United Nations ST/SG/AC.8/2003/L.4

Secretariat

Distr.: Limited
24 June 2003

Original: English

Ad Hoc Group of Experts on International Cooperation in Tax Matters
Eleventh meeting
Geneva, 15-19 December 2003

The interaction of tax, trade and investment*

Summary

This paper addresses the relationship between tax and trade law, as embodied in the network of bilateral tax treaties and the multilateral agreements underlying the World Trade Organization, and the impact of this relationship on the achievement of financing for development goals envisaged by the Monterrey Consensus. The paper argues that: (i) there is considerable overlap in the goals to be achieved by tax and trade agreements, and full achievement of these goals is not possible without addressing both tax and trade aspects; (ii) the tax treaties contribute to the avoidance of double taxation but, because of their bilateral nature, cannot effectively address the problem of double non-taxation resulting from tax competition; (iii) the World Trade Organization agreements as currently drafted address some aspects of the tax competition issue (for example, preferential tax regimes for trade in goods) but not others (competition for investment and trade in services, including traditional tax havens); (iv) to fully achieve the goals of tax and trade agreements it is necessary to reach a multilateral agreement that will address services and investment issues, as well as goods; (v) the United Nations is the most appropriate forum for reaching such an agreement, but its capacity needs to be strengthened.

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03-40691 (E) 180703

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I. Introduction

1. The Monterrey Consensus on financing for development encouraged countries to “strengthen international tax cooperation, through enhanced dialogue among national tax authorities and greater coordination of the work of the concerned multilateral bodies and relevant regional organizations, giving special attention to the needs of developing countries and countries with economies in transition.”

2. A major issue in regard to international tax cooperation is tax competition among developing countries to attract foreign direct investment (FDI).

3. To understand the tax competition issue and how to address it, it is important to evaluate the relationship between tax, trade and investment regimes as embodied in the bilateral tax and investment treaty network and in the multilateral World Trade Organization (WTO).

II. The relationship between tax, trade and investment

4. It is accepted that an agreement covering tariffs only would not be sufficient to achieve free trade. There are a host of non-tariff policies which would have a trade restricting impact, such as discriminatory government procurement rules and procedures, administrative procedures such as health and sanitary regulations, quantitative restrictions such as quotas, anti-dumping rules and procedures. The General Agreement on Tariffs and Trade (GATT) distinguishes between tariffs and other kinds of restrictions, holding that the latter, as a matter of principle, and with exceptions, are to be abolished forthwith; in contrast, the reduction of tariffs was recognized as a goal to be achieved gradually via agreements among contracting parties.

5. Of particular interest among non-tariff barriers to trade are subsidies, including both production subsidies and export subsidies, and taxes, including both indirect and direct taxes. The economic and revenue effects of an import tariff can be exactly replicated by a destination-based consumption tax along with, at equal rate, a subsidy to domestic production. In either case one would expect a price increase to be faced by both domestic consumers and domestic producers. There is, though, no production inefficiency caused by a consumption tax. Thus, from an economics perspective, the objectionable component of a tariff is its implicit subsidy to domestic producers.

6. Article XVI of GATT treats subsidies as, in principle, undesirable interferences with the free flow of goods (GATT, 1994). Section B is concerned exclusively with export subsidies. Section A is more general, applying to any subsidy; it says that if any country maintains a subsidy which increases exports or decreases imports, it must notify the contracting parties of GATT. If serious prejudice to the interests of another contracting party is determined to exist, GATT shall consider the possibility of limiting the subsidy. However article III.4 provides that imports be accorded treatment in all laws and regulations “no less favourable than domestic products”, and this presumably applies to production subsidies. However, article III.8 (b) limits the applicability of article III.4, by providing that it “shall not prevent the payment of subsidies exclusively to domestic producers”.

7. Article XVI was significantly expanded by the Subsidies Code included in the 1994 version of GATT. The Subsidies Code defines "subsidy" as including cases where "government revenue that is otherwise due is foregone or not collected". To be actionable under GATT, a subsidy must be "specific to an enterprise or industry or group of enterprises or industries". In addition, a specific subsidy is prohibited only if it is "contingent, in law or in fact … upon export performance" or "upon the use of domestic over imported goods". The annex to the Subsidies Code contains an "illustrative list of export subsidies" which includes "[t]he full or partial exemption remission, or deferral specifically related to exports of direct taxes … paid or payable by industrial or commercial enterprises". However, a footnote clarifies that this language "is not intended to limit a signatory from taking measures to avoid the double taxation of foreign source income earned by its enterprises".

8. The quoted language of the Subsidies Code recognizes that the direct tax system can be the vehicle for providing export subsidies, such as the case when income ascribed to the production of goods for export are given preferential tax treatment. This type of policy is not fundamentally different from levying a non-discriminatory income tax along with an export subsidy, in this case at a rate related in a potentially complicated way to the company's income tax situation.

