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The WTO and Direct Taxation

by

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ABSTRACT

The widely-followed ruling by the WTO's Dispute Settlement Body against the United States concerning the latter's FSC/ETI scheme, which led to the largest retaliation award ever authorized in a dispute at the WTO, confirmed (if there were ever any doubt) that, generally speaking, direct taxes, like indirect taxes (including tariffs), are subject to the multilateral rules of the WTO, notwithstanding efforts by tax authorities to secure specific exemptions for certain direct tax measures in these agreements. This ruling reconfirmed the traditional distinction under international trade rules between direct and indirect taxes, particularly with respect to how such taxes should be treated under the subsidy and border tax adjustment rules of the WTO. It prompted the US Congress finally to pass legislation in late 2004 to repeal the FSC/ETI scheme as part of a larger overhaul of the US corporate tax system. The most recent disputes between the United States and the European Communities over assistance to large civil aircraft (allegedly amounting in each case to even more than the FSC/ETI) also encompass direct tax measures.

It would be not be surprising if other WTO-inconsistent direct tax measures were identified in the future, leading to further disputes among WTO Members. Multilateral WTO rules, which are agreed by consensus, can therefore be expected to continue to be an important factor in how Members' shape their tax policies as they will undoubtedly want to avoid having their tax policies successfully challenged in the WTO.

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I. INTRODUCTION

International rules concerning measures that affect trade and those regarding direct taxation appear to have broadly similar goals, namely the removal of obstacles to the cross-border movement of goods, services, capital, labour and technology. Whereas international trade rules pertain largely to the movement of goods and services, those with respect to direct taxation mainly involve factors of production, especially capital. Notwithstanding their broadly similar goals, and the apparent analytical equivalence between cross-border flows of products and flows of factors[1], the two sets of rules have, in general, evolved quite separately.[2] Binding rules concerning tariffs and non-tariff barriers (NTBs) to trade have been negotiated multilaterally under the auspices of the General Agreement on Tariffs and Trade (GATT) and its successor, the World Trade Organization (WTO). By contrast, rules concerning direct taxation have been either decided unilaterally, as in the case of the methods used to relieve international double taxation[3], or negotiated bilaterally, in the case of withholding tax rates on cross-border income flows. These bilateral negotiations have been based to a large extent on the OECD *Model Tax Convention on Income and on Capital* ("the Model"), which evolved from working groups established by the International Chamber of Commerce and the League of Nations in the 1920s.

GATT/WTO rules recognize that internal taxation, including direct tax measures, can, like other laws and regulations, have economic effects that are similar, if not equivalent, to tariff and non-tariff border measures as well as production and export subsidies. They can also be used to deter or encourage international flows of capital and labour. With tariffs declining as a consequence of successive rounds of multilateral trade negotiations during the past 50 years or so under the General Agreement on Tariffs and Trade (GATT[4]), attention has focused increasingly on non-tariff measures, including internal taxes. This has raised concerns that internal tax measures may vitiate the effects of tariff reductions on international trade in goods, as it has long been known that such measures can have effects equivalent to tariffs.[5] Moreover, with trade in services accounting for around three-quarters of production and employment in industrialized countries, it is recognized that non-tariff restrictions, particularly internal regulations, can be important obstacles to the cross-border provision of services, which is more likely to require providers of such services to be located close to consumers, although services may also be embodied in goods. Consequently, obstacles to foreign direct investment (FDI) impede the establishment of foreign firms that provide these services; likewise, measures to encourage FDI facilitate trade in services.[6] Liberalization of trade in services and of FDI thus often go hand in hand.

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[1] This equivalence is a long-recognized implication of mainstream international trade theory (the Heckscher-Ohlin model) that product flows and factor flows are substitutes for each other in the sense that a similar equilibrium world price ratio will prevail with either products freely mobile and with factors immobile, or with products immobile but with factors mobile (Mundell, 1957). There is also a close relationship between a country's trade deficit (or surplus) and its net foreign investment; a country whose imports exceed exports is likely to finance the resulting trade deficit by promising to pay foreigners in the future, thereby increasing inbound foreign investment (Auerbach and Kotlikoff, 1995). Hence, trade policies affecting imports will have similar effects to tax policies affecting international investment.

[2] See Warren (2000) for a more detailed discussion of this evolution.

[3] International double taxation has long been recognized as an impediment to international trade and investment It arises most obviously if cross-border investments are taxed both in the country where the investment is made (the "source" country) and the country where the investor resides (the "residence" country).

[4] The overall import-weighted tariff average for manufactured products in industrialized countries is currently 6.3 per cent and will fall to 3.9 per cent, once commitments made under the Uruguay Round are fully implemented.

[5] See Slemrod (1995), for example. Bond and Guisinger (1985) found that Ireland's replacement of tariffs with tax as well as direct incentives for investment after joining the European Community left Irish industry in roughly the same position with regard to the domestic protection of labour as before. This finding is hardly surprising given that the economic and revenue effects of an import tariff can be replicated by the combination of a destination-based consumption tax plus either a subsidy or a tax exemption to domestic production at equal rates.

[6] Commercial presence (mode 3), involving FDI, is estimated to account for around 56 per cent of total world trade in services.

In recognition of its potentially important effects on international trade and investment flows, taxation is coming under increased scrutiny at the WTO.[7] This recognition is reflected in several of the multilateral agreements reached at the conclusion of the Uruguay Round in December 1993. These agreements include those on Subsidies and Countervailing Measures (SCM), Agriculture, Trade-Related Investment Measures (TRIMs), and services (GATS), which encompass direct as well as indirect taxation. These agreements reflect the growing realization on the part of national governments that multilateral rules need to play an increasingly important role in regulating the use of tax measures, especially where these measures affect the international movement of goods, services, capital, persons and technology. The expansion of WTO rules concerning trade and investment has increased the potential for conflict between these rules and tax laws and hence the scope for the WTO to encroach on Members' freedom to decide their own internal tax policies. Not surprisingly, therefore, disputes concerning taxation are becoming more frequent at the WTO, implying inconsistency between Members' tax laws and WTO agreements.

Hitherto, most of these disputes have involved indirect taxes, including excise taxes on alcoholic beverages (in Japan, Korea and Chile) and periodicals (in Canada), sales taxes on automobiles (in Indonesia), and VAT on integrated circuits (in China). However, in a recent high-profile and contentious case involving direct taxation, initiated by the European Communities (EC), a WTO Panel, upheld by the Appellate Body, ruled that the United States' "foreign sales corporation" (FSC) scheme (and its replacement, the Extraterritorial Income Exclusion Act (ETI)) constituted a prohibited export subsidy and, as such, violated the Agreement on Subsidies and Countervailing Measures as well as that on Agriculture. The amount of retaliation authorized when the United States failed to implement the ruling within the time period specified by the Dispute Settlement Body (DSB) was some US$4 billion per annum, by far the largest amount ever awarded in a WTO dispute. This ruling will undoubtedly be of interest as Members formulate their domestic tax policies in the future, especially where such policies differentiate between export-oriented and domestically-oriented sectors, and may even move Members to reformulate certain of these policies, as was the case with the US Furthermore, the dispute over the FSC prompted the US to initiate six other cases with the EC over certain income tax measures in Member States, although these cases have never gone beyond the consultation phase. More recently, another major dispute between the US and the EC concerning government assistance to Airbus and Boeing, respectively, has gone to the WTO, with (at the time of writing) both Members requesting the establishment of separate panels. In the case of the EC's complaint over government assistance to Boeing, it is alleged that such assistance involves tax incentives provided not just by the US Federal Government, notably the FSC/ETI scheme, of which Boeing was one of the main beneficiaries, but also tax incentives provided by some state and local governments, including those amounting to US$3 billion or so from the State of Washington, where much of Boeing's main manufacturing facility is located.

The WTO's interest in taxation is not confined to ensuring Members' compliance with the rules of its various agreements, however. Irrespective of whether they comply with WTO rules, Members' tax policies, practices and measures are being monitored much more closely under the WTO Trade Policy Review Mechanism (TPRM). Such monitoring throws light on how tax measures not yet covered by WTO rules may nonetheless have economic effects equivalent to (or more important than) tax or non-tax measures prohibited by existing WTO rules. By identifying new issues, the TPRM may pave the way for the adoption of further multilateral rules concerning taxation. On the other hand, as these measures tend to be more detrimental to the economy of the country imposing them than to the economies of its trading partners, a case can be made for removing or modifying such measures unilaterally, regardless of whether they are permitted by WTO rules.[8]

[7] Taxation was also a major issue during negotiations at the OECD regarding the Multilateral Agreement on Investment (Daly, 1997).

[8] Historically, unilateral liberalization, which is usually linked to a broader program of domestic reform, has accounted for most of the reductions in border protection. Most comprehensive trade reforms among large countries (Argentina, Brazil, China and India in the early 1990s) were primarily unilateral reforms that were undertaken to increase competition, and thus productivity, in the domestic economy.

The rest of this paper is organized as follows. The next section provides an overview of the extent to which present WTO rules apply to taxation, particularly direct taxation. Section 3 contains a summary of disputes concerning income tax measures that have arisen at the WTO since its establishment, with special attention to the protracted dispute between the EC and the US over the latter's FSC/ETI schemes. Section 4 focuses on some issues regarding direct taxation that have been identified in recent trade policy reviews; the tax policies and measures involved do not necessarily contravene WTO rules. Section 5 provides a comparison of the rationale and principles underlying WTO rules and those underlying international taxation. Section 6 reviews some recent empirical evidence regarding the incidence of direct taxes, which has a bearing on existing WTO rules concerning border tax adjustment in respect of exports and also on the assessment of damages in respect of tax measures found to contravene these rules. Some concluding remarks are found in Section 7.

II. TAXATION IN WTO AGREEMENTS

A. The General Agreement on Tariffs and Trade (GATT), 1994

A WTO Member is legally obliged not to raise border taxes in the form of tariffs above the specified rates agreed in GATT negotiations and incorporated into its schedule of concessions. The tariff rates so agreed are known as "bound" rates. Their purpose is to provide greater commercial certainty through the establishment of a ceiling on tariffs that cannot be breached without an offer of compensation to affected trading partners. Bound tariff rates are often higher than "applied" rates.

The cornerstone of the GATT, as well as other WTO agreements, is non-discrimination; it has two aspects, namely most-favored-nation (MFN) and national treatment (NT). The MFN principle, which is embodied in Article I (*General Most-Favoured-Nation Treatment*) of the GATT, stipulates that countries should not discriminate between trading partners' goods; that is,

> " ... any advantage, favor, privilege or immunity granted by any contracting party to any product originating in or destined for any other country shall be accorded immediately and unconditionally to the like product originating in or destined for the territories of all other contracting parties."

In other words, concessions accorded to one country's goods should be granted to those of *all* countries.[9] The MFN principle thus ensures import neutrality as far as goods are concerned.

The principle of NT is embodied in Article III (*National Treatment on Internal Taxation and Regulation*) of the GATT. In particular, Article III(1) states that

> "(T)he contracting parties recognize that internal taxes and other internal charges, and laws, regulations and requirements affecting the internal sale, offering for sale, purchase, transportation, distribution or use of products, ... should not be applied to imported or domestic products so as to afford protection to domestic production."

Article III(2) requires that

> " ... products of the territory of any contracting party imported into the territory of any other contracting party shall not be subject, directly or indirectly, to internal taxes or other internal charges of any kind in excess of those applied, directly or indirectly, to like domestic products. Moreover, no contracting party shall otherwise apply internal taxes or other internal charges to imported or domestic products in a manner contrary to the principles set forth in paragraph 1."

In addition, Article III(4) states that

> " ... products of the territory of any contracting party imported into the territory of any other contracting party shall be accorded treatment no less favourable than that accorded to like products of national origin in respect of laws, regulations and requirements affecting their internal sale, offering for sale, purchase, transportation, distribution or use."

In other words, imported goods must be treated the same as or no less favourably than domestically-produced goods so as to ensure that discriminatory internal taxes are not used as substitutes for tariffs.

As those GATT rules concerning import barriers pertain to goods only, it would appear that these rules relate more to indirect taxes (border and internal) than to direct taxes.[10] The lack of

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[9] Article XXIV permits departures from the MFN principle in respect of regional and bilateral free trade agreements, provided these preferential (and therefore discriminatory) agreements cover substantially all trade between the parties. More than 200 such agreements are currently in force even though no determination has yet been made by the WTO as to whether any of them is actually in accordance with Article XXIV.

[10] See Lennard (2004). According to Jackson (1969, p. 297), for example, "(T)he interpretation was made several times that income taxes did not fall within the language like that of Article III, paragraph 2, because that language 'is concerned solely with internal taxes on goods'". But given the apparent equivalence between flows of products and factors and indirect taxes are levied on the former and direct taxes on the latter, the two types of taxes can have equivalent effects.

disputes, until recently, was viewed by some as providing support for the view that there was little or no scope for coverage by the GATT 1947 of direct taxes because such taxes did not relate sufficiently to products. However, the recent Panel Report by the WTO on the FSC/ETI (discussed below) makes abundantly clear that such taxes do indeed fall within the scope of Article III of the GATT. More specifically, the Panel stated that

> "(I)n this connection, we can see no specification or limitation in the text of Article III:4 concerning the type of advantage linked to the measure under examination under Article III:4 of the GATT 1994. Thus, nothing in the plain language of the provision specifically excludes requirements conditioning access to income tax measures from the scope of application of Article III".[11]

The Panel went on to conclude that

> "Article III:4 of the GATT 1994 applies to measures conditioning access to income tax advantages in respect of certain products."

As regards exported goods, in a 1960 draft declaration giving effect to the provisions of Article XVI:4 (*Subsidies*) of the GATT, the "remission, calculated in relation to exports, of direct taxes or social welfare charges on industrial or commercial enterprises" are considered as export subsidies, whereas tariff or consumption tax refunds on exports are not. Similar language is found in Annex I (e) of the SCM Agreement (see below). Furthermore, Ad Article XVI of the GATT specifies that

> "(T)he exemption of an exported product from duties or taxes borne by the like product when destined for domestic consumption, or remission of such duties or taxes in amounts not in excess of those which have accrued, shall not be deemed a subsidy."

Also noteworthy with regard to direct taxation is an "Understanding" reached by the GATT Council in 1981 as a result of four panel reports issued in connection with disputes between the United States and the European Community over direct taxation. These disputes involved a complaint lodged in February 1972 by the EC against the United States' Domestic International Sales Corporation (DISC) scheme, which exempted so-called DISC income from corporate income tax and allowed partial deferment of tax on that income received by shareholders, and the related US complaints against the "territorial" income tax systems of Belgium. France and the Netherlands.[12] The GATT panel, whose report was issued in November 1976, found elements of subsidy in both the United States' DISC and "territorial" tax systems.

Following the issuance of the panel reports, the next step in the dispute-resolution process would normally have been for the GATT Council to consider whether or not to adopt these reports. However, the United States and the EC had reached an impasse. The United States was willing to accept the finding against the DISC, but only if the findings against the three "territorial" systems were also adopted; the three European countries were only willing to adopt the finding against the DISC. As a result, a GATT Council decision remained in abeyance for nearly five years. The hiatus was partly due to the increased opposition to the DISC within the United States itself. In addition, the negotiation of a new GATT Subsidies Code during the Tokyo Round appeared to point to a resolution of the dispute. The Code explicitly included tax deferrals as subsidies, casting doubt on the DISC's legality, while affirming the importance of using arm's-length pricing in intra-firm transfers, a key element of the United States' complaint against "territorial" systems. At the same time, the Subsidies Code appeared to countenance the legality of "territorial" systems in general.

In December 1981, the four panel reports were finally adopted by the GATT Council, subject to an Understanding. The Understanding, which later assumed an important role in the United States' defence of the Foreign Sales Corporation (FSC) at the WTO, involved agreement on three

[11] Panel Report, *United States – Tax Treatment for "Foreign Sales Corporations", Recourse to Article 21.5 of the DSU by the European Communities*, WT/DS108/RW, adopted 29 January 2002, as modified by the Appellate Body Report, WT/DS108/AB/RW, paragraphs 8.142-8.143.

[12] See Brumbaugh (2004).

points. First, countries need not tax economic processes occurring outside their territory. Notwithstanding the panel reports, "territorial" tax systems did not, in other words, generally contravene the GATT. Second, arms-length pricing should be followed in allocating income among related firms. Third, the GATT does not prohibit measures designed to alleviated double-taxation of foreign-source income.

However, the 1981 Understanding and adoption of the reports did not end the controversy. Indeed, the meaning of the Understanding itself shortly became a bone of contention, and in 1982 a debate occurred in the GATT Council over how the Understanding applied to the DISC scheme. The EC continued to argue that the DISC was an illegal export subsidy, while the United States maintained that it was merely approximating the effect of the "territorial" tax system commonly used by European countries. In 1984, however, the United States did replace the DISC with the Foreign Sales Corporation (FSC) scheme, which remained unchallenged until 1998.

B. Agreement on Trade-Related Investment Measures (TRIMs)

Not only do governments use tax as well as non-tax incentives to attract foreign investment, they may also impose conditions to ensure that the investments accord with certain national priorities. Such conditions include, *inter alia*: local content provisions, which require the investor to utilize a certain amount of local (instead of imported) inputs in production; and export performance requirements that compel the investor to export a certain proportion of its output. Such conditions, which can distort trade, just like import tariffs (or quantitative restrictions) and export subsidies, are known as trade-related investment measures (TRIMs).

The TRIMs Agreement applies to investment measures related to trade in goods only. It prohibits WTO Members from applying any TRIM that is inconsistent with Articles III *(National Treatment)* and XI *(General Elimination of Quantitative Restrictions)* of the GATT. The illustrative list of prohibited TRIMs contains four categories of measures: (a) benefits that are conditional upon local content requirements; (b) the conditioning of a firm's ability to import on its export performance; (c) foreign exchange balancing requirements or restrictions; and (d) domestic sales requirements involving restrictions on exports. Prohibited TRIMs thus include not only mandatory measures but also those "with which compliance is necessary to obtain an advantage". Although the term "advantage" is not defined explicitly in the Agreement, it is understood to encompass all types of advantages, including tax relief. The Agreement is limited in scope, however. It is noteworthy, for example, that it does not prevent countries from attaching export performance requirements to tax or non-tax incentives for investment. Nor does it prevent them from requiring that a minimum percentage of equity be held by local investors or that the foreign investor must bring in the most up-to-date technology or must conduct a certain amount or type of R&D locally.

C. Agreement on Subsidies and Countervailing Measures (SCM)

The SCM Agreement regulates the provision by WTO Members of subsidies with respect to goods and the actions that can be taken against such subsidies by a WTO Member (the application of the SCM to agricultural products is, however, limited in some respects by the Agreement on Agriculture). Article 1 (*Definition of a Subsidy*) of the Agreement defines a subsidy as a financial contribution by a Member of the WTO or by any public body within the territory of a Member which confers a benefit. Such contributions include revenue forgone as a consequence of tax incentives.[13]

The SCM Agreement divides subsidies into prohibited and permissible subsidies. Export subsidies (that is, those contingent on export performance) and subsidies contingent on the use of domestic over imported goods are prohibited. The SCM Agreement distinguishes between two categories of permissible subsidies: those that are

[13] They also include direct transfers of funds, actual (e.g., grants, loans, equity) or potential (e.g., loan guarantees), provision of goods or services other than general infrastructure, purchases of goods and price support. In accordance with Article XVI of the GATT, however, the definition does not include the refund or remission of duties or indirect taxes on goods upon exportation.

actionable and those that are non-actionable.[14] Annex I of the SCM Agreement contains an illustrative list of export subsidies. Item (e) of the list refers to measures involving "full or partial exemption, remission, or deferral specifically related to exports, of direct taxes".[15] Footnote 59 makes clear that item (e) is not intended to prevent Members from taking measures to avoid double taxation of foreign-source income. Further, item (f) treats as an export subsidy "...special deductions directly related to exports or export performance, over and above those granted in respect to production for domestic consumption, in the calculation of the base on which direct taxes are charged". By contrast, and in accordance with Article XVI of the GATT, the SCM Agreement provides that the exemption or remission of an exported product from indirect taxes or import duties upon exportation does not constitute a subsidy.

D. Agreement on Agriculture (AoA)

Under Article 1 (*Definition of Terms*) of the Agreement on Agriculture (AoA), "budgetary outlays" or "outlays" include revenue forgone, so that tax measures are covered by the Agreement insofar as they constitute export subsidies. The disciplines on subsidies agreed for the agriculture sector are quite different from those found in the SCM Agreement in at least one important respect. While the AoA has established rules concerning the acceptability of various subsidization practices – "green box" measures are acceptable, "amber box" measures are not[16] – it also involves commitments to reduce aggregate levels of support. Hence, subsidy disciplines are designed in accordance with commitments to a progressive reduction in levels of subsidization.

E. General Agreement on Trade in Services (GATS)

In contrast to the GATT, SCM and TRIMs agreements, which deal solely with trade in goods, the GATS applies to trade in services. The GATS constitutes a first attempt to subject the provision of services to international trading rules embodying the principles of MFN and national treatment.[17] The concept of NT in the GATS is of particular relevance because it involves non-discrimination on the basis of the origin, not only of the services, but of the service suppliers. Hence, FDI is covered by the GATS insofar as it involves a commercial presence for the delivery of services. Under Article XIV (General Exceptions), to the extent that countries have made NT (Article XVII) commitments in their schedules, these commitments apply to tax measures (including tax incentives), except where such measures are aimed at ensuring "the equitable or effective imposition or collection of direct taxes in respect of services or service suppliers of other Members". This implies that direct tax measures would generally be covered by Article XVII[18]; otherwise Uruguay Round negotiators would not have deemed it necessary to create such an explicit exception when drafting the relevant provisions of the GATS. Also, tax measures that depart from the MFN treatment obligation (Article II) are permitted if they are the result of a bilateral agreement on the avoidance of double taxation (or similar binding provisions in other international agreements).

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[14] Broadly speaking, this distinction is based on the concept of "specificity". Specific subsidies are actionable insofar as they have "adverse effects" on the interests of other Members. Although other subsidies – in particular, certain subsidies for environmental, research and development and regional development – were for a time non-actionable under Article 8 of the SCM, that provision expired at the end of 1999.

[15] For the purpose of the SCM Agreement, "direct taxes" refer to taxes on wages, profits, interest, rents, royalties, and all other forms of income, and taxes on the ownership of real property (see footnote 58 of the SCM Agreement). "Indirect taxes" mean sales, excise, turnover, value added, franchise, stamp, transfer, inventory and equipment taxes, border taxes and all taxes other than direct taxes and import charges.

[16] "Green" subsidies are those that have "no, or minimal, trade-distorting effects or effects on production" and do not have the "effect of providing price support to producers" and are thus exempt from reduction commitments. Such commitments do apply to "amber" subsidies, which include certain direct payments under production-limiting programmes (sometimes dubbed "blue" box measures).

[17] Unlike in the GATT, NT under the GATS is not a general commitment; it applies only to scheduled sectors.

[18] The meaning of "equitable or effective" is spelled out in footnote 6 to article XIV(d).

F. Trade Policy Review Mechanism (TPRM)

The above provisions of WTO agreements are not the only ones to exert disciplines on the use of tax measures. The notification obligations contained in these agreements also enhance transparency.[19] Transparency is further enhanced by the Trade Policy Review Mechanism (TPRM). The purpose of the TPRM is to contribute to improved adherence by all Members to rules, disciplines and commitments made under the WTO agreements, and hence to the smoother functioning of the multilateral trading system, by achieving greater transparency in, and understanding of, Members trade policies and practices, including tax measures. In the case of taxation, transparency entails four key elements: (a) a description of the nature of tax measures; (b) their rationale or objectives; (c) their cost (or benefits) in terms of revenue forgone (or taxes collected)[20]; and (d) an economic evaluation of the effectiveness of individual tax measures (relative to alternative measures) in achieving their given objectives. Accordingly, the mechanism enables the regular collective appreciation and evaluation of a full range of individual Members' trade policies and practices and their impact on the functioning of the multilateral trading system. The TPRM is not, however, intended to serve as a basis for the enforcement of specific obligations under the Agreements, or for dispute settlement purposes. Nor is it intended to impose new policy commitments on Members. Nevertheless, it does permit the evaluation of trade and trade-related policies and measures, even though they may not necessarily contravene, or indeed be subject to, WTO obligations.

The mechanism involves periodic[21] reviews by the Trade Policy Review Body of each Member's trade and trade-related policies, practices and measures based mainly on a report drawn up by the WTO Secretariat on its own responsibility and a report supplied by the Member (or Members) under review. Both reports are published after the review.

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[19] Under the SCM Agreement's notification (or transparency) mechanism, for example, Members are obliged to notify the WTO of all existing subsidies as defined in Article 1, that are specific within the meaning of Article 2, whether prohibited, actionable or non-actionable. (Members were also required to notify the WTO of any prohibited subsidies in existence when the Agreement was signed.) In accordance with Article 25, this notification must be sufficient to enable other Members to understand how the subsidy operates and to evaluate its effects on international trade in goods. It should include budgetary information, but not confidential business information. Likewise, under the TRIMs Agreement, Members are required to notify the WTO of all TRIMs that are not in conformity with the provisions of the Agreement.

[20] Several WTO Members publish tax expenditure accounts which show the amounts of tax revenues forgone as a consequence of various forms of tax relief. Some Members also publish studies evaluating the effectiveness of such measures.

[21] The US, EC, Japan and China are reviewed every two years; the next 16 largest traders are reviewed every four years; other Members are reviewed every six years, although a longer period may be allowed for least-developed country Members.

III. DISPUTES AT THE WTO CONCERNING DIRECT TAXATION

The expansion of WTO rules concerning international trade and investment has increased the potential for conflict between these rules and Members' tax laws and thus for disputes between Members. Disputes at the WTO imply inconsistency between WTO rules and domestic as well as international tax laws. Hitherto, out of a total 330 disputes initiated at the WTO (with a request for consultation), 34 have been over taxation, 24 of which entailed indirect taxes and the other 10 direct taxes. By and large, disputes over indirect taxes have involved alleged differential treatment of imported products (including periodicals, beverages, cigarettes, automobiles and integrated circuits) in relation to like domestic products, in violation of GATT Article III (*National Treatment on Internal Taxation and Regulation*). However, there have also been several disputes involving direct taxation, the most notable of which involved the US FSC/ETI schemes. These disputes are outlined below, with special attention focused on the FSC/ETI schemes because of their potentially far-reaching implications.

A. Turkey's Taxation of Foreign Films

In June 1996, the US requested consultations with Turkey regarding the latter's taxation of revenues generated from the showing of foreign films, which it alleged violated GATT Article III concerning NT. The Dispute Settlement Body (DSB) established a panel in February 1997 to hear the case.. In July 1997, however, both parties notified the WTO of a mutually agreed solution.

B. United States' Foreign Sales Corporation (FSC) and Extraterritorial Income (ETI) Schemes[22]

The dispute between the United States and the European Community that resulted in the "1981 Understanding" re-surfaced in November 1997, when the EC formally challenged the US over the DISC's successor, the FSC scheme, which was enacted in 1984. The FSC, like the DISC and subsequent ETI, was intended to offset the perceived tax disadvantage encountered by US producers in respect of their exports.[23] When consultations failed to resolve the dispute, the EC requested the establishment of a dispute settlement panel at the WTO and such a panel was formed in September 1998.

The EC argued that the FSC constituted a violation of the Agreement on Subsidies and Countervailing Measures (SCM) and the AoA, which entered into force in 1995. Specifically, the EC complained that the FSC violated Article 3.1(a) and 3.1 (b) of the SCM, which prohibit provision of subsidies that are contingent upon export performance or upon the use of domestic over imported goods, as well as Articles 3, 8, 9 and 10 of the AoA. In general, the EC argued that the FSC scheme's special tax exemptions for export income together with "administrative pricing" rules conferred a benefit on US exporters and therefore constituted an export subsidy in violation of WTO rules.[24]

For its part, the US claimed that the FSC was analogous to "territorial" taxation, which was consistent with WTO rules. More specifically, the US maintained that the "1981 Understanding" and the SCM provided that countries need not tax income from "foreign economic processes," the basis for the acceptability of "territorial" taxation. The US then argued that FSC's various foreign economic presence and management requirements linked the tax benefit to foreign economic

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[22] A more detailed history and description of the DISC/FSC/ETI measures and resulting disputes between the EC and US can be found in Brumbaugh (2004).

[23] This disadvantage, it was argued, involved two elements. The first element concerned the fact that whereas some European countries generally tax only income earned domestically (the so-called "territorial" system of direct taxation), the US generally taxes world-wide income of its residents (the so-called "world-wide" system of direct taxation). Secondly, whereas US exports to the EU are subject to the EU value-added tax (VAT), EU exports to the US are not because the EU exempts its own imports and the US does not levy such a tax. This is argued by some to give a distinct advantage to EU exports to the US not enjoyed by US exports to the EU. Apparently, the combination of specified exemptions and pricing rules embodied in the FSC amounted to a total tax exemption of between 15 and 30 per cent of income from exports.

[24] The FSC, like the DISC, provisions also contained "administrative" income allocation rules that assigned more income to the tax-favoured FSC subsidiary than could be allocated under "arm's length" pricing method, although firms could use the latter method if they wished.

processes. The US further maintained that the SCM Agreement gives countries considerable scope for setting required intra-firm pricing methods, and FSC's "administrative pricing" rules merely identified the portion of income attributable to foreign economic processes.

The WTO Panel, whose Report was issued in October 1999, concluded that the "carve-out" of foreign-source income attributable to exports from the "world-wide" income tax system allowed by the FSC did indeed constitute a prohibited subsidy contingent on exporting, and thus violated Article 3.1(a) of the SCM.[25] The Panel also found that the US had acted inconsistently with its obligations under Article 3.3 of the AoA (and consequently with its obligations under Article 8 of that Agreement).

In reaching its conclusion, the Panel rejected the US analogy between FSC and "territorial" taxation. Although the Panel accepted that countries need not tax income from foreign economic processes, whether a provision forgives taxes "otherwise due", and therefore constitutes a subsidy, depends on how the provision in question compares to a country's own general method of taxation. In short, because the FSC carved out an exception from the way the US normally taxed income from exports, it was, the Panel concluded, an export subsidy.

The US appealed the Panel's decision almost immediately, arguing again that the WTO rules hold that a country need not tax income from foreign economic processes and that FSC was therefore permissible. However, on 22 February 2000, the WTO Appellate Body ruled as follows:

- it upheld the Panel's finding that the FSC measure involved subsidies "contingent upon export performance" and therefore constituted a prohibited subsidy under SCM Article 3.1(a);

- it reversed the Panel's finding that the FSC measure involved "the provision of subsidies to reduce the costs of marketing exports" of agricultural products under Article 9.1(d) of the AoA and, in consequence, reversed the Panel's findings that the US had acted inconsistently with its obligations under Article 3.3 of AoA;

- it found that the US acted inconsistently with its obligations under Articles 10.1 and 8 of the AoA by applying export subsidies, through the FSC measure, in a manner which results in, or threatens to lead to, circumvention of its export subsidy commitments with respect to agricultural products; and

- it also emphasized that it was not ruling that a Member must choose one kind of tax system over another so as to be consistent with that Member's WTO obligations, or on the relative merits of the "worldwide" and "territorial" systems, while rejecting US arguments invoking footnote 59 of the SCM, which covers measures to relieve international double taxation.

More broadly, the Appellate Body concluded that, having decided to tax foreign source income in general, the US provided a subsidy by carving out an exception to that treatment, thus once again rejecting the analogy between FSC and "territorial" taxation. The DSB adopted the Appellate Body Report and the Panel Report, as modified by the Appellate Body Report, at its meeting in March 2000.

In the face of the Appellate Body's decision, the US was confronted with the following dilemma: either make some adjustments to the FSC scheme's design to make it comply with WTO rules, or undertake broad reform of its income tax system – with some prominent policy-makers suggesting that the US adopt a broad-based consumption tax and others advocating adoption of the "territorial" tax system. In the event, the US opted for the narrower approach, enacting the ETI provisions in November 2000. Although the US claimed that, with the adoption in November 2000 of the FSC Repeal and Extraterritorial Income Exclusion Act (the amended FSC legislation), it had implemented the recommendations and rulings of the DSB, this claim was disputed by the EC, which requested authorization from the DSB to take appropriate countermeasures and suspend concessions pursuant to Article 4.10 of the SCM and Article 22.2 of the Dispute Settlement Understanding (DSU). In response to

[25] WTO (1999b), page 23.

an EC request, the WTO established a compliance Panel in January 2001, whose Report was issued in August 2001.

Once again, the WTO Panel ruled against the US, essentially on four grounds. Firstly, it found that the ETI provisions imposed enough special conditions on their use that they were an effective departure from the general US tax practice, and therefore constituted a subsidy (within the meaning of Article 1.1 of the SCM).[26] Secondly, the Panel concluded that the subsidy was "dependent or contingent upon export" performance (within the meaning of Article 3.1(a) of the SCM).[27] Thirdly, the Panel rejected the US argument that the ETI was intended to avoid double-taxation (within the meaning of footnote 59), concluding that the scope of the benefit was considerably broader than the type of income that would ordinarily be at risk of double-taxation.[28] In addition, the Panel found that the 50 per cent "foreign content limitation" violated Article III(4) of GATT 1994 by according less favourable treatment to imported products than to like domestic products.[29] Although the US asked the WTO Appellate Body (AB) to reverse the Panel's findings, the AB issued its Report in January 2002 upholding the Panel's ruling on each of these four main arguments advanced by the US[30] Following adoption of both reports by the DSB and failure by the US to take further compliance actions, an arbitration proceeding was carried out pursuant to Article 22.6 of the DSU.

In August 2002, the Arbitrator's award was circulated. The Arbitrator determined that the suspension by the EC of concessions under the GATT 1994 in the form of the imposition of a 100 per cent *ad valorem* charge on imports of certain goods from the US in a maximum amount of US$4,043 million per year, as described in the EC's request for authorization to take countermeasures and suspend concessions, would constitute appropriate countermeasures within the meaning of Article 4.10 of the SCM. In April 2003, the EC requested authorization from the DSB to suspend concessions or other obligations under Article 22.7 of the DSU and Article 4.10 of the SCM. In May 2003, the DSB authorized the EC to take appropriate countermeasures and to suspend concessions. The EC in turn began to impose retaliatory tariffs, as authorized, in a phased manner, beginning in March 2004.

In October 2004, after more than two years of complex negotiations between the House and Senate, the US Congress passed legislation to repeal the FSC/ETI and replace it with a new corporate tax law, which provides for the phasing out of the FSC by 2007 and its replacement with US$138 billion in tax relief for domestic manufacturing, US multinationals, and a wide range of other industries and businesses. The new legislation called the American Jobs Creation Act of 2004, which some have described as the most significant corporate tax bill since 1986, was signed into law by the President on 22 October 2004.

Shortly afterwards, the EC moved to lift sanctions that it had imposed on US exporters. At the same time, however, the EC expressed concern over transition provisions in the newly-passed legislation repealing the FSC/ETI, one involving the phase-out of the ETI over two years[31], the other concerning the "grandfathering" of existing contracts so that the full benefit of the ETI applies to exports made under contracts entered into before 17 September 2003. EU officials have argued that the "grandfathering" provision favours exporters of capital goods that have long delivery times; such exporters include Boeing, Microsoft, Intel, Motorola, and Caterpillar. In any event, on 5 November 2004 the EC initiated proceedings at the WTO challenging these provisions. Some United States' observers have suggested that the EC appeal is linked to a separate WTO complaint lodged by the United States against Airbus (see below).

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[26] WTO (2001b), page 23.

[27] Ibid, page 32.

[28] Ibid, page 43.

[29] One of the conditions of eligibility for tax relief under the ETI measure was that no more than 50 per cent of the fair market value of qualifying property be attributable to the article produced or direct labour performed outside the US.

[30] WTO (2002), pages 77-78.

[31] This provision permits firms to claim 80 per cent of their otherwise applicable ETI benefit in 2006 and 60 per cent in 2007 before ending in 2008.

C. Certain Income Tax Measures used by Member States of the European Communities

In an apparent tit-for-tat, the US requested consultations in May 1998 with France, Ireland, Greece, the Netherlands and Belgium in respect of certain income tax measures, which it alleged constitute prohibited subsidies (under Article 3 of the SCM). In the case of France, the measures in question involve the temporary deduction under French income tax law for certain start-up expenses of a French company's foreign operations through a tax-deductible reserve account and a special reserve equal to ten percent of the company's receivable position at year end for medium-term credit risks in connection with export sales. The US has contended that each of these measures constitutes an export subsidy, and that the deduction for start-up expenses constitutes an import substitution subsidy. The complaint by the US against Ireland is with regard to "special trading houses", which qualify for a special tax rate in respect of trading income from the export sale of goods manufactured in Ireland. In the case of Greece, the complaint concerns Greek exporters' entitlement under Greek income tax law to a special annual tax deduction calculated as a percentage of export income. As regards the Netherlands, the complaint concerns a provision of Dutch income tax law, which allows exporters to establish a special "export reserve" for income derived from export sales. Finally, the measure in question in Belgium is a special (index linked) tax exemption accorded to Belgian companies for recruiting a departmental head for exports (known as an "export manager"). Consultations are still pending with regard to these measures.

D. Canadian Measures Affecting the Export of Civilian Aircraft

The matter of direct taxation also arose in the dispute between Brazil and Canada over measures affecting the export of civilian aircraft.[32] More specifically, Brazil asserted that Canada's exemption of the Export Development Corporation (EDC) from corporate income tax place the EDC at a decided advantage in the market place. However, this allegation was rejected by the Panel (WTO, 1999a).

[32] See WTO (1999a).

E. United States' Measures Affecting Trade in Large Civil Aircraft

When the US requested consultations with the EC and certain Member States concerning subsidies for large civil aircraft allegedly inconsistent with the Article XXIII:1 of the GATT 1994 and Articles 4, 7 and 30 of the SCM, the EC made its own request on similar grounds.[33] These two disputes each entail larger amounts of assistance than even the FSC/FTI.[34] Unlike the US complaint against the EC and its Member States, which concentrated on government grants, loans and equity infusion, the EC's complaint initially cited several direct tax measures, notably the FSC/ETI and Research and Experimentation Tax Credits,[35] both provided by the Federal Government, together with incentives offered by three states (Illinois, Kansas and Washington) and local governments.[36] As discussed earlier, the European Commission has also expressed concern that the transition provisions in the legislation repealing the FSC/ETI scheme would allow companies such as Boeing to continue to benefit from tax relief under the scheme.

[33] See WTO documents WT/DS316/1 and WT/DS317/1, 12 October 2004.

[34] The US alleges that Airbus has received more than US$15 billion in government assistance since 1967, while the EC claims that Boeing has received US$23 billion since 1992.

[35] Research and Experimentation Tax Credits were mentioned in the EC's request for consultations, but not in its subsequent request for the establishment of a panel (See WTO documents WT/DS317/2, 3 June 2005).

[36] The State of Washington, for example, agreed in 2003 to provide a package of some US$3 billion in tax incentives to Boeing (Watkins, 2004); the incentives include reduced tax rates on income and tax credits (Washington State Department of Revenue, 2004).

IV. SOME DIRECT TAX MEASURES IDENTIFIED IN TRADE POLICY REVIEWS

In addition to the above measures subject to dispute at the WTO, other kinds of direct tax measures have been identified as instruments of economic policy in the course of Trade Policy Reviews. Such measures, which may or may not be consistent with WTO agreements, can be broadly categorized as: (a) those protecting domestic producers from imports; (b) those providing assistance for exports; (c) those subsidizing domestic production; and (d) those aimed at deterring or attracting foreign investment. Some examples of these types of measures and their use in different countries are found below.

A. Direct tax measures providing protection against imports

Direct tax measures may have effects very similar to an import tariff. For example, in some countries, including Member States of the EU, contributions to private pension plans and life insurance policies may qualify for relief under the personal income tax, provided the pension plan or life insurance policy is supplied by domestic companies (who may be foreign-owned).[37] In Malaysia, income from annuities purchased from foreign-owned life insurance companies did not qualify for the personal tax exemption otherwise applicable to such income, even if those companies were established in Malaysia.[38] Although governments often argue that such restrictions are for prudential reasons and perhaps to prevent tax fraud, such tax relief is nonetheless equivalent to an import duty because it protects domestic providers of such financial services from providers located abroad.[39]

In an effort to combat tax evasion, Bangladesh levies a so-called advance income (or withholding) tax at the rate of 2.5 per cent on imports.[40] This tax is creditable for corporate tax purposes, which means that it does not constitute an additional levy on imports as long as corporate (or personal) taxes payable are sufficient to be offset by the tax. However, if the importer is in a non-tax paying position, possibly because the importer is operating at a loss for income tax purposes or is enjoying a corporate tax holiday, the 2.5 per cent levy is tantamount to an import surcharge.[41]

B. Direct tax measures as export assistance

Some direct tax measures may constitute assistance to exports. Indeed, many WTO Members, including Bangladesh, China, India, Malaysia, Papua New Guinea and the Solomon Islands, provide relief from corporate taxes for income from exports or export activities.[42] Relief may take the form of lower corporate tax rates for export-oriented enterprises or adjustments to the tax base (such as a double deduction for certain expenses related to exports). In China, for example, "foreign-invested enterprises" (FIEs) exporting at least 70 per cent of their output qualify for a 50 per cent income tax reduction (or possibly more if they are located in special zones) and a full refund of the income tax paid on the amount of their profits that they reinvest in export-oriented businesses (for at least five consecutive years). The economic effect of such measures is not fundamentally different from that of levying a non-discriminatory corporate income tax combined with an export subsidy (related in a potentially complicated way to the company's income tax situation).

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[37] In Korea, it has been alleged that the purchase of a foreign automobile can trigger a tax audit, thereby dissuading taxpayers from purchasing imported cars.

[38] Section 49 of the Income Tax Act 1967 and Section 127 of the Act read with paragraph 6 in Schedule 6 of the Act (WTO, 2001a, p.55).

[39] In the EU, such tax relief has been identified as an impediment to labour mobility across Member States. In addition, special corporate tax treatment is often accorded to insurance companies' contributions to policy-reserves used to fund future payments to life insurance policy-holders.

[40] A similar tax of 0.25 per cent is also levied on exports.

[41] Such a levy would counteract the effects of tax holidays that are widely used in Bangladesh to attract FDI (although the effectiveness of tax holidays is, in any event, rather dubious).

[42] Full or partial exemption of direct taxes on income related to exports is included in the illustrative list of export subsidies found in Annex I of the SCM. Article 27.4 of the SCM accorded developing country Members an eight-year transition period for phasing out export subsidies.

C. Direct tax measures as assistance to domestic production and other activities

Direct tax measures have long been used to assist domestic production of goods and services in certain sectors (such as agriculture, manufacturing and various services) and activities (such as R&D). Among the most common types of direct tax measures are reduced rates of corporate tax, if not complete tax holidays, usually for a prescribed period of time. Reduced rates or tax holidays can apply to specific sectors or activities. Other widely used direct tax measures include accelerated depreciation allowances and investment tax credits, often aimed at specific types of activity. Indeed, specificity in the provision of relief from direct taxes can be achieved with superficially uniform rules by, for example, maintaining a uniform tax rate but manipulating other aspects of the tax base, such as depreciation schedules, or applying investment tax credits. It is widely known that, even if explