The WTO, Export Subsidies, and Tax Competition

Reuven S. Avi-Yonah
University of Michigan Law School

Publication Information & Recommended Citation

Avi-Yonah, Reuven S. "The WTO, Export Subsidies, and Tax Competition." In *WTO and Direct Taxation*, edited by M. Lang et al., 115-31. Eucotax Series on European Taxation, vol. 10. The Hague: Kluwer Law International, 2005.

EUCOTAX Series on European Taxation

WTO and Direct Taxation

Michael Lang, Judith Herdin and Ines Hofbauer

Department of Austrian and International Tax Law
Vienna University of Economic and Business Administration

Eucotax

Linde

KLUWER LAW INTERNATIONAL

The WTO, Export Subsidies, and Tax Competition

Reuven S. Avi-Yonah

The Problem of Tax Competition

The Problem of Tax Competition

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

Two recent developments have dramatically augmented the ability of both individuals and corporations to earn income overseas free of income taxation: The effective end of withholding taxation by developed countries, and the rise of production tax havens in developing countries.[1] Since the U.S. abolished its withholding tax on interest paid to foreigners in 1984, no major capital importing country has been able to impose such a tax for fear of driving mobile capital elsewhere (or increasing the cost of capital for domestic borrowers, including the government itself).[2] The result is that individuals can generally earn investment income free of host country taxation in any of the world's major economies.[3] Moreover, even developed countries find it exceedingly difficult to effectively collect the tax on the foreign income of their individual residents in the absence of withholding taxes imposed by host countries, because the investments can be made through tax havens with strong bank secrecy laws.[4] Developing countries, with much weaker tax administrations, find this task almost impossible. Thus, cross-border investment income can largely be earned free of either host or home country taxation.[5]

For example, consider a wealthy Mexican who wishes to earn tax-free interest income from investing in the bonds of an American corporation. All he needs

1 Reuven S. Avi-Yonah, Globalization, Tax Competition and the Fiscal Crisis of the Welfare State, *Harvard Law Review* 113:1573.

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

3 Reuven S. Avi-Yonah and Linda Z. Swartz, *Virtual Taxation: Source Based Taxation in the Age of Derivatives*, Derivatives 2:247 (1997); Edmund S. Cohen, *Individual International Tax Planning Employing Equity Derivatives*, Derivatives 4:52 (1996).

4 Vito Tanzi, *Taxation in an Integrating World* (1995).

5 Chander Kant, Foreign Direct Investment and Capital Flight, *Princeton Studies in International Finance* 80:1 (1996); Charles E. McLure, Jr., U.S. Tax Laws and Capital Flight from Latin America, *University of Miami Inter-American Law Review* 20:321 (1989).

to do is set up, for a nominal fee, a Cayman Islands corporation to hold the bonds. The interest payments are then made to the Caymans corporation without any U.S. tax withheld under the so-called "portfolio interest exemption." (Internal Revenue Code section 871 (h)). The individual does not report the income to the Mexican tax authorities, and they have no way of knowing that the Caymans corporation is effectively an "incorporated pocketbook" of the Mexican resident. Nor is the exchange of information provisions of the U.S.-Mexico tax treaty of any help, because the IRS has no way of knowing that the recipient of the interest payments is controlled by a Mexican resident and therefore cannot report this to the Mexican authorities.

As a result, the income is earned completely free of tax (the Caymans, of course, impose no income taxes of their own).

When we switch our attention from passive to productive investment, a similar threat to the taxing capacity of both home and host jurisdictions emerges. In the last decade, competition for inbound investment has led an increasing number of countries (103, as of 1998) to offer tax holidays specifically geared to foreign corporate investors.[6] Given the relative ease with which an integrated multinational can shift production facilities in response to tax rates, such "production tax havens" enable multinationals to derive most of their income abroad free of host country taxation.[7] Moreover, most developed countries (including the U.S.) do not dare impose current taxation (or sometimes any taxation) on the foreign source business income of their resident multinationals, for fear of reducing the competitiveness of those multinationals against multinationals of other countries.[8] If they did, new multinationals could be set up as residents of jurisdictions that do not tax such foreign source income.[9] Thus, business income can also be earned abroad largely free of either host or home country taxation.