9. Article III of GATT, entitled "National treatment on internal taxation and regulation", takes up the matter of internal taxes. Paragraph 2 of this article prohibits internal taxes levied on imported products that are in excess of those applied to "like" domestic products. Paragraph 1 is more general, referring not only to internal taxes but also to other internal laws and regulations and says that these "should not be applied to imported or domestic products so as to afford protection to domestic production".

10. Because paragraph 1 of article III refers to taxes on products, the presumption has always been that direct taxes, in particular income taxes, are not in its purview. However, in principle, a protectionist policy can be effected via the direct tax system. Two categories of such a practice are worth distinguishing. In the first category, the direct tax system just happens to be the vehicle for a protectionist policy. An example is if expenditures for inputs are deductible only if the inputs are domestically-produced goods. This policy is not really different than allowing deductibility for all inputs and levying an import tariff equal to the business tax rate. Such a policy could be applied to intermediate goods, but not to final consumption goods. But, using the individual income tax system, a similar effect can be obtained. Imagine a 10 per cent income tax credit for domestically-produced automobile purchases. In the foregoing examples the income tax systems serve as the vehicle for offering a discriminatory fiscal advantage to domestically-produced goods. In neither example is the protectionist element anything but completely transparent.

11. The second category of using direct taxes for a protectionist objective makes use of the fiscal equivalence that (under perfect competition) an output subsidy of a given rate is equivalent to a subsidy at that rate to all inputs. It follows that a subsidy to a subset of inputs has a similar effect to a subsidy on output; in addition, it causes substitution in the technique of production towards the subsidized input.

12. Thus a production subsidy effect can be achieved through direct taxes by applying differentially lower taxes on factors used in a particular sector. A subsidy on cars can be achieved by preferentially taxing labour income derived from the production of cars and/or preferentially taxing capital used in car production. This

implies that any multilateral trade agreement which intends to proscribe or limit production subsidies (on which, as the earlier discussion suggests, GATT is ambiguous) must extend its concern to sector-specific subsidies to factor inputs.

13. In the case of capital taxes, sector specificity can be achieved with superficially uniform rules, by maintaining a uniform tax rate and manipulating other critical aspects such as the tax depreciation schedules, inventory accounting rules, the rate and applicability of investment tax credits and the system of inflation adjustment. It is widely known that, ignoring any explicitly sector-specific features of tax law, there is wide variation in the effective taxation of capital income across sectors in most, if not all, Organisation for Economic Cooperation and Development (OECD) countries.

14. There is no evidence that business tax systems in fact have been manipulated to achieve a desired production subsidy equivalent. Nor would it be easy. Setting sector-specific effective production subsidies by altering technical aspects of the tax system would be a tricky business, indeed. However, factor taxes are relevant for free trade even if they are effectively uniform, rather than sector-specific. This is because, due to varying factor intensities of production, any given factor tax (but not a uniform tax on all factors) will have a differential effect on the cost of products; this is known as the excise tax effect of factor taxes. Thus, a uniform subsidy on labour will reduce the relative production cost of relatively labour-intensive goods. Note that this argument does not apply with the same force to residence-based factor taxes, as in this case much of the tax burden will be borne by the suppliers of the factors, be they workers or capital owners, and not reflected in the relative cost of production of goods.

15. In sum, not only sector-specific factor taxes and subsidies, but also statutorily and even effectively uniform business and labour taxes, if they are source-based, can produce the same kind of locational inefficiencies that trade agreements seek to limit. However, they are a blunt instrument for a Government seeking to protect certain sectors and therefore may be of limited practical importance, especially in comparison with export subsidies delivered through the tax system.

III. Services and foreign investment

16. The underlying objective of GATT is to limit government policies whose aim is to increase domestic production, generally at the expense of imports and perhaps in only certain sectors. Thus the location of production is a critical concept. But a concern over where production is located often represents a concern over who receives the benefits of local production. Local workers perceive that their real income is higher if domestic production is higher; the same applies to owners of domestically-located physical capital, land, or location-specific human capital.

17. There are two areas in which the concept of the location of production itself becomes fuzzy, the distinction between where a product is produced and who produces it becomes blurred and thereby raises particularly challenging policy issues. They are foreign direct investment and services.

18. There is no generally accepted comprehensive definition of what constitutes a service. A common classification scheme includes as services the following sectors: (i) wholesale and retail trade, hotels and restaurants; (ii) transport and

communications; (iii) finance, insurance, real estate, business services; and (iv) community, social and personal services. Stern and Hoekman (1988) identify two distinguishing characteristics of services — non-storability and intangibility. Because of these characteristics, in order to be tradable, services have to be applied or embodied in objects, information flow or persons. Services may or may not require the physical proximity of the producer and consumer.

