

Models of fiscal federalism, however, focus on vertical tax assignment.\textsuperscript{129} They attempt to provide guidance about which level of a federal system ought to provide a given good: the centralized federal government or the decentralized local governments. The ECJ has provided Member States with a different model. By shifting away from the system in which each Member State was entirely responsible for funding charity within its borders, the European Union has abandoned complete decentralization; instead, it has coordinated horizontally, rather than centralizing upward. This structure—referred to here as horizontal subsidization—could arguably retain many of the benefits of both centralization and decentralization and thus provide a new model of fiscal federalism. These possible benefits are discussed in the two subsections that follow.

1. Interjurisdictional Spillovers

The existence of spillovers across jurisdictions poses significant challenges to the general theory that decentralization produces greater efficiency. Instead, it could be used to argue in favor of more centralized policies because vertically integrated levels of government are better positioned to offset the inefficiencies inherent in spillovers.\textsuperscript{130} Areas where this has been shown to be true include environmental regulation and police services. In the former, decen-
Centralized jurisdictions are likely to underregulate the environment, resulting in measurably lower air quality when municipalities are in charge of regulating air pollution than when a centralized authority is. As a recent study shows, even negotiation between municipalities is not enough to offset this inefficiency. In the case of police services, spillover occurs when one jurisdiction increases its supply of police. Although this would decrease crime within the jurisdiction, neighboring jurisdictions would likely see an increase in crime. This outcome, along with the harsher sentences that often result from local control over police, has been used to suggest that police services should be provided at a more centralized level.

Interjurisdictional spillovers are one reason to support the court’s approach to tax expenditures. If, for example, charitable giving is seen to create cross-border spillovers, then prior to Walter Stauffer, certain Member States likely overpaid for their resident charitable organizations, while other Member States underpaid for the benefits they received from nonresident charitable organizations. To take the facts of Walter Stauffer, if Germany were not responsible for subsidizing charitable organizations that were resident in Italy, even if those organizations were providing benefits in Germany, then Germany was not paying for the benefit spillover it received from Italy’s charitable giving incentives. This is also true for deductions. Imagine a charitable organization based in France that focuses on clean air in Alsace-Lorraine. If Germany refused to allow deductions for donations to that charity by its residents, as it did prior to Persche, then Germany would again not be paying for any benefit spillover it received in the form of cleaner air flowing across the Franco-German border. Note that tax expenditures add an interesting wrinkle to the fiscal federalism literature in that the spillovers in question here are benefit spillovers, whereby the recipients—rather than the producers—of spillovers are underpaying. The benefits in question are the results of charitable activity, such as a reduction in the percentage of the population living below the poverty line or an increase in the level of education or environmental protection.

After the charitable giving cases, Member States that have maintained their charitable giving incentives must now pay for at least some of this benefit spillover if their residents choose to donate to nonresident organizations or if nonresident organizations choose to establish themselves in those Member States. If we assume that charitable organizations that either receive cross-border donations or establish themselves in other Member States are likely to produce benefits that cross borders, then requiring Member States to subsidize each other is achieving one benefit of centralization: it is at least partially offsetting interjurisdictional spillovers.

131. Id. at 2.
132. Id.
133. Hakim et al., supra note 124, at 211 (finding that “police expenditure in neighboring communities . . . affects the crime level . . . of the community”).
134. Teichman, supra note 124, at 1874-75 (concluding that decentralized criminal justice systems may lead to excessive sentences).
2. Continued Representation of Political Preferences and Competition

While the horizontal subsidization resulting from the ECJ’s tax expenditure jurisprudence arguably leads to one of the major benefits of centralization, it also preserves some of the benefits of decentralization. It still allows Member States and charitable organizations to respond to different political preferences and encourages competition between both Member States and charitable organizations across the European Union.

In terms of political preferences, horizontal subsidization does not directly eliminate Member State charitable organizations, thus allowing them to continue to represent the preferences of local donors. Moreover, it also achieves one of the political preference benefits that previous commentators have identified in the European Union: minorities are given more voice than they would otherwise have in a fully decentralized system. In the charitable giving context, this means that one of the benefits of horizontal subsidization may be to increase the size and scope of charitable organizations that represent minority interests across the European Union. Imagine that the charitable organization in Alsace-Lorraine is an educational institution that is focused on the area’s history. Imagine also that a minority of German residents and a majority of French residents could be potential donors. When Germany previously refused to grant deductions for donations to this organization by German residents, the German minority would not have had the opportunity to support the organization by way of subsidized donations. After Persche, the organization would now arguably better represent those interested in Alsace-Lorraine across Member State borders.

Horizontal subsidization may also maintain the interjurisdictional competition that is one of the benefits of decentralization. Since there is no federal organization equipped to vertically subsidize charitable giving and thus eliminate the benefits of competition, Member States and charitable organizations are still able to compete. While this benefit applies in theory to both Member States and organizations, it likely applies more to the latter. Under a pure Tieboutian analysis, Member States can compete for “consumer-voters” depending on their charitable sectors and charitable giving incentives. Residents who do not want to live in a Member State that subsidizes the charitable sectors of other countries can, for example, leave Sweden for Hungary. In the European Union, however, this concept of residents voting with their feet seems extremely unlikely, particularly if such voting is thought to be based entirely on preferences about the charitable sector.

Competition between charitable organizations may be more likely to oc-

cur than competition between Member States, meaning that horizontal subsidization would maintain some of the benefits of decentralization. Since organizations are now able to benefit from tax incentives from Member States other than the one in which they are established, they may target a wider donor base, and more donors may consider a larger group of charitable organizations for their charitable giving. This larger playing field may bring with it the various benefits that are attached to greater competition, including efficiency gains.

The result of the ECJ’s tax expenditure jurisprudence may thus achieve one of the major benefits of centralization (greater internalization of spillovers) while not foregoing some of the benefits of decentralization (responsiveness to political preferences and interjurisdictional and interorganizational competition). Compared to vertical models of fiscal federalism, where the benefits of centralization require foregoing the benefits of decentralization, horizontal subsidization is arguably a better model for fiscal federalism.

This conclusion, however, requires significant empirical research after the modified charitable giving incentive structures have been in effect for several more years. The only way to determine whether horizontal subsidization offsets spillovers involves a two-step process: first, to determine whether there are cross-border spillovers from charitable giving, and second, to determine whether expanded tax incentives accurately account for the benefits of these spillovers. As for the benefits of decentralization, future research is necessary to determine whether cross-border giving incentives have achieved greater efficiency. The benefits of horizontal subsidization, while possibly quite significant for fiscal federalism literature, cannot yet be ascertained. As the following Section will show, the same cannot be said for the costs of the court’s tax expenditure jurisprudence.

B. Regulatory and Analytic Inconsistency

While there may be ultimate gains from horizontal subsidization, the means of achieving those gains raise significant concerns. In the first subsection below, I argue that the ECJ overlooks the different systems that exist in Member States and favors a particular type of social policy. The result of attempting to impose horizontal subsidization on twenty-eight very different regulatory systems will likely distort the charitable sector in favor of large charitable organizations that already have an international presence. The more important downside of the court’s tax expenditure jurisprudence, however, is that the ECJ ignores economic realities in favor of formalism. By treating tax expenditures differently than it likely would treat economically equivalent direct spending provisions, the court thus distorts Member State policy choices toward greater direct expenditures. I assess this analytic formalism in the second Subsection below.

1. Regulatory Inconsistency

By allowing the Member States to retain their individual charitable giving incentives while requiring that those who choose to do so extend them to
Member States across the European Union, horizontal subsidization also retains the downside of competition: diversity. Diversity of charitable giving incentives in different Member States means that donors, Member States, and organizations all need to learn the twenty-eight different regulatory systems.

In Persche, the ECJ allowed Member States to retain substantiation requirements for charitable giving incentives. Thus, while Member States could not limit charitable giving incentives based on residence or geography, they could design their own requirements about what recipient organizations need to prove to show that they would qualify as charitable organizations if they were resident in the Member State in question. This allowance permits Member States to retain extremely diverse regulatory systems, which in turn both favors certain charitable organizations and creates opportunities for certain Member States to avoid horizontal subsidization, thus perhaps undoing the competitive benefit mentioned above. The effect of this is to undermine the concept of negative harmonization that underlies many arguments about the ECJ.

First, the requirement that charitable organizations and donors provide information to show that the organizations in question meet all the requirements for Member State charitable organizations other than residency may make it more likely that larger charitable organizations already established throughout the European Union will benefit from horizontal subsidization. As an example, if a charitable organization that is only established in Belgium wants to appeal to donors in other countries, the organization would have to assure non-Belgian donors that it meets all the requirements of their individual Member States. The cost of appealing to donors in Member States with regulations with which the organization is unfamiliar is thus quite high in comparison to the cost of appealing to local donors. By contrast, large organizations that already have a Europe-wide presence would not face these costs, and they might benefit more from horizontal subsidization. Thus, complete competition between organizations may be more of an ideal than a reality, and competition may be limited to larger organizations.

Another consequence of retaining regulatory diversity is that it provides opportunities for Member States to avoid horizontal subsidization. This consequence can already be seen in Member States such as France and Germany, which changed their definitions of charitable organizations in order to circumvent the prohibition against geographic limitations. If Member States choose not to shift to direct expenditures but still want to avoid horizontal subsidization, they may try to add requirements to their regulations for charitable organi-

138. See supra notes 58-60 and accompanying text.
139. Id.
140. See supra Section III.A.2.
141. For more on negative harmonization, see supra note 28 and accompanying text. Since the concept of negative harmonization is based on the idea that, by eliminating differences in Member State laws, the ECJ is pushing the States all toward similar systems. However, the fact that they are able to retain diverse regulatory systems in the wake of the charitable giving cases shows that not every ECJ case has this effect.
142. See supra notes 101-107 and accompanying text.
zations that create significant hurdles to cross-border giving. While the Commission will likely challenge such hurdles eventually if they are seen as too similar to residence requirements, even requirements that are not intended to be discriminatory may be sufficiently unique that they act as a bar to cross-border giving.

Taken together, these consequences of retaining diversity highlight that the horizontal subsidization model of fiscal federalism may not be entirely positive. As shown by the very different responses of Member States to the charitable giving cases, the negative harmonization created by the charitable giving cases is quite far away from actual harmonization. Instead, negative harmonization allows individual states to retain systems that remain different in terms of both design and effect.

2. Analytic Inconsistency

Although the Member States involved in the ECJ charitable giving cases argued that the tax provisions at issue were similar to subsidies, the ECJ ignored the economic equivalence of tax expenditures and direct expenditures. In doing so, the court continued to apply an analytically inconsistent two-part system, by which tax expenditures would be challenged as violations of the Treaty freedoms, while direct expenditures would be analyzed completely differently.143 This distinction matters because direct expenditures may be more likely to survive challenges than tax expenditures—even if their economic effect is exactly the same—and the result of the ECJ’s tax expenditure jurisprudence may be to shift spending into direct expenditures.

Had the tax incentives challenged in the charitable giving cases been direct payments to charitable organizations, the ECJ would likely have approached them very differently. This is because such direct payments would have had to be challenged under the state aid rubric. “State aid” is the term used in the European Union for direct subsidies from Member States to specific domestic industries,144 and the court has decided dozens of cases dealing with state aid since its creation.145 Under Article 107 of the TFEU, “any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition” is impermissible, unless the aid falls within a list of numbered exceptions.146 Although state aid is generally thought

143. Note that this discussion is distinct from the state aid analysis in Traversa and Vintras’s article. Traversa & Vintras supra note 81, at 181-89 (arguing that when the ECJ analyzes tax expenditures that could also be considered state aid, it should not simultaneously analyze them under both state aid rules and EU Treaty freedoms).
144. Kaye, supra note 16, at 100 (“In general, state aid is financial support given by a government to a certain business sector, enterprise, or geographic region through either direct or indirect transfer of resources.”).
145. The Code of Conduct discourages tax provisions that may have the effect of state aid. Id. at 110 (“Article J of the Code of Conduct urged the Commission to strictly apply the state aid rules to those measures that were deemed to be harmful.”).
of as focusing on competition—or, in American terms, antitrust—in that the relevant treaty provisions focus on competition-distorting state aid, Article 107 of the TFEU applies by its terms to state aid "in any form whatsoever."\textsuperscript{147}

Direct expenditures to the charitable sector would thus appear to fall under the state aid rubric. However, if Member States were to shift their charitable spending to direct expenditures and those provisions were to be challenged by the Commission or other Member States, there are several reasons that horizontal subsidization would not likely result.

First, it is unlikely that the ECJ would consider spending in this sector to be state aid. State aid is focused on domestic industries and competition, and the broad charitable sector is not analogous to other industries considered in state aid cases.\textsuperscript{148} State aid is limited to "undertakings," which are themselves defined as entities that carry out an economic activity.\textsuperscript{149} Although the Commission's guidance states explicitly that entities can qualify as undertakings whether or not they make a profit,\textsuperscript{150} non-profit and profit-making entities alike are only undertakings if they engage in economic activities by offering goods or services on the market.\textsuperscript{151} This is again a counterfactual that cannot be determined until the Commission decides a state aid case involving a charitable organization. However, based on the court's precedent, it seems unlikely that a charity involved in charitable activities will be seen as being an "undertaking" unless it engages in profit-making activities on the side.

Second, even if the ECJ found that direct spending constituted anti-competitive state aid, it would very likely fall under one of the many exceptions provided in Article 107 of the TFEU and various EU guidance on state aid. Therefore any restriction on this state aid would likely be found not to violate the treaty protections.\textsuperscript{152} Since a determination of whether direct spending

\textsuperscript{147.} TFEU, supra note 2, art. 107(1). For a list of the many different forms of state aid that have been recognized as such, see Christopher H. Bovis, The Application of State Aid Rules to the European Union Transport Sectors, 11 COLUM. J. EUR. L. 557, 574 (2005). See also Michael Reynolds, Sarah Macrory & Michelle Chowdhury, EU Competition Policy in the Financial Crisis: Extraordinary Measures, 33 FORDHAM INT'L J. 1670, 1674-75 (2010) ("The Commission has historically adopted a broad interpretation of the notion of 'state resources.' Aid can include 'grants, loans at a low rate of interest, deferment of tax liabilities, schemes of aid financed by compulsory contributions by all traders including those who do not benefit and in general, any gratuitous advantage such as a state guarantee of a firm's debt.'").

\textsuperscript{148.} See, e.g., Case C-6/97, Italy v. Comm’n, 1999 E.C.R. I-2997 (striking down state aid to Italian trucking industry).

\textsuperscript{149.} See, e.g., Community Framework for State Aid for Research and Development and Innovation, 2006 O.J. (C 323), 11.

\textsuperscript{150.} Id.

\textsuperscript{151.} Id.

\textsuperscript{152.} Depending on the recipient organization, charitable giving incentives would likely fall under one of these exceptions. E.g., Article 107(2)(a) of the TFEU ("[A]id having a social character, granted to individual consumers, provided that such aid is granted without discrimination related to the origin of the products concerned"); Article 107(2)(b) of the TFEU ("[A]id to make good the damage caused by natural disasters or exceptional occurrences"); Article 107(3)(a) of the TFEU ("[A]id to promote the economic development of areas where the standard of living is abnormally low or where there is serious underemployment, and of the regions referred to in Article 349, in view of their structural, economic and social situation"); Article 107(3)(d) if the TFEU ("[A]id to promote culture and heritage conservation where such aid does not affect trading conditions and competition in the Union to an extent that is contrary to the common interest"). Other exceptions that could include support to charitable or-
would be struck down by the ECJ would depend on the specific fact pattern, the outcome of such a case is impossible to predict with complete certainty. However, the ECJ's case law and articles on state aid suggest that the court likely would not have reached the decision it did, had the Member States subsidized local charitable organizations directly rather than through their tax systems.153

Third, if the provisions were found to be state aid that did not fall under one of the treaty exceptions, the court would still apply a very different analysis than it did to the tax expenditures in the charitable giving cases. Under the State Aid Action Plan issued by the Commission in 2005, state aid is only permitted if it satisfies a three-part test.154 According to this test, the aid measure must be "aimed at a well-defined objective of common interest"; it must be "well designed to deliver the objective of common interest"; and any distortions of competition or effect on trade must be limited.155 This test would likely make it easier for at least some aid to charitable organizations to survive than the free movement analysis that the court applied in the charitable giving cases does.

It should be noted that the entire legal framework surrounding state aid is quite different from that surrounding free movement. Except when explicitly exempted, potentially invalid state aid measures must receive Commission approval before they are implemented, and an ECJ finding that state aid was in violation of the treaty requirements may mandate repayment by the beneficiaries.156 A transition from tax expenditures to direct expenditures would thus require Member States that did not already have direct expenditures in place to either petition the Commission for approval or ensure that the direct spending falls within one of the exceptions. But these different frameworks also mean that similar provisions are treated entirely differently because of their formal structure, rather than their similar effect.

EU law does not necessarily require this different treatment. In 1998, the Commission issued a notice on the application of state aid rules to direct tax measures.157 That document repeatedly acknowledges that direct tax provisions could be considered as state aid and could thus be challenged as violations of Article 117.158 In several cases brought by the Commission, tax expenditures

organizations include the de minimis exception for organizations that receive less than €200,000 and many of the exceptions provided in the General Block Exemption Regulation (such as the exception for small and medium-sized enterprises or the exception for environmental protection). See Commission Regulation 1998/2006, 2006 O.J. (L 379) 8, 9 (EC); Commission Regulation 800/2008, 2008 O.J. (L 214) 18 (EC).

153. This is of course a counterfactual, and the ECJ may reach a different decision in a future state aid case that considers direct spending to charities. I argue based on analogies to previous state aid cases.


156. See id. Note that repayment often also requires payment of interest.


158. Id. at 4 (stating that "loss of tax revenue is equivalent to consumption of State resources in
have in fact been challenged as state aid. But the court appears to apply state aid analysis only to tax expenditures that the Commission is explicitly challenging as impermissible state aid. While there is some rational basis for this approach, given that the Commission is charged with approving state aid, this also means that tax expenditures that have not yet caught the attention of the Commission or that are otherwise first challenged as violations of free movement are subject to a completely different legal analysis than are expenditures that the court has been instructed to consider as state aid measures.

This jurisprudential distinction between tax expenditures and direct expenditures thus ignores the economic reality. Tax expenditures are economically equivalent to direct expenditures, and a discriminatory version of the latter should not be granted more deference just because the ECJ respects the formal distinction between the two. Although the ECJ is not the only court to find that economic equivalence does not create legal equivalence, that does not mean that this analytic inconsistency is correct. Furthermore, such differential treatment of expenditures based on whether they are or are not in the tax code has very real consequences.

The ECJ is now creating an incentive for Member States to shift away from tax expenditures in favor of direct spending. Until the ECJ determinatively states that the analytic inconsistency identified here is incorrect, state aid precedent will lead Member States to predict that direct expenditures can be limited based on residence, while tax expenditures cannot. In the charitable giving context, this means that direct subsidies to local charitable organizations appear much less likely to be struck down than do tax expenditures that are limited to local organizations, and Member States may choose to forego tax expenditures in favor of direct expenditures. This is particularly true for Member States that already had a system of direct support in place.

This incentive to shift away from tax expenditures is problematic for several reasons. First, in many Member States, it is likely to lead not to the replacement of tax expenditures with direct expenditures but rather to the elimination of tax expenditures entirely, with no replacement, due to the political difficulty of authorizing direct expenditures. Second, the court’s inconsistent analysis and oversight of economic equivalence in favor of legal formalities are themselves problematic. Courts, of course, often respect legal formalism based on a belief that form carries with it fundamental legal differences. But in this context, the ECJ has neither pointed to a legal difference to justify the reliance on formalism, nor has it even acknowledged that there might be any equivalence that was being ignored in favor of formalism. Third, if some Member States see horizontal subsidization as creating an incentive to shift toward di-

160. See surrey, supra note 80.
rect expenditure—even if they cannot politically achieve such a shift—that incentive raises much more significant concerns. While this move away from tax expenditures may have been the ultimate goal of commentators who originally introduced the concept of tax expenditures, its imposition by a court that ignores economic realities likely was not. Fourth, this prioritization of direct expenditures favors certain charitable sectors over others. As mentioned earlier, the Member States of the European Union have very different histories and cultures of giving. So too do they have very different histories in terms of the relationship between the state and the individual. While some Member States have a history of encouraging private activity through tax expenditures, others have divergent models. Some have provided services and support directly to the individual, some have relied on religious organizations to provide services and support, and some of the newer Member States have a very different history of direct support from an all-encompassing state apparatus.

Prior to the charitable giving cases, at least some of the newer Member States were moving toward using tax expenditures to encourage charitable giving. Yet the ECJ's analysis now suggests that they should return to direct spending and that other Member States with a culture of using tax expenditures should also shift to direct spending. In the terms that Fritz Scharpf has recently used, this preference is favoring social market economies (SMEs) over liberal market economies (LMEs). This preference is the opposite of what the ECJ has created in its other direct tax cases, which Scharpf argues prioritize LMEs at the expense of SMEs. While this balance may be preferable to a one-sided advancement of LMEs, the court, in deciding its charitable giving cases, is not explicitly choosing to offset its earlier jurisprudence. Instead, it is favoring a certain approach to charitable giving without any explanation. All the while, the court is distorting the balance of spending provisions within the European Union, without any apparent awareness of its rulings' consequences.

As shown above, the consequences of the ECJ's tax expenditure jurisprudence are mixed. On the positive side, horizontal subsidization may have created a new model for fiscal federalism that achieves the benefits of both centralization and decentralization. Even if future research shows that such benefits exist, however, the costs of achieving them are high. To create this new model of fiscal federalism, the ECJ had to ignore economic realities in favor of legal formalism. This approach prioritizes direct spending over tax expenditures and may encroach on Member State policy choices between direct spending and tax incentives. Moreover, this new model of fiscal federalism also retains the negatives of diverse regulatory regimes and may strengthen larger

163. See Surrey, supra note 80.
164. See supra notes 37-40 and accompanying text.
165. See Shaviro, supra note 82, at 187 n.1 (listing several Member States that release tax expenditure data, including Austria, Belgium, Finland, France, Germany, Ireland, Italy, the Netherlands, Portugal, Spain, and the United Kingdom).
166. See supra note 84 and accompanying text.
168. Id at 26-27.
charitable organizations at the expense of smaller ones. It may also provide opportunities for Member States to make it progressively harder for charitable organizations to operate both within their borders and beyond them.

Do the negative effects of this development outweigh the positive effects? To answer that question, Part IV compares the European Union’s tax expenditure jurisprudence to that of another jurisdiction that faces questions of discriminatory state-level spending provisions: the United States.

IV. STATE-LEVEL TAX EXPENDITURES AND DIRECT SPENDING IN THE UNITED STATES

Unlike in the European Union, where tax expenditures are generally considered under the free movement rubric and direct expenditures are generally considered under the state aid rubric, both types of state-level spending in the United States are analyzed using the Supreme Court’s Dormant Commerce Clause jurisprudence. As this Part will highlight, however, just because the same source of law governs these two forms of spending does not mean that the Supreme Court is any less formalistic than the ECJ. Like the ECJ, the Supreme Court analyzes state tax expenditures differently than state direct expenditures, despite their economic equivalence.

The so-called Dormant Commerce Clause is not written into the United States Constitution. Instead, it is a prohibition on state restrictions on interstate commerce that has been read into the Constitution for the last two centuries.169 Although some judges and academics have recently questioned the validity of Dormant Commerce Clause analysis,170 the Supreme Court continues to analyze discriminatory state measures as possible violations of the Clause.171

Many commentators have highlighted the inconsistency and illogic surrounding the Supreme Court’s Dormant Commerce Clause analysis.172 Yet, despite the confusing nature of the Supreme Court’s Dormant Commerce

169. Brannon P. Denning, Reconstructing the Dormant Commerce Clause Doctrine, 59 WM. & MARY L. REV. 417, 421 (2008) ("In some form, the dormant Commerce Clause doctrine (DCCD) has been a feature of American constitutional law for nearly two centuries.") (citation omitted); see also Edward A. Zelinsky, The False Modesty of Department of Revenue v. Davis: Disrupting the Dormant Commerce Clause Through the Traditional Public Function Doctrine, 29 VA. TAX REV. 407, 412 (2010) ("One of the great debates of the American constitutional tradition is whether this explicit grant of legislative power [in the Commerce Clause] implicitly constrains the authority of the states. From this debate has emerged the notion of the ‘dormant’ (or ‘negative’) Commerce Clause, i.e., the proposition that, even in the absence of federal legislation, the Clause on its own displaces the authority of the states relative to interstate commerce.").

170. See, e.g., Dan T. Coenen, Where United Haulers Might Take Us: The Future of the State-Self-Promotion Exception to the Dormant Commerce Clause Rule, 95 IOWA L. REV. 541, 626 (2010) ("Justices Scalia and Thomas . . . have advanced the position that the dormancy doctrine is fundamentally inconsistent with originalist thinking."); Zelinsky, supra note 169, at 419 (referring to Justice Thomas’s concurrence in Kentucky v. Davis and stating that “[s]ince there is no textual basis in the Constitution for that case law and since that case law ‘has proved unworkable in practice,’ Justice Thomas stated that the Court has ‘no authority to invalidate Kentucky’s differential tax scheme.’").

171. See, e.g., Dep’t of Revenue of Ky. v. Davis, 553 U.S. 328 (2008) (rejecting Justice Thomas’s criticism and considered whether the state measure in question violated the Dormant Commerce Clause).

172. See, e.g., Denning, supra note 169, at 476-77 (referring to “the DCCD’s notorious confusion and incoherence”).
Clause jurisprudence, one distinction that it makes stands out quite clearly. When the Supreme Court considers discriminatory state measures, it applies different analyses depending on whether the measures are direct expenditures or tax expenditures. The result of these different analyses is that it is generally easier for a state to favor its residents by way of direct subsidies than by way of tax expenditures. In other words, discriminatory tax expenditures are harder to defend than are discriminatory direct expenditures.

Although the Court's Dormant Commerce Clause analysis should theoretically apply to both tax expenditures and direct expenditures, commentators have noted that the case law of the Supreme Court has treated these types of expenditures very differently. State tax expenditures that favor resident individuals or corporations are considered under a "strict rule of equality," pursuant to which out-of-state commercial interests must be treated in a manner that is no worse than that applied to resident commercial interests.173 State direct expenditures, by contrast, appear to be treated with much more leniency.174

Unlike in the European Union, however, this difference in outcome is not due to application of different legal tests. Instead, the Supreme Court has arrived at this outcome in two ways. First, the Court's practice has been to allow states to defend their discriminatory non-tax measures as the most narrowly tailored means to achieve a legitimate purpose, but not to provide states the same opportunity when the measure in question is a tax expenditure.175 Second, when those non-tax measures are subsidies, the Court appears to have concluded that direct subsidies are entirely beyond the scope of its Dormant Commerce Clause analysis. It stated this explicitly in West Lynn Creamery, Inc. v. Healy, when it wrote that the Court had "never squarely confronted the constitutionality of subsidies, and we need not do so now,"176 and it repeated this later in Camps Newfound/Owatanna, Inc. v. Town of Harrison.177 Furthermore, the Court stated in New Energy Co. v. Limbach that "[d]irect subsidization of domestic industry does not ordinarily run afoul of" the Dormant Commerce Clause.178

As a general matter, therefore, the high courts of the United States and the European Union both favor direct subsidies over tax expenditures. However, this favoritism is achieved through different methods and to different degrees.

174. See id. at 967-68.
175. Zelinsky, supra note 169, at 412-13 ("[O]utside of the tax context, the Court's dormant Commerce Clause decisions afford the states the opportunity to defend discriminatory legislation as the most carefully-tailored means of achieving a legitimate state purpose. The states sometimes satisfy this burden. In contrast, the Complete Auto formula for scrutinizing state taxes under the dormant Commerce Clause generally invalidates a discriminatory tax with no opportunity for the state to justify its favored tax treatment of in-state activities."). But see New Energy Co. of Indiana v. Limbach, 486 U.S. 269 (1988) (allowing the state of Indiana to justify its discriminatory tax measures).
177. Camps Newfound/Owatanna, Inc. v. Town of Harrison, 520 U.S. 564, 589 (1997); see also Coenen, supra note 173, at 968.
In the European Union, direct spending and tax expenditures have ended up being analyzed under different rubrics. Although tax expenditures could be assessed as state aid, they are more often assessed as violations of free movement. Furthermore, discriminatory direct spending, while more likely to survive challenge than spending through the tax code, is still much less likely to survive in the European Union than in the United States. The charitable giving cases are in some ways the exceptions that prove the rule since they are unlikely to be considered to fall under the EU Single Market requirement that state aid deal with "undertakings." Once the state spending in question is directed at "undertakings," state aid is subject to a generally restrictive analysis that would strike down many of the examples of discriminatory direct spending that come before the ECJ. Furthermore, the penalties for violating state aid rules are strict, and the Commission expects Member States to submit their potentially discriminatory spending provisions for pre-clearance to ensure that they are not impermissible state aid. By contrast, in the United States, discriminatory state subsidies are much more likely to survive, both relative to tax expenditures generally and in comparison to tax expenditures in the United States.

This then raises the question of whether the EU charitable giving cases would have been decided in the same way had they dealt with state-level limits on charitable activity and been considered by the U.S. Supreme Court. The two Supreme Court cases that are most directly comparable are \textit{WHYY Inc. v. Borough of Glassboro}\textsuperscript{180} and \textit{Camps Newfound/Owatonna, Inc. v. Town of Harrison}.\textsuperscript{181} In \textit{WHYY}, the Court considered a New Jersey statute that allowed a property tax exemption only for New Jersey-based non-profit organizations. As the ECJ did in \textit{Walter Stauffer},\textsuperscript{182} the Supreme Court held that it was constitutionally impermissible for New Jersey to discriminate against out-of-state charitable organizations "solely because of the different residence of the [organizations]."\textsuperscript{183} In \textit{Camps Newfound/Owatonna}, the Court considered a town property tax exemption for charitable organizations and held that the Town of Harrison's exemption violated the Dormant Commerce Clause because the town refused to extend the exemption to a Maine-based camp that primarily benefited out-of-state residents.\textsuperscript{184}

The Court emphasized in \textit{Camps Newfound/Owatonna} that its unwillingness to extend the Dormant Commerce Clause to state subsidies did not apply to tax expenditures, despite the town's argument that "its discriminatory tax exemption is, in economic reality, no different from a discriminatory subsidy of those charities that cater principally to local needs."\textsuperscript{185} The Court also made clear that the Dormant Commerce Clause applies just as much to non-profit

\textsuperscript{179} See supra notes 148-151 and accompanying text.
\textsuperscript{182} See supra notes 44-46 and accompanying text.
\textsuperscript{183} \textit{WHYY, Inc.}, 393 U.S. at 120.
\textsuperscript{184} \textit{Camps Newfound/Owatonna, Inc.}, 520 U.S. at 576.
\textsuperscript{185} Id. at 589.
entities as to for-profit entities.\textsuperscript{186} Therefore, although the Court has discussed only tax exemptions, and has not yet addressed any cases considering discriminatory tax deductions, similar to those in question under Persche or Commission v. Austria,\textsuperscript{187} the Court's precedents in this area make it highly likely that it would reach the same outcome as the ECJ. In other words, it is very likely that a charitable deduction that was limited to Member States would be found to violate the Dormant Commerce Clause.

This outcome is even more likely if one considers the rest of the Court's Dormant Commerce Clause jurisprudence in the context of tax expenditures. Although commentators differ on the exact confines of the Court's current Dormant Commerce Clause doctrine,\textsuperscript{188} the Court generally disallows discriminatory tax expenditures except in a few limited circumstances. These include the market-participant exception and the public-entities—or state-self-promotion—exception.\textsuperscript{189} Because territorially restricted charitable deductions do not fall under either of these exceptions, the Supreme Court is extremely unlikely to arrive at a different outcome from the ECJ if confronted with a charitable tax deduction that discriminates against out-of-state organizations or donors.

Under the market participant exception, states are permitted to discriminate against non-residents if they are acting as market participants rather than as market regulators. For instance, states are subject to the Dormant Commerce Clause when they regulate markets by setting prices or imposing barriers to market entry, but they are free to discriminate as market participants, even if they are participating in those same markets.\textsuperscript{190} These two roles are generally understood to be mutually exclusive, so once a state is found to be engaged in market regulation, it is bound by the Dormant Commerce Clause.\textsuperscript{191} It seems clear that a charitable deduction would not qualify as market participation. The

\textsuperscript{186} Id. at 584 (stating that the Court sees "no reason why the nonprofit character of an enterprise should exclude it from the coverage of either the affirmative or the negative aspect of the Commerce Clause").

\textsuperscript{187} This is not to say that the Supreme Court has not considered many cases addressing deductions and credits, as well as exemptions, but it has done so in contexts other than the Dormant Commerce Clause. One common area in which the Supreme Court has continued its formal distinction between tax expenditures and direct spending is in Establishment Clause cases, in which a tax expenditure that benefits religion is more likely to be upheld than a direct subsidy to a religious entity. See, e.g., Arizona Christian Sch. Tuition Org. v. Winn, 131 S. Ct. 1436 (2011).

\textsuperscript{188} See, e.g., Zelinsky, supra note 169, at 415-16 ("There is also a strong argument that the dormant Commerce Clause nondiscrimination principle is incoherent. Even its supporters acknowledge that this principle is 'under-theorized'.").

\textsuperscript{189} See, e.g., Robin Kundis Craig, Multistate Decision Making for Renewable Energy and Transmission: Spotlight on Colorado, New Mexico, Utah, and Wyoming: Constitutional Contours for the Design and Implementation of Multistate Renewable Energy Programs and Projects, 81 U. COLO. L. REV 771, 795-96 (2010) ("Two exceptions to the application of the dormant Commerce Clause are potentially relevant to multistate agreements regarding alternative energy. First, the U.S. Supreme Court has recognized a market participant exception for state or local governments . . . Second, in [United Haulers,] the Supreme Court determined that facilities operated by public authorities do not facially discriminate against interstate commerce even if they impose requirements that restrict interstate commerce.").

\textsuperscript{190} Zelinsky, supra note 169, at 414.

\textsuperscript{191} Dan T. Coenen, The Supreme Court's Municipal Bond Decision and the Market Participant Exception to the Dormant Commerce Clause, 70 OHIO ST. L.J. 1179, 1189 (2009).
types of activities that the Court has found to include market participation include funding construction projects,\textsuperscript{192} selling cement,\textsuperscript{193} and bidding on abandoned cars.\textsuperscript{194} However, allowing a deduction for charitable giving is not analogous to any of these, since the state is not itself making the donations. Instead, the state is more likely to be seen as regulating the market for charitable giving since it lowers the barrier to entry for this market for certain donors.

Nor would most charitable deductions likely fall under the state-self-promotion exception. This exception is a much more recent addition to the Court's Dormant Commerce Clause analysis, first discussed in\textit{United Haulers Ass'n v. Oneida-Herkimer Solid Waste Mgmt. Auth.},\textsuperscript{195} and reaffirmed in\textit{Dep't of Revenue of Ky. v. Davis}.\textsuperscript{196} In\textit{United Haulers}, the Court held that a rule requiring private haulers to deliver solid waste to a publicly owned and operated waste facility did not violate the Dormant Commerce Clause because waste disposal was a "traditional public function" and the regulation in question favored the government, rather than private residents.\textsuperscript{197} In\textit{Dep't of Revenue of Ky. v. Davis}, the Court affirmed this holding in the context of tax expenditures. It held that Kentucky could limit its state tax exemption for municipal bonds issued by the state because the discrimination was in favor of the state itself, rather than resident non-state actors.\textsuperscript{198}

This state-self-promotion exception has sparked debate amongst academics and lawyers.\textsuperscript{199} Although the confines of the exception remain uncertain, it seems unlikely that the Court would find a charitable deduction to fall under this exception, especially given that it has made clear that this exception is quite narrow.\textsuperscript{200} One of the primary arguments in favor of charitable deductions is that states use deductions to outsource their responsibilities to private actors.\textsuperscript{201} In allowing deductions only to resident organizations, the state would

\begin{footnotesize}
\textsuperscript{195}. United Haulers Ass'n v. Oneida-Herkimer Solid Waste Mgmt. Auth., 550 U.S. 330 (2007).
\textsuperscript{196}. Dep't of Revenue of Ky. v. Davis, 553 U.S. 328 (2008).
\textsuperscript{197}. United Haulers Ass'n, 550 U.S. at 346.
\textsuperscript{198}. Dep't of Revenue of Ky. v. Davis, 553 U.S. at 343.
\textsuperscript{199}. See, e.g., Zelinsky, supra note 169, at 409 ("Davis disrupts the Court's preexisting dormant Commerce Clause doctrine by confirming the Roberts Court's use of the 'traditional public function' category to immunize government activity from dormant Commerce Clause scrutiny.").
\textsuperscript{200}. Coenen, supra note 170, at 624 ("[T]he Court's state-self-promotion decisions on their face reflect an openness within the current Court—perhaps an openness of unprecedented dimensions—to reining in the dormancy doctrine.").
\textsuperscript{201}. See, e.g., Case C-318/07, Hein Persche v. Finanzamt Lüdenscheid, 2009 E.C.R. I-00359, ¶ 42 ("The German, Spanish and French Governments add that if a Member State abstains from levying certain tax revenue by exempting gifts made for the benefit of charitable bodies established in that State, that is because such bodies absolve that Member State of certain charitable tasks which it would other-
\end{footnotesize}
not be discriminating in favor of itself, as was the case in *United Haulers* and *Davis*. Instead, it would be discriminating in favor of non-profit organizations separate from the state, and therefore the state-self-promotion exception would not apply.

Arguably, deductions for donations to state-run institutions may be an exception. As Coenen pointed out in an earlier article, the state-self-promotion exception may apply to state tax incentives for state residents who attend state educational institutions. Thus, if the Supreme Court were to decide a case on state tax incentives for donations to state-run institutions, it could potentially reach a different outcome than the one that the ECJ reached in *Commission v. Austria*. However, even this exception may be narrow. The exception may not apply to donations to state educational institutions—the example Coenen offered in his article because it is an open question whether higher education qualifies as a traditional public function. Furthermore, even if the Court does find an exception in the case of donations to state educational institutions, charitable deductions in general are still likely to fall outside the state-self-promotion exception and thus be struck down if they discriminate in favor of state residents.

Most states have chosen not to run afoul of this predicted holding. The vast majority of states in the United States, unlike the Member States of the European Union before the charitable giving cases, do not limit their charitable tax incentives to resident taxpayers. In fact, most states that have charitable deductions tie them directly to Sections 170 and 501 of the Internal Revenue Code. Even those states that do not directly cite the Internal Revenue Code often use federal taxable income as their starting point for calculating state tax liability, meaning that the federal charitable deduction has already been subtracted from the tax base.

Therefore, both the United States and the European Union have judicial doctrines that prohibit their sub-federal states from retaining discriminatory tax

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203. In the United States, at least, even the earliest institutions of higher education were supported by a mix of public and private actors, thus raising the question of how public a function higher education served traditionally. See, e.g., Thomas Dudley, *The Charter of the President and Fellows of Harvard College, Under the Seal of the Colony of Massachusetts Bay, and Bearing the Date May 31st, A. D. 1650*, HARVARD UNIVERSITY ARCHIVES, http://library.harvard.edu/university-archives/using-the-collections/online-resources/charter-of-1650 (last visited Oct. 24, 2013) (approving, in this state document, the appointment of a private governing body for Harvard College and referring to the fact that "many well devoted persons have been, and daily are moved, and stirred up, to give and bestow, sundry gifts, legacies, lands, and revenues for the advancement of all good literature, arts, and sciences in Harvard College").

204. Note that some states with income taxes do not have charitable deductions, while other states do not have income taxes at all. See, e.g., 45 IND. ADMIN. CODE § 3.1-1-4 (2012).


206. See, e.g., MINN. STAT. § 290.01(31) (2013); N.D. CENT. CODE §§ 57-38-01(13), 57-38-30.3(2) (2013); N.Y. TAX LAW § 612(a) (2006).
expenditures. Furthermore, both treat tax expenditures differently from direct spending, and both treat discriminatory direct spending more favorably than discriminatory tax expenditures, at least in the context of charitable giving.

Does the U.S. practice of disallowing discriminatory state tax expenditures add validity to the ECJ’s tax expenditure jurisprudence? Or do the significant differences between the two jurisdictions mean there are no meaningful lessons to be drawn from comparing the two? The next Part considers what can be learned from the similarities and differences between the U.S. and EU approaches to discriminatory state-level tax expenditures.

V. FORMALISM VERSUS FEDERALISM: A COMPARISON OF THE U.S. AND EU APPROACHES TO TAX EXPENDITURES AND DIRECT SPENDING

To summarize the lessons of Parts III and IV, the European Union and the United States are similar in their approaches in that they tend to strike down discriminatory tax expenditures while upholding discriminatory direct expenditures. Beyond this similarity, however, differences abound. In the European Union, the ECJ is likely to strike down both tax expenditures and direct spending. With some exceptions—likely including charitable subsidies—direct subsidies that have a territorial limitation are likely to run afoul of the ECJ’s state aid analysis. In cases dealing with direct subsidies that affect the EU Single Market, Member States are required to have these subsidies pre-approved by the Commission or face significant interest expenses if those subsidies are later struck down by the ECJ.

By contrast, the U.S. Supreme Court is far more favorable to subsidies than the ECJ. The Supreme Court has assumed that all state subsidies are beyond the scope of its Dormant Commerce Clause doctrine. Therefore, many discriminatory state-level business subsidies that would be found to be impermissible state aid in the European Union remain unchallenged in the United States.

Moreover, the fact that both the United States and the European Union ignore economic equivalence in favor of legal formalism does not, by itself, make the ECJ’s tax expenditure jurisprudence normatively desirable. In the United States, the debate over whether economic equivalence should trump differences in form is not a recent development. This debate has taken place in many areas of the law, and tax is no exception. Edward Zelinsky, for example, has argued that discriminatory state tax expenditures should be treated the same way as discriminatory state subsidies due to their economic equivalence. In the European Union, the debate has been more muted. Discussions about the ECJ’s tax expenditure analysis has focused more on whether the ECJ should apply both free movement analysis and state aid analysis to tax expenditure

207. See Coenen, supra note 191, at 1195 ("[O]ne leading critic, Professor Edward A. Zelinsky, has vigorously argued that local-industry-supporting tax exemptions, credits, and deductions (which historically have been invalidated) should be treated no differently than local-industry-supporting affirmative monetary subsidies (which historically have been upheld . . . .). The centerpiece of Professor Zelinsky’s analysis is that the economic effects of state monetary payments and so-called tax expenditures are functionally identical, so that there is no good reason to attach to them different legal effects.")
cases, rather than whether two separate analyses should exist.\textsuperscript{208}

In the context of U.S. state taxes, Coenen has been one of the strongest proponents of the different treatment of tax expenditures and direct spending.\textsuperscript{209} In an earlier article assessing the dissimilar treatments of business subsidies and business tax incentives,\textsuperscript{210} he listed seven reasons to favor this differential treatment. These included: (i) the greater visibility of subsidies to the public, (ii) the greater visibility of the cost of subsidies to the public, (iii) the presumptive permanence of tax expenditures compared to subsidies, (iv) the unrestricted nature of tax expenditures, (v) the administrative machinery necessary to implement subsidies, (vi) the public's unwillingness to understand the tax system, and (vii) the public's willingness to "look the other way" when legislators enact tax expenditures.\textsuperscript{211} Although Coenen did not present these arguments in behavioral economic terms at the time, they all fit into what is now a fairly developed literature on the salience of tax expenditures.\textsuperscript{212}

Salience is a term borrowed from behavioral economics to refer to the visibility of a legal provision.\textsuperscript{213} Discussions of the salience of tax expenditures have focused on two aspects: market or economic salience, which means the extent to which consumers are aware of a given provision's effect on the price; and political salience, which means the extent to which voters take into account a given provision—or the party that has passed the provision—in their political decision-making.\textsuperscript{214} Generally, tax expenditures are seen as less politically salient than direct subsidies, and tax provisions in general are seen as less economically salient than direct regulations or expenditures.\textsuperscript{215} In other words, some tax provisions, including tax expenditures, may be "hidden" from public view and often do not factor into the public's market and political decisions.\textsuperscript{216}

Under all seven of Coenen's arguments, the low political salience of tax expenditures weighs in favor of treating tax expenditure differently from direct spending. In essence, the main reason for treating these two types of spending differently is that, although they are economically equivalent, voters and citizens do not view them equivalently. Instead, since discriminatory tax expenditures are less visible, they are easier to implement, less likely to be challenged, and therefore harder to overturn. In other words, Coenen's arguments suggest

\textsuperscript{208} See generally Traversa & Vintras, supra note 81 (criticizing the simultaneous appreciation of EU Treaty Freedoms and provisions on state aid).

\textsuperscript{209} See, e.g., Coenen, supra note 191, at 1196 (rejecting Zelinsky's argument in favor of similar treatment of economically equivalent provisions).

\textsuperscript{210} Coenen, supra note 173.

\textsuperscript{211} Coenen, supra note 173, at 985-92.

\textsuperscript{212} See, e.g., Brian D. Galle, Carrots, Sticks, and Salience, 67 TAX L. REV. (forthcoming 2014); Lilian V. Faulhaber, The Hidden Limits of the Charitable Deduction: An Introduction to Hyper-salience, 92 B.U. L. REV. 1307 (2012); Schenk, supra note 162; Gamage & Shanske, supra note 162.


\textsuperscript{214} Gamage & Shanske, supra note 162, at 24, 54-58; Schenk, supra note 162, at 272.

\textsuperscript{215} It is possible, however, that tax expenditures are more economically salient in that consumers over-internalize the value they are receiving from such expenditures. See Faulhaber, supra note 212.

that the reason for treating tax expenditures differently from direct expenditures is that the latter face greater political scrutiny when they are proposed and implemented by the legislative branch; as a result, the former, which do not face such political scrutiny due to their lower salience, must instead face more exacting judicial scrutiny.

The problem with this argument is that neither the Supreme Court nor the ECJ claim that their differential treatment of spending provisions is based on salience. Nor is there any sense that a tax expenditure provision with high salience would be treated as a subsidy. Furthermore, even if this argument were to justify the U.S. approach, the differences between the ECJ and the Supreme Court’s tax expenditure jurisprudences mean that the ECJ’s approach is harder to defend. First, the confines of ECJ’s state aid analysis are much less clear than those of the U.S. Supreme Court’s state subsidy analysis. While the Supreme Court has suggested that direct spending is entirely outside the scope of its Dormant Commerce Clause analysis, the scope of the ECJ’s state aid analysis is unclear. Although the ECJ is more likely to strike down provisions that implicate the EU Single Market, a question remains as to which provisions fall into that category. It appears likely that charitable subsidies would not, but the ECJ and Commission have provided little guidance.

Second, the ramifications of the ECJ’s differential approach are not as clear as in the United States. By holding state subsidies beyond the scope of its Dormant Commerce Clause analysis, the Supreme Court has made clear that, absent any other holding in the future, tax expenditures are more likely to be challenged than direct expenditures. The ECJ’s analysis does not lead to this clear conclusion. When faced with a direct spending case, the ECJ applies state aid analysis. When faced with a tax expenditure case, however, the ECJ could apply free movement analysis, state aid analysis, or both. Thus, not only is the ECJ’s jurisprudence is unclear on the scope of its state aid and free movement analyses, but it is also failing to create clear precedent for when a tax expenditure will be treated the same as a direct expenditure, and when it will not be. The ECJ’s tax expenditure jurisprudence simply suggests that the court has multiple tools that it can apply to strike down tax expenditures, one of which can also be applied to direct spending, and provides little guidance on when it will use these different tools. Therefore, whatever the reason is for treating tax expenditures and direct expenditures differently in the United States cannot be a defense for the ECJ’s tax expenditure jurisprudence.

Furthermore, the result of this jurisprudence, as shown by Member States’ responses to the charitable giving cases, creates more problems in the European Union than have resulted in the United States. In the United States, the Supreme Court’s hostility to discriminatory tax expenditures is leavened by the fact that state-level income taxes are much less financially significant than federal income taxes. The existence of a federal tax system in the United States means that states can peg their tax expenditures to federal-level tax expenditures. As shown above, very few U.S. states have discriminatory charitable de-

217. See supra note 179 and accompanying text.
ductions for just this reason: the vast majority of them peg their charitable deductions to Sections 170 and 501 of the federal Internal Revenue Code, which means that they have a non-discriminatory tax expenditure after which they can model their own provisions.218

In the European Union, by contrast, there is no EU-level direct tax system. The state tax systems thus have much more of an impact on Member State taxpayers, and there are no EU-wide models to which Member States can peg their own tax expenditures. The only options for Member States that want discriminatory charitable deductions are to either maintain tax expenditures or to shift to discriminatory subsidies. The result is the regulatory inconsistency and lack of oversight mentioned in Part III. While the United States has a federal tax system that directly regulates charitable organizations and provides a model for state statutes, the European Union does not. This lack of a federal tax system means that the ECJ’s tax expenditure jurisprudence, while intending to encourage harmonization, may instead allow Member States’ approaches to remain very separate, which is in fact what happened after the charitable giving cases. While this diversity may be a good thing for fiscal federalism, it may also hurt both the beneficiaries of the tax expenditures and EU taxpayers as a whole. In the context of the charitable giving cases, large charitable organizations may be favored at the expense of their smaller competitors, while taxpayers may become more vulnerable to fraudulent charities due to the lack of EU-level oversight.219

For now, therefore, the ECJ’s tax expenditure jurisprudence cannot be characterized as an unqualified success. While it may represent a new model of fiscal federalism, it also depends on an incoherent distinction between two economically equivalent but unharmonized provisions. Although the U.S. Supreme Court has also disallowed state-level tax expenditures that discriminate against out-of-state residents, the different degrees of federalism in the two jurisdictions and the greater coherence of the Supreme Court’s approach mean that the EU approach is less defensible. As shown by the recent charitable giving cases decided by the ECJ, the lack of an EU-level tax system, as well as the ECJ’s lack of guidance on the interaction between state aid and free movement cases, result in a system that is both unpredictable and inconsistent.

218. See supra notes 204-206 and accompanying text. When states peg their state-level tax expenditures to the Internal Revenue Code, the resulting provision is by definition non-discriminatory because the Internal Revenue Code does not discriminate between the taxpayers (or beneficiaries of tax expenditures) based on state. For more on the state practice of tying state-level provisions to federal provisions, see generally Ruth Mason, Delegating Up: State Conformity with the Federal Tax Base, 62 DUKE L.J. 1267 (2013) (assessing the advantages and disadvantages of federal tax base conformity and concluding that the administrative and compliance advantages are so significant that states are unlikely to abandon it).

219. The European Union’s recently proposed Foundation Statute is intended to address some of these concerns, but it has not been accepted, nor will it apply to existing non-profits that opt not to become European Foundations (FEs). See Proposal for a Council Regulation on the Statute for a European Foundation (FE), EUR. PARL. DOC. (COM 35) (2012).
VI. CONCLUSION

Although the economic magnitude of the charitable giving cases may be small, they are structurally significant. They provide the clearest example of the ECJ's tax expenditure jurisprudence. Although this jurisprudence may ultimately result in closer coordination between the Member States and a new model of fiscal federalism, this Article argues that it raises some red flags. Based on a comparison with U.S. tax expenditure jurisprudence, this Article concludes that the ECJ's jurisprudence is inconsistent from both analytic and regulatory perspectives. While the United States and the European Union are similar in their ignorance of the economic equivalence between tax expenditures and direct spending, the U.S. Supreme Court's jurisprudence accords with the United States' more integrated federal structure. The ECJ, by contrast, advances a system that to be successful would require a federal-level tax system. Unless and until the political arm of the European Union establishes such a system, the ECJ at least must provide Member States with clearer guidance on how they can financially support their residents.