For example: Intel Corporation, a top 10 multinational, has operations in more than 30 countries around the globe. The company states that "[a]n Intel chip developed at a design center in Oregon, might be manufactured at a wafer fabrication facility in Ireland, packaged and tested in Malaysia, and then sold

6 Raymond Vernon, *In the Hurricane's Eye* (1998); United Nations, *World Investment Report* (1996).

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

8 Robert J. Peroni, Back to the Future: A Path to Progressive Reform of U.S. International Income Tax Rules, *University of Miami Law Review* 51:975 (1997).

9 James R. Hines, Jr. The Flight Paths of Migratory Corporations, *Journal Of Accounting, Auditing and Finance* 6:447 (1991).

to a customer in Australia. Another chip might be designed in Japan, fabricated in Israel, packaged and tested in Arizona, and sold in China."[10] Specifically, outside the United States, Intel has major manufacturing facilities in Puerto Rico, China, Malaysia, the Philippines, Ireland, and Israel.[11] Thus, outside the United States, all of Intel's manufacturing facilities are located in countries granting tax holidays. Nor does Intel pay current U.S. tax on its income from those foreign operations, because under U.S. law, active income earned by foreign subsidiaries of U.S. multinationals is not taxed until it is repatriated in the form of dividends, which Intel can delay for many years.[12] Thus, the effective tax rate on Intel's foreign source income is far below the nominal U.S. corporate rate of 35%.

If income from capital can escape the income tax net, the tax becomes in effect a tax on labor. Several empirical studies have in fact suggested that in some developed jurisdictions the effective tax rate on income from capital approaches zero, and tax rates on capital have tended to go down sharply since the early 1980s (when exchange controls were relaxed).[13] As a result, countries that used to rely on the revenues from the income tax are forced to increase relatively regressive taxes. The two fastest growing taxes in OECD Member countries in recent years have been consumption taxes (from 12% of total revenues in 1965 to 18% in 1995) and payroll taxes (from 19% to 27%), both of which are more regressive than the income tax.[14] Over the same period, the personal and corporate income taxes have not grown as a percentage of total revenues (the personal income tax accounted for 26% of total revenues in 1965 and 27% in 1995, while the figures for the corporate income tax are 9% and 8% respectively).[15] The total tax revenue as a percentage of GDP in developed countries went up sharply during the same period (from an average of 28% in 1965 to almost 40% in 1994), and this increase is largely accounted for by the rise of consumption and payroll taxes.[16] Moreover, there is evidence that as the degree of openness of an economy in OECD Member countries increases, taxes on capital tend to go down while taxes on labor go up (the income tax is imposed on both capital and labor, so that its stability may mask this trend).[17]

10 Intel (1998), www.intel.com/intel/intelis/sites.htm.
11 Intel, *Annual Report* (1999).
12 Reuven S. Avi-Yonah, International Taxation of Electronic Commerce, *Tax Law Review* 52:507 (1997).
13 Jeffrey Owens and Jacques Sasseville, *Emerging Issues in Tax Reform* (1997); Dani Rodrik, *Has Globalization Gone Too Far?* (1997).
14 Jeffrey Owens and Jacques Sasseville, *Emerging Issues in Tax Reform* (1997).
15 Jeffrey Owens and Jacques Sasseville, *Emerging Issues in Tax Reform* (1997).
16 World Bank, *Tax Policy Handbook* (1994).
17 Enrique G. Mendoza, Assaf Razin & Linda L. Tesar, Effective Tax Rates in Macroeconomics: Estimates of Tax Rates on Factor Income and Consumption, *Journal of Monetary Economics* 34:297 (1994); Enrique G. Mendoza, Gian Maria Milesi-Ferretti and Patrick Asea, *On the Ineffectiveness of Tax Policy in Altering Long-Run Growth*, Centre For Economic Policy Research Discussion Paper 1378 (1996).

The same trends can be observed in developing countries as well. In non-OECD Member countries (outside the Middle East) total government revenues as a share of GDP rose from an average of 18.8% in 1975-80 to 20.1% in 1986-92.[18] This growth was financed primarily by the growth of revenues from the VAT in the same period (from 25.5% of total revenues to 31.8%). At the same time, revenues from both the individual and the corporate income tax were flat or declined.[19]

A recent study by *Keen* and *Simone* (2004) illustrates both the extent of this problem and its impact on developing countries. *Keen* and *Simone* show that from 1990 to 2001 corporate tax rates have declined in both developed and developing countries. However, while in developed countries this decline in the rates was matched by a broadening of the tax base, so that no decline in revenues can be observed,[20] in developing countries the same period witnessed a decline of corporate tax revenues by about 20 percent on average. This decline is particularly important in light of the larger share of tax revenues produced by the corporate tax in developing countries (average 17 percent, as opposed to 7 percent for developed countries). *Keen* and *Simone* (2004) attribute most of this decline to the spread of targeted tax incentives for MNEs. From 1990 to 2001 the percent of developing countries granting tax holidays to MNEs grew from 45% to 58%, and similar trends can be seen for tax breaks for exporters (32% to 45%), reduced corporate rates for MNEs (40% to 60%), and free trade zones (17.5% to 45%). These figures are particularly important because a companion paper by *Altshuler* and *Grubert* (2004) shows that the evolution of country effective tax rates in the period between 1992 and 1998 seems to have been driven by tax competition, and that US manufacturers are becoming increasingly important in determining location of their investments.

1. Tax Competition and Developing Countries

The drawbacks of tax competition for developed countries are relatively clear, because such countries have an elaborate social insurance safety net that requires a high level of government expenditure and that is threatened by tax competition.[21] But how does tax competition affect developing countries?

First, it should be pointed out that developing countries need the revenues at least as much as developed countries do, if not more. A common

18 World Bank, *Tax Policy Handbook* (1994).

19 World Bank (1994).

20 Rachel Griffith and Alexander Klemm, What Has Been the Tax Competition Experience of the Last 20 Years, 34 *Tax Notes Int'l* 1299 (2004).

21 Willi Leibfritz et al., *Ageing Populations, Pension Systems and Government Budgets*, OECD Economics Department Working Paper 156 (1995).

misperception is that only OECD Member countries are confronted by a fiscal crisis as a result of the increasing numbers of elderly people in the population. In fact, the increase in dependency ratios (the ratio of the elderly to the working population) is expected to take place in other geographic areas as well, as fertility rates go down and health care improves.[22] Outside the OECD and the transition economies, the dependency ratio starts in the single digits in the 1990s, but rises to just below 30% by 2100.[23] Moreover, while outside the OECD and the transition economies direct spending on social insurance is much lower, other forms of government spending (e.g., government employment) effectively fulfill a social insurance role. In Latin America, for example, direct government spending on social insurance is much lower than indirect spending through government employment and procurement programs.[24]

Moreover, it seems strange to argue that developing countries need tax revenues less than developed countries because they have less developed social insurance programs. If one accepts the normative case for social insurance, it applies to developing countries with even greater force because of widespread poverty, which means that losing a job can have much direr consequences.[25] But the need for revenues in developing countries goes far beyond social insurance. In some developing countries revenues are needed to ensure the very survival of organized government, as the Russian experience demonstrates.[26] In other, more stable developing countries revenues are needed primarily to provide for adequate education (investment in human capital), which many regard as the key to promoting development.[27] For example, the UN has estimated that for only $30-$40 billion, all people in the world can obtain basic social services (such as elementary education).[28] Given current trends in foreign aid, most of these funds have to come from developing country governments.[29]

Second, the standard advice by economists to small open economies is that they should refrain from taxing foreign investors, because such investors

---

22 World Bank, *Tax Policy Handbook* (1994).

23 Charles E. McLure, Jr., *Tax Policies for the 21st Century*, Keynote Address to the International Fiscal Association Congress, Geneva (1996).

24 K. Subbarao et al., *Safety Net Programs and Poverty Reduction: Lessons from Cross-Country Experience* (1997).

25 United Nations, *Human Development Report* (1997).

26 *The Economist*, Meltdown in Russia (August 29, 1998).

27 Amartya Sen, Development Thinking at the Beginning of the XXI Century, in Emmerij (ed.), *Economic and Social Development in the XXI Century* (1997).

28 United Nations, *Human Development Report* (1997).

29 United Nations, *Report of the Secretary-General to the Preparatory Committee for The High-Level International Intergovernmental Event on Financing for Development* (2001).

cannot be made to bear the burden of any tax imposed by the capital importing country.[30] Therefore, the tax will necessarily be shifted to less mobile factors in the host country, such as labor and/or land, and it is more efficient to tax those factors directly. But while this argument seems quite valid as applied to portfolio investment, it seems less valid in regard to FDI, for two reasons. First, the standard advice does not apply if a foreign tax credit is available in the home country of the investor, which frequently would be the case for FDI.[31] Second, the standard advice assumes that the host country is small. However, an extensive literature on multinationals suggests that typically they exist in order to earn economic rents.[32] In that case, the host country is no longer "small" in the economic sense. That is, there is a reason for the investor to be there and not elsewhere. Therefore, any tax imposed on such rents (as long as it is below 100%) will not necessarily drive the investor to leave even if it is unable to shift the burden of the tax to labor or landowners.

This argument clearly holds in the case of rents that are linked to a specific location, such as natural resources or a large market. But what if the rent can be earned in a large number of potential locations?[33] In this case, the host country will not be able to tax the rent if the multinational can credibly threaten to go elsewhere, although once the investment has been made the rent can be taxed. This situation, which is probably the most common,[34] would require coordinated action to enable all host countries to tax the rent earned within their borders. Some possibilities for such action are described below.

This relates to the final argument, which is that host countries need to offer tax incentives to be competitive. An extensive literature has demonstrated that taxes do in fact play a crucial role in determining investment location decisions.[35] But all of these studies emphasize that the tax incentives are crucial *given the availability of such incentives elsewhere.*[36] Thus, it can be argued that given the need for tax revenues, developing countries would in

---

30 Assaf Razin and Efraim Sadka, International Tax Competition And Gains from Tax Harmonization, *Economics Letters* 37:69 (1991).

31 Timo Viherkentta, *Tax Incentives in Developing Countries and International Taxation* (1991).

32 Jean-Francois Hennart, The Transaction Cost Theory of the Multinational Enterprise, in Pitelis and Sugden (eds.), *The Nature of theTransnational Firm* (1991).

33 Dunning, *Explaining International Production* (1988).

34 Jean-Francois Hennart, The Transaction Cost Theory of the Multinational Enterprise, in Pitelis and Sugden (eds.), *The Nature of the Transnational Firm* (1991).

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

36 Stephen E. Guisinger & Associates, *Investment Incentives and Performance Requirements* (1985).

general prefer to refrain from granting tax incentives, if only they could be assured that no other developing country would be able to grant such incentives.[37]

Thus, restricting the ability of developing countries to compete in granting tax incentives does not truly restrict their autonomy or counter their interests. That is the case whenever they grant the incentive only for fear of competition from other developing countries, and would not have granted it but for such fear. Whenever competition from other countries drives the tax incentive, eliminating the competition does not hurt the developing country, and may aid its revenue raising efforts (assuming it can attract investment on other grounds, which is typically the case). Moreover, under the proposals described below, developing countries remain free to lower their tax rates generally (as opposed to granting specific tax relief aimed at foreign investors).

Two additional points need to be made from a developing country perspective. The first concerns the question of tax incidence. Since the tax competition that is most relevant to developing countries concerns the corporate income tax, it is important to attempt to assess the incidence of that tax in evaluating the effects of collecting it on the welfare of the developing country. Unfortunately, after decades of analysis, no consensus exists on the incidence of the corporate tax. While the older studies have tended to conclude that the tax is borne by shareholders or by all capital providers, more recent studies have suggested that the tax is borne to a significant extent by consumers or by labor.[38] Another possibility is that the tax on established corporations was borne by those who were shareholders at the time the tax was imposed or increased, because thereafter it is capitalized into the price of the shares.[39] It is unlikely that this debate will be decided any time soon (in fact, the incidence may be shifting over time, especially as globalization may enable corporations to shift more of the tax burden to labor). However, from the perspective of a developing country deciding whether to collect taxes from a multinational, three out of the four possible alternatives for incidence (current shareholders or capital providers, old shareholders, and consumers) are largely the residents of other jurisdictions, and therefore from a national welfare perspective the developing country gains by collecting the tax. And even if some of the tax is shifted to labor in the developing country, it can be argued that as a matter of tax administration it is more efficient (as well as

[37] Reuven S. Avi-Yonah, Globalization, Tax Competition and the Fiscal Crisis of the Welfare State, *Harvard Law Review* 113:1573 (2000).

[38] Joseph A. Pechman, *Federal Tax Policy* (1987); U.S. Treasury, *Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once* (1992).

[39] Joseph A. Pechman, *Federal Tax Policy* (1987).

more politically acceptable) to collect the tax from the multinational than to attempt to collect it from the workers.

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

2. The OECD and Tax Competition

The tax competition problem is thus essentially a problem of coordination and trust. Each jurisdiction would prefer to tax investors from abroad to gain the revenue, but is afraid that by doing so it would drive the investors to other jurisdictions that do not tax them. If there was a way to coordinate actions among the relevant jurisdictions, they all could gain added revenues without running the risk of losing the investment.

A good illustration of how this dynamic works is the history of German taxation of interest income. In 1988, Germany introduced a 10% withholding tax on interest paid to bank depositors, but had to abolish it within a few months because of the magnitude of capital flight to Luxembourg. In 1991, the German Federal Constitutional Court held that withholding taxes on wages but not on interest violated the constitutional right to equality. The government thereupon reintroduced the withholding tax on interest, but made it inapplicable to non-residents.[40] Non-residents may, however, be Germans investing through Luxembourg bank accounts. To cope with this problem, the Germans have led an EU effort to introduce either exchange of information or a withholding tax on all interest payments to EU residents.[41] This proposal was adopted as a directive after a prolonged political fight, but it is still conditioned upon the cooperation of Switzerland

---

[40] Leif Muten, International Experience of How Taxes Influence the Movement of Private Capital, *Tax Notes International* 8:743 (1994).

[41] European Union, Conclusions of the ECOFIN Council Meeting on 1 December 1997 Concerning Taxation Policy, *O.J.* (C 2) 1 (1998).

and upon the actual implementation of withholding taxes by Luxembourg, Belgium and Austria.[42]

Thus, the key to finding a solution to the tax competition problem is to attack it on a broad multilateral basis, through an organization such as the OECD. Under current conditions, the OECD is the natural choice for leading such coordinated actions against tax competition, for three reasons. First, for individual investors to earn decent returns on their capital without incurring excessive risks, they need to invest in an OECD Member country. Tax havens do not offer adequate investment opportunities, and developing countries are generally considered too risky for portfolio investment (other than through mutual funds, which do not offer tax avoidance opportunities). Thus, if all OECD Members enforced taxation of portfolio investment, it could be subject to tax without requiring cooperation from the tax havens.

Second, about 85% of the world's multinationals are headquartered in OECD Member countries. This is likely to continue to be the case for a while, because OECD Members offer stable corporate and securities law protection to investors that is lacking in other countries. Thus, if all OECD Members agreed on a coordinated basis to tax their multinationals currently on their income from abroad, most of the problem of tax competition from direct investment could be solved.

Third, the OECD has the required expertise (its model tax treaty is the global standard) and has already started on the path of limiting tax competition. In 1998, it adopted a report entitled "Harmful Tax Competition: An Emerging Global Issue."[43] This Report is somewhat limited, because it only addresses tax competition for financial activities and services (as opposed to, e.g., Intel's manufacturing plants). It also does not address the taxation of investment income. But it represents an extremely useful first step, and proof that a consensus can be reached on the tax competition issue (Switzerland and Luxembourg abstained, but did not dare veto the adoption of the Report by the other 27 Members of the OECD).

The OECD makes a useful distinction between tax competition in the form of generally applicable lower tax rates, and tax regimes designed to attract foreign investors. This distinction is both normatively and pragmatically sound: Restricting tax competition should not and cannot mean that voters in democratic countries lose their right to determine the size of the public sector through general tax increases or reductions. But it does mean that countries

42 Sibren Cnossen, Reform and Coordination of Corporation Taxes in the European Union: An Alternative Agenda, 34 *Tax Notes Int'l* 1327 (2004).

43 Organization for Economic Cooperation and Development, *Harmful Tax Competition: An Emerging Global Issue* (1998).

should not provide windfalls for foreign investors at the expense of the ability of other countries to provide those public services their residents desire. Such limitations are particularly appropriate because those foreign investors themselves often reside in countries providing a high level of services, and yet refuse to pay the tax price that providing such services entails.

However, relying on the OECD to restrict tax competition suffers from three significant drawbacks. First, the OECD only has 30 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 the OECD, and solutions that rely on the OECD as the market assume no significant markets outside the 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 the OECD. While several developing countries have joined the OECD recently (e.g., South Korea and Mexico), it is hard to imagine China or India doing so in the near future.

Second, relying on the 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 the 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 the OECD will not act in their interests even if it can actually be made to do so. In fact, the effort by the OECD to develop a multilateral agreement on investments (MAI) 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.

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. This has led commentators to look for an alternative, and the obvious candidate, especially after the FSC case, is the WTO.

3. The WTO and Tax Competition

3.1. The WTO Rules

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

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

Article XVI was significantly expanded by the Subsidies Code included in the 1994 version of the 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 the 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." Annex I to the Subsidies Code includes 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 Member from taking measures to avoid the double taxation of foreign source income earned by its enterprises."

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

3.2. Application to Tax Havens

In previous work,[44] I have 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.

How do the GATT rules previously described apply to these three types of tax haven? 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 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 the OECD) exclude "real" investments (i.e., manufacturing).

There seems to be little doubt that such production tax havens constitute prohibited export subsidies under the GATT. They invariably involve foregone revenue, are specific to certain taxpayers (in fact they are frequently negotiated deals), and are "in fact" contingent on export performance because the products or services they involve cannot be targeted at the domestic market. The exception would be a regime for foreign investors that is targeted mainly at the domestic market, but such regimes are dwindling in importance as large developing countries realize that if MNEs need to access their domestic market, it is generally not necessary to offer tax reductions to induce them to come because they would need proximity to the market in any case.

The two other types of tax havens, traditional tax havens and headquarters tax havens, are probably not in violation of WTO rules because they mostly offer a subsidy to services and not goods (although if goods are defined to include intangibles, a case could be made to include them). Fortunately, these types of tax havens are the focus of the OECD efforts, so it would seem advisable for the WTO to focus on production tax havens.

44 Reuven S. Avi-Yonah, Globalization, Tax Competition and the Fiscal Crisis of the Welfare State, *Harvard Law Review* 113:1573 (2000).

4. Conclusion: Is the WTO the Best Forum to Deal with Tax Competition?

From the perspectives described above, the WTO is a more attractive candidate for "world tax organization". It has a much broader membership than the 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 explained above, the WTO rules already cover and prohibit the form of tax competition that is most prevalent in developing countries, namely granting targeted tax incentives to MNEs engaged in the manufacture of goods. As long as the goods are primarily intended for export (as would typically be the case for small developed countries), such targeted incentives arguably constitute a prohibited export subsidy.[45] Moreover, if the goods are primarily intended for the local market, there is much less pressure of the developing countries to grant tax incentives (see, e.g., Argentina, Brazil, and China, which are phasing them out).

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

Robert Green has advanced a more serious objection arguing that the costs of imposing the WTO's legalistic dispute-resolution mechanism outweigh any benefits.[46] *Green* argues that the need for the 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 ensures 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.

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 U.S. began a race to the bottom by abolishing its withholding tax, and other countries responded (i.e., retaliated) by abolishing

[45] Slemrod and Avi-Yonah, (How) Should Trade Agreements Address Income Tax Issues, 55 *Tax L. Rev.* 533 (2002).

[46] Robert Green, Antilegalistic Approaches to Resolving Disputes Between Governments: A Comparison of the International Tax and Trade Regime, 23 *Yale J. Int'l L.* 79 (1998).

their own taxes. In the current situation no country dare re-impose 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 MNEs 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.

However, *Green* also raises another objection to giving the 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 U.S. and almost led to the failure of the entire Uruguay Round as the U.S. insisted at the last minute to exclude direct taxes from the purview of the GATS. *Green* argues that if the WTO dispute resolution mechanism were given authority over tax issues, this may lead to widespread noncompliance especially given the perception that the WTO is non-transparent and lacks democratic legitimacy.

Green may be wrong about this estimate, especially since the analysis above has shown that the WTO already has jurisdiction on the most important form 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 DISC case in the GATT and the adoption of the tax competition report by the 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.

In the final analysis, it may thus be necessary to set up a multilateral organization with different rules than the WTO, but with similarly broad membership. The UN 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.

To sum up: As a result of globalization and tax competition, tax rules can no longer be set by countries acting unilaterally or by bilateral tax treaties. In a world in which capital can move freely across national borders and multinationals are free to choose among many investment locations, the ability of any one country (or any two countries in cooperation) to tax (or otherwise regulate) such capital is severely limited. Any such unilateral attempt will be undercut by other countries, and will probably not be even attempted in the name of preserving national competitiveness. Thus, a multilateral solution is essential if the fundamental goals of taxation or other regulation are to be preserved. Private market activities that span the globe can only be regulated or taxed by organizations with a similar global reach.

This chapter has attempted to outline some of the ways in which such global governance can be achieved in the area of capital income taxation. Achieving this goal will not be easy, given the expected resistance of both private actors eager to preserve their freedom from taxation and of governments concerned about preserving their sovereign ability to set their own tax rules. But it is not impossible. Moreover, since preserving the ability of developing nations to tax income from capital is essential to the achievement of important policy goals, it must be tried.