19. For the sake of discussion, consider a service for which the provider and consumer must be in physical proximity and for which the technology dictates that the provider must move to the consumer, rather than vice versa. Free trade would allow that, if the most efficient provider of the service is a non-resident, no fiscal (or regulatory) barriers be erected that will induce the domestic consumer to prefer a less efficient domestic provider. Now assume further that the only input to this service is the labour of the provider. In this case an equivalent to an import tariff is a source-based tax on labour provided by foreigners. If this tax is not offset by the residence country, either by means of a foreign tax credit or exemption, then the double taxation of labour income serves as a fiscal barrier to the free trade of this service. For achieving global efficiency, the mechanism for avoiding double taxation (i.e., source or residence country renunciation) is not critical, although that will matter for the cross-country allocation of revenue, and therefore welfare.

20. In the previous example, the source of comparative advantage was expertise embodied in the service provider. The service transaction need not require any physical investment or permanent establishment, just the temporary presence of the service provider.

21. Next, consider the case where the expertise is possessed not by an individual, but by a corporation. The expertise pertains to a production technique for a tangible good. In order to take global advantage of its expertise, the corporation has three options. It can export the good, it can license the technology to foreign producers, or it can set up a foreign subsidiary which produces the good. If transportation costs are high, the exporting option will not be attractive. If the firm fears that a licensing agreement will not be able to protect its proprietary expertise, that option will not be attractive, leaving foreign direct investment as its best choice.

22. Analogous to the cross-border service provider, the taxation of the income flows from the foreign direct investment can constitute a fiscal barrier to free trade. The issue is much more complex because the flows of income from the subsidiary to the foreign parent may represent not only a payment for the use of the expertise, but also a return on a capital investment. (In the case of a licensing agreement, in which the licensee owns all of the capital, the payment is clearly only for the services of the intangible asset (i.e., the expertise) and not for the services of capital per se.) Double taxation of the income from the intangible asset is a fiscal barrier to the efficient application of this corporation's expertise. As above, the institutional mechanism for avoiding double taxation is not critical for the issue of global efficiency, but does matter for the inter-nation division of tax revenues.

23. Of course, the economic ramifications of barriers against inward foreign direct investment are different from the ramifications of barriers against imports. In either case, domestic consumers will be hurt by the restriction of access to low-cost providers. But, while import restrictions may help domestic workers, restrictions against foreign direct investment will not. The bottom line is, when delivery of a good or service is tied to the temporary or permanent movement of factors, source-

based taxation of factor incomes can constitute a fiscal barrier to free trade, especially if there is no mechanism for the alleviation of double taxation due to overlapping jurisdictions.

24. The potential problem of double taxation is to a large extent alleviated by agreements in bilateral tax treaties that limit double taxation and assign the taxing jurisdiction of various income types between the source and residence countries, and by the unilateral granting of double tax relief by many capital exporting countries, either via limited credits for foreign taxes paid, or by a territorial system of taxation. It is as if, faced with tariffs imposed by all nations importing a certain good, all the exporting nations imposed exactly offsetting export subsidies. This would eliminate any attendant trade distortion, and thus would be optimal from a global perspective, but the system would not be in the exporting countries' interest because it would essentially be a transfer payment to the importing countries' Governments. Thus it is inevitable that the division of revenues becomes an important and contentious element of the current international tax regime. Bilateral tax treaties generally favour a reciprocity clause, requiring equal withholding levies for capital flows in both directions; this is designed to maintain an "equitable" distribution of revenues in the presence of two-way capital flows. Whether it in fact achieves this goal depends also on the corporate tax rates and the detail of integration systems in place; on this point see Ault (1992). In the case where the capital flows are mostly one way, the distribution of revenues may be skewed, which may explain the relative paucity of tax treaties between developed and developing countries.

IV. Border protectionism versus ownership protectionism

25. One important difference between trade policy and tax policy is that while trade policy operates at the border and is blind to corporate residency, tax policy can operate at the margin of corporate residency. For example, tariffs are imposed on all imported products, regardless of whether the good is produced abroad by a foreign-owned company or an affiliate of a domestically-owned company. Domestically-produced goods are not subject to tariffs and benefit (or suffer, if the imported goods are inputs) from the higher domestic prices caused by tariffs, regardless of whether the producer is domestically-owned or foreign-owned. Thus, trade policy raises the issue of what might be called "border protectionism".

26. Income taxation, because it can impose differential taxation depending on corporate residence, may also involve another kind of protectionism that we will refer to as "ownership protectionism". Whether it does or not depends on the structure of the income tax in place. If, for example, all countries scrupulously practised non-discrimination of business enterprises, levied no withholding taxes and all operated territorial systems of taxation, any two corporations with the same real operations and results spread over the world would pay the same total tax, regardless of the residency of the parent corporations and even in the face of varying tax rates across countries. For example, a French company and United States company would pay the same total tax if both companies operated exclusively in the United States, exclusively in France, exclusively in Singapore, or in some combination of these and/or other countries.

27. Differences can arise, though, because the United States taxes its resident multinationals on a worldwide basis and France taxes on a territorial basis. In this

case there is a potential tax penalty placed on a United States multinational versus a French multinational that depends on the locational pattern of activity. There would be no substantial difference if the two multinationals operated exclusively in countries of similar tax rates, such as France and the United States. The difference arises only to the extent of operations in a low-tax country. The United States parent company, but not the French parent, could be subject to a residual tax, but generally only upon repatriation of income from its affiliate in the low-tax country. The apparent difference is also mitigated if the United States multinational operates not only in low-tax countries, but also in foreign countries with average tax rates that exceed the United States average rate. In this case the United States system allows repatriated income from a low-tax country such as Ireland to be "mixed" with repatriated income from a high-tax country such as Germany, with the result that no net tax need be paid to the United States Government.

V. Income shifting and tax havens

28. Another important difference between tariff policy and tax policy is that the basis for duties is the value of transaction, while for income tax policy the basis is a measure of income. Income is a considerably more slippery concept to define and the location of the income of an integrated global enterprise is a conceptual nightmare; Ault and Bradford (1990) have gone so far as to argue that it is not meaningful.

29. Given differences in tax rates across countries, and the fact that no country has a pure residence-based system of taxing corporations, there are incentives to take advantage of the difficulty of locating income to reduce an enterprise's worldwide tax burden. A multinational operating in two countries in which the marginal tax rate on a dollar of income is different would, *ceteris paribus*, prefer to shift income from the high-tax country to the low-tax country. Such shifting can be accomplished by the judicious setting of prices of transactions between corporate affiliates, or by judicious international financial policy (e.g., doing borrowing in high-tax countries).

30. Holding the location of real activity constant, a country gains when a dollar of taxable income is shifted into it, while the country from which it is shifted loses. The world is currently populated by a set of countries, known loosely as tax havens, that set low tax rates and look the other way, or even encourage, the inward shifting of taxable income. To stanch the outward flow of taxable income, countries which have relatively high tax rates must establish an enforcement structure to monitor transfer pricing, earnings stripping, and other methods of income shifting.

31. Tax havens can be classified into two types. In one type, the country levies a very low tax rate on the income from manufacturing operations located in its jurisdiction ("production tax havens"). In the second type, the country offers a low tax on the income of corporations whose legal domicile is that country ("traditional tax havens"). One motivation behind becoming the first type of tax haven is to attract real investment and economic activity into the country. This is not a primary motivation behind the second kind of tax haven; in this case the country is essentially offering its services, for a fee, to individuals and corporations pursing tax avoidance and evasion. In the first type, but not in the second, there is usually a domestic tax base that is segregated from the operations benefiting from the low tax regime.

32. Even the first type of tax haven (production tax haven) opportunistically gains from income shifting. Consider the example of country A, which has a low statutory rate on corporate income reported due to manufacturing operations in that country. Having established an affiliate in country A, a multinational enterprise has the incentive to shift taxable profits to that country from higher tax countries. Thus it is no coincidence that such countries implement a low marginal effective tax rate on investment via a low statutory tax rate strategy as opposed to a strategy of a high statutory rate combined with generous investment tax credits and/or depreciation allowances. Although any particular low marginal effective tax rate can be obtained with the latter strategy, it would not make the country a magnet for income shifting, only for real activity.

33. Local content rules are a useful analogy to tax havens in the domain of international trade. Imagine that the United States imposes quantity restrictions on the import of steel from Japan and the Republic of Korea. In order to enforce such restrictions, there must be a way to identify imports from an unrestricted country, such as Mexico, as having originated in Mexico rather than in Japan or the Republic of Korea. This is usually accomplished by attempting to measure the "local content" of the imports from Mexico and requiring it to be above a prespecified level in order to be imported without restriction. These rules are similar to the anti-treaty shopping provisions of income tax treaties, which seek to limit the re-routing of income through tax havens to minimize tax payments. A country which, for some compensation, collaborates with the restricted countries to evade the United States' local content rules is acting similarly to a tax haven. In what follows we will refer to the behaviour of tax havens with a concocted term — "predatory tax protectionism". It is predatory because it is clearly a zero-sum or, as we argue below, a negative-sum game, in which the tax haven's gains are offset by losses to the rest of the world.

34. From a global perspective, the presence of tax havens is costly for at least two reasons. First, there are substantial resource costs expended by the tax collection agencies of the rest of the world to minimize inappropriate income shifting, and substantial resources costs expended by the multinationals themselves to accomplish such shifting. Second, there are distortions in the kind of real activity that the (first type of) tax haven attracts, i.e. high margin production such as pharmaceuticals and electronics which facilitate income shifting. In the absence of income shifting considerations, there is no economic reason why such activities should be located in Ireland or Puerto Rico, which can offer income shifting advantages to United States corporations.

VI. Bilateral tax treaties and their limitations

35. From their modern origin, States have levied direct taxes (taxes imposed on incomes or property) on one, or both, of two bases: (i) because the person owning the property or receiving income was a resident or (ii) because the income or property was located in the State's territory. That the two bases for taxation raised the possibility of double taxation of foreign-source income or foreign-located property was recognized from the start.

36. In the 1920s the League of Nations commissioned several studies of international double taxation and how to alleviate it. These eventually led in 1928 to

the issuance of several draft model treaties, which provided the framework for the negotiation of a network of treaties, primarily among European countries.

37. The goal of tax treaties was considered in the initial report, issued in 1923, by four eminent economists — Bruins, Einaudi, Seligman and Sir Joseph Stamp. Because double taxation represented an unfair burden on exiting investment, and an arbitrary barrier to the free flow of capital, goods, and persons, it was in nations' interests to eliminate or at least limit it.

38. In their 1923 report, the economists considered four methods for alleviating taxation, but favoured exemption by the source State of residents' income. They argued that this approach avoided theoretical complexities and accorded with what they viewed as economic reality — that the source country should cede the right to tax when it sought investment from abroad. They also proposed to divide revenues among countries according to a formula based upon the relative magnitude of the different types of income deemed to have originated in each State.

39. The League model treaties settled on another alternative, denoted "classification and assignment". Under this method, income is classified by type and the primary rights to tax some types of income (primarily active) is assigned to the source State and other types (primarily passive) are assigned to the State of residence. This is the structure used in nearly all tax treaties. The actual classifications and assignments used today also stem from the League's work in the 1920s. Real property business income connected to a fixed location is generally assigned to the source State. Passive investment income is generally assigned to the residence State.

40. After the Second World War the work of the League of Nations on tax treaties was taken up by the Organisation for European Economic Cooperation (later Organisation for Economic Cooperation and Development, OECD). OECD issued a model treaty in 1977 (revised in 1994), which is the basis for most treaties currently in effect. The United States has issued a model treaty (1996) which follows the OECD model in most, but not all, respects. The United Nations model treaty (2001) is more favourable to source country taxation.

41. Coverage of the bilateral treaty network extends to most developed countries, but it is sporadic for developing countries. According to Hufbauer (1991), the income tax treaty networks of the United States, Japan, Germany and the United Kingdom each cover between 92 and 98 per cent of the developed world, measured in terms of gross domestic product (GDP) or imports. There is much less coverage of the developing world. Hufbauer's calculations indicate that the United States income tax treaty network covers only about 22 per cent of developing country GDP, and 21 per cent of their imports, although the United States treaty network with developing countries has expanded significantly since 1991. The treaty networks of Japan, Germany, and the United Kingdom each cover between 37 and 46 per cent of the developing world, measured by GDP or imports.

VII. The limits of the bilateral treaty network

42. Should a free trader be concerned about the present state of the international tax system? In one important sense, the answer is clearly no. The commitment embodied in bilateral tax treaties and unilateral provisions of capital-exporting

countries to avoid double (and zero) taxation is consistent with a free trade tax system. One could argue that international tax institutions have already achieved what multilateral trade agreements have for years been struggling to accomplish.

43. Though the international tax system is broadly consistent with free trade, in its details it clearly falls short. A pure free trade tax system would require a residence-based tax system in all countries, so that the effective tax on labour or capital income for any person did not depend on where the factors were applied to the productive process. This is not the state of affairs, due to the prevalence of source-based taxes and the unwillingness or inability of residence countries to perfectly offset these taxes. Note that non-discrimination or national treatment is not sufficient to prevent this kind of trade distortion. For example, a source-based subsidy to labour income, granted in a non-discriminatory fashion to domestically-owned and foreign-owned companies, still provides a production subsidy to relatively labour-intensive sectors, in the same way that a tariff on those sectors would.

44. There are, furthermore, aspects of taxation which on the face of things appear to be discriminatory, because they differentiate tax liability depending on residence. To some extent, these tax features exist because of two important differences between tax matters and tariff matters. The first difference is that the magnitude of revenues involved is much larger and, even given bilateral agreements on the total taxes owed for a particular activity, the division of revenues between the host and residence country is not a matter of indifference, as it will be for the taxpayer. Thus, there must be rules governing this division, and administrative considerations might dictate that these rules be effected via apparently discriminatory tax practices.

45. The second difference is that, especially with respect to multinational enterprises, there is tremendous flexibility in where taxable income is reported. Thus, in order to defend their revenues, countries may have to resort to enforcement techniques that are apparently discriminatory.

46. Finally, a related concern is the presence of many countries that construct their tax systems precisely to attract tax liability away from other countries, with or without the desire to at the same time attract real resources. This practice, which we have labelled above “predatory tax protectionism”, complicates the tax enforcement process of non-haven countries, and emphasizes that the commitment to single (as opposed to zero) taxation is not a multilaterally shared commitment. Apparently discriminatory tax features which serve to uphold single taxation may in some cases be necessary to support free trade taxation.

47. There is, though, a protectionist temptation that arises in the context of income taxation that does not arise in the context of tariffs — what we have called ownership protectionism. The instruments of income tax policy do give Governments the capability to differentiate in favour of domestically-owned, or domestically-headquartered, corporations at the expense of foreign corporations, in a way that tariffs do not permit.

48. Fundamentally, the principal limitation of the current set of bilateral tax treaties stems directly from their bilateral nature, which in turn follows from the principle of reciprocity. Tax treaties are intended to shift revenues from source to residence jurisdictions by reducing source-based taxation. This shift is generally acceptable, however, only if the reduction in source-based taxation is reciprocal and

capital flows in each direction are broadly similar. In that situation, which is typical between developed countries, it make sense to mutually reduce source-based taxes because each country will collect more residence-based taxes (assuming it gives a credit for source-based taxation). This explains why there are relatively fewer treaties between developed and developing countries (capital flows are too lopsided). It also explains why tax treaties are bilateral and do not contain a most favoured nation provision (i.e., cannot be automatically extended to third countries). The parties to a tax treaty do not wish to extend the same benefits (reduction of source-based tax) to situations where the flow of capital is unbalanced, resulting in net loss of revenue (because the reduced source-based tax is not accompanied by increased residence-based tax).

49. However, this limitation means that the tax treaty network cannot adequately deal with the distortions (predatory tax protectionism) caused by either production or traditional tax havens. Traditional tax havens are simply not covered by tax treaties because they do not typically impose an income tax. Production tax havens (as well as similar regimes designed to attract headquarters facilities, known as headquarters tax havens) are located in countries that do impose generally applicable income taxes and grant specific exemptions to the activities they wish to attract. In this case the bilateral treaty network is inadequate because no two countries can agree on abolishing such regimes for fear that multinationals would relocate to third countries that are not covered by the agreement (see Avi-Yonah, 2000, for further elaboration of this point).

VIII. Tax and the current WTO agreements

50. We summarized above the current WTO agreements as they relate to taxation issues. How do these agreements apply to potentially distortive elements in countries' tax rules?

51. In previous work (Avi-Yonah, 2000) we identified three types of tax havens: (i) "production tax havens", in which there is a specific tax holiday or other type of tax benefit designed to attract foreign investors to set up production facilities in a host country; (ii) "traditional tax havens", i.e., jurisdictions with little or no income tax that seek to attract foreign investors and financial service providers through the promise of no taxation and bank secrecy; (iii) "headquarters tax havens", i.e., regimes designed to attract multinational enterprises to locate their headquarters in a jurisdiction by promising no taxation (or no current taxation) of income derived from foreign subsidiaries.

52. How do the GATT rules previously described apply to these three types of tax havens? The clearest application is in the case of production tax havens. These regimes are invariably "ring fenced", i.e., they are designed to foster exports and therefore are separated from the domestic economy (and sometimes also not available to domestic investors). The regimes are ring fenced precisely because they are set up by countries with a real domestic tax base that do not wish to see that base eroded by the tax concessions granted within the preferential regimes. The European Union (EU) and OECD reports on harmful tax competition cite dozens of such regimes, even though they limit themselves only to regimes of member countries and (in the case of OECD) exclude "real" investments (i.e., manufacturing) (EU 2000, OECD 2000).

53. There seems to be little doubt that such production tax havens constitute prohibited export subsidies under GATT. They invariably involve foregone revenue (i.e., are tax expenditures), are specific to certain taxpayers (in fact they are frequently negotiated deals) and are "in fact" contingent on export performance because the products they involve cannot be targeted at the domestic market.

54. The case of traditional tax havens is harder. Since there is no income tax, they do not involve "foregone revenue" or a tax expenditure in the traditional sense. However, traditional tax havens frequently grant exemptions to the offshore sector from those taxes that they do collect (e.g., value-added tax). Moreover, they frequently involve not just pure investments (which are presumably not covered by the current GATT) but in particular the provision of financial services, such as brokerage or insurance, targeted entirely at foreigners (and frequently ring fenced as well). However, services are not covered by the current Subsidies Code. Thus, traditional tax havens, including that part of their activities that is more than pure passive investment, do not fall within the prohibition on export subsidies unless they can be considered as trading in intangible goods. This is a significant limitation on the scope of the current GATT.

55. Headquarters tax havens also pose significant analytic problems. This category covers specific regimes designed to attract foreign multinational enterprises, which are akin to production tax havens. Those are presumably export subsidies for the reasons stated above. However, they also cover things like the United States deferral regime and the European exemption for foreign source income of domestic multinational enterprises. Are these export subsidies under GATT? If the only activity involved is pure investment (e.g., the acquisition of a foreign target), then the regime is not covered. But usually there is also the transfer of intangibles, and frequently also the sale of goods to the foreign subsidiaries. In these cases there is trade in goods, and the provision could be an export subsidy.

56. The ultimate question in this regard is whether deferral or exemption is a tax expenditure, because foregone revenue is a precondition to finding a subsidy under GATT. In a worldwide regime such as the United States, the answer is clearly yes (and deferral is in the tax expenditure budget). However, if the transfer of goods to subsidiaries benefiting from deferral is accompanied by adequate transfer pricing enforcement (e.g., through royalties), then there is no subsidy (except a subsidy for investment, which is not covered).

57. What about an exemption regime? The Europeans have argued that the exemption of foreign source income in Europe is part of the normative baseline. But defining the baseline for the European regimes is hard, since they contain many worldwide features (such as controlled foreign corporations (CFC) regimes). Thus, we think that it is possible to argue that there is "foregone revenue" here as well, even if it is not reflected in the tax expenditure budget.

58. But what about the footnote that specifically excludes regimes designed to avoid double taxation? While the intent of this footnote was to exclude the European regimes, the query is whether an exemption regime that does not take into account whether the income was subject to tax at source qualifies as a "measure to avoid double taxation". Fundamentally, a general exemption regime distinguishes between domestic and foreign source activities in a way that frequently subsidizes exports, not just investments, and therefore can be construed as an export subsidy if the income is not taxed at source.

59. Even if one is satisfied that many of the practices identified by OECD as "harmful tax competition" and labelled by us "predatory tax protectionism" are covered by existing WTO rules, it does not necessarily follow that WTO adjudication is the best way to address the problem. The recent WTO decision on the United States Foreign Sales Corporations (FSC) is a case in point: Even though FSC is a well documented export subsidy (Desai and Hines, 2000), it took a major effort to have it adjudicated to be one by WTO. And although the United States did comply with the decision by repealing the FSC regime, it promptly replaced it with a territorial regime for exports that provides a similar subsidy. Presumably, this was done in order to bolster the argument that what the United States is doing is no different than European exemption regimes, although two wrongs do not make a right. In any case, the litigation now has to begin again. The prospect of litigating every one of the 66 regimes identified by EU and OECD as harmful tax competition under WTO rules is unappetizing, as Green (1998) has argued. On the other hand, the mere possibility of such challenges may provide some needed teeth to the OECD effort.

IX. A multilateral agreement on goods, services and investment?

60. The foregoing discussion has indicated that both the trade and tax treaties play a significant role in achieving the goals of free trade. The tax treaties prevent double taxation, as well as most forms of discrimination against foreigners covered by the treaties. However, because of their bilateral nature, the tax treaties do not do a good job of addressing predatory tax protectionism as embodied in production, traditional and headquarters tax havens. The trade agreements do a better job in this regard because of their multilateral nature, but are limited in this context to trade in goods, and do not cover trade in services or investment activities. Therefore, the trade agreements clearly apply only to production tax havens.

61. What is needed (ideally) is a multilateral treaty similar to GATT that will address investment as well as trade issues and that will apply to subsidies for services as well as goods. However, in the near future, the prospects for such a multilateral treaty do not appear promising. For example, Slemrod (1988) has argued that the costs due to tax havens and income shifting are appropriately dealt with via a multilateral agreement which would restrict statutory corporate tax rates to lie within a small band and impose sanctions on those countries that choose not to comply. Countries would be permitted to be magnets for real investment, but would have to do so by offering investment tax credits rather than low statutory tax rates. This (i.e., a minimum statutory corporate tax rate) is the approach suggested as a first step towards more corporate tax harmonization by the Ruding Committee, the experts' committee of the European Commission charged with recommending what, if any, tax harmonization should be adopted in concert with the 1992 curtailment of barriers to free trade in goods and services. This suggestion was not, however, embraced by the European Community, and it seems unlikely that it will be embraced in the near future.

62. The current OECD effort to combat harmful tax competition (OECD, 1998) is more limited. It requires a low or no tax rate as a condition for defining a tax regime as harmful, but does not envisage a minimum tax rate. However, the OECD project

applies only to geographically mobile activities (such as financial services) and not to real investment. In addition, the OECD effort is limited to production and headquarters tax havens in member countries, which leaves out most of the world. Efforts by OECD to combat traditional tax havens have met considerable opposition and may not lead to significant limits on such tax havens. A broader OECD effort to craft a multilateral agreement on investment collapsed in the face of internal disagreement and outside criticism.

63. Relying on OECD to restrict tax competition suffers from three significant drawbacks. First, OECD only has 29 members, and it is not clear that it can effectively enforce its anti-tax competition rules on non-member countries. For example, solutions that rely on where the parents of MNEs are located assume that no significant growth in MNEs will take place outside OECD, and solutions that rely on OECD as the market assume no significant markets outside OECD. Either assumption may become wrong, and when that happens solutions that rely on OECD enforcement will lose their effectiveness unless those emerging markets were to join OECD. While several developing countries have joined OECD recently (e.g., the Republic of Korea and Mexico), it is hard to imagine China or India doing so in the near future.

64. Second, relying on OECD to implement solutions to the tax competition problem, even if those solutions are tailored to benefit developing countries, may not be acceptable to those countries. Even though OECD has made a huge effort to include non-OECD members in the tax competition project, it is still identified as the rich countries' club. Thus, it is hard to believe that developing countries will be able to shed their suspicions that OECD will not act in their interests, even if it can actually be made to do so. In fact, the effort by OECD to develop a multilateral agreement on investments foundered precisely because developing countries and left-leaning non-governmental organizations coordinated a campaign against it as representing the interests of the rich countries and "their" MNEs.

65. Third, the OECD effort is limited so far to geographically mobile financial services, and excludes real investments, although these constitute a significant part of the problem. In addition, even for the areas it does cover, the OECD has only the power to persuade, not to adjudicate.

66. From these perspectives, WTO is a more attractive candidate for "world tax organization". It has a much broader membership than OECD, and developing countries are much better represented (and have real clout, as shown by the recent struggle over choosing the Director General of WTO). Moreover, as indicated above, the WTO rules already cover and prohibit most forms of harmful tax competition identified by OECD.

67. But there are several serious objections to including tax matters in the jurisdiction of WTO. First, it has been argued that WTO lacks sufficient tax expertise. However, that problem can be remedied by hiring an adequate number of tax experts to sit on the WTO panels. In fact, as WTO has expanded its jurisdiction to non-tariff matters, its staff already includes tax experts who also understand trade issues.

68. Robert Green has advanced a more serious objection, arguing that the costs of imposing the WTO legalistic dispute-resolution mechanism outweigh any benefits (Green, 1998). Green argues that the need for WTO to resolve trade disputes

legalistically is based on two features that are typically lacking in the tax context: retaliation and lack of transparency. Retaliation is a feature of repeated prisoners' dilemma type games and insures that players have an incentive to cooperate. In an assurance (stag hunt) game, both players cooperate if they can be assured of the other player's cooperation. In the first case an organizational setting is needed to manage retaliatory strategies, while in the second it is needed to provide the information needed for the assurance to exist.

69. However, in the context of tax competition it would seem that both retaliation and lack of information are serious problems. For example, in the case of portfolio investment, the United States began a race to the bottom by abolishing its withholding tax, and other countries responded (i.e., retaliated) by abolishing their own taxes. In the current situation no country dare reimpose its tax without adequate assurance that other countries will follow. Similarly, for direct investment, countries have adopted tax incentives or adopted deferral and exemption rules for their resident multinational enterprises in response to the actions of other countries and fear changing such policies without assurance that others will follow suit. Thus, whether these developments are characterized as prisoners' dilemma or assurance games, they seem to present precisely the kind of problem that only a multilateral organization with rule-making power can effectively resolve.

70. However, Green also raises another objection to giving WTO authority over taxes which in practice is likely to be far more potent: the problem of sovereignty. Countries are wary of giving up their sovereignty over tax matters, which lies at the heart of their ability to exercise national power. This concern is particularly acute in the United States and almost led to the failure of the entire Uruguay Round as the United States insisted at the last minute to exclude direct taxes from the purview of the General Agreement on Trade in Services (GATS). Green argues that if the WTO dispute resolution mechanism were given authority over tax issues, this might lead to widespread non-compliance, especially given the perception that WTO is non-transparent and lacks democratic legitimacy.

71. Green may be wrong about this estimate, especially since the analysis above has shown that WTO already has jurisdiction on most forms of harmful tax competition, so that no further extension of its powers is necessary. But even if Green is right and sovereignty poses a real problem, there may be a solution to this as well. Under the GATT regime, all decisions had to be reached by consensus, i.e., with the agreement of the party whose regime is at stake. Under the WTO rules, on the other hand, all dispute settlement rulings are binding unless there is a consensus not to implement them, i.e., when even the complaining party agrees to refrain from action. Perhaps the former rule is more appropriate for tax matters than the latter because it gives the loser a veto if it feels that its sovereignty is truly at stake. Similar rules exist for tax matters in both the EU and the OECD. But, as the Domestic International Sales Corporation (DISC) case in GATT and the adoption of the tax competition report by OECD show, a country will typically reserve its veto power only to those cases in which the adverse result is truly perceived as a severe limit on its sovereignty. In other cases, the stigma of disapproval is sufficient to ensure cooperation.

72. **In the final analysis, it may thus be necessary to set up a multilateral organization with different rules than WTO, but with similarly broad membership. The United Nations is the obvious venue for setting up such an**

organization, building on the important work of the League of Nations Fiscal Committee. The current ad hoc Group of Experts on International Cooperation in Tax Matters should be upgraded to provide the basis for such an organization.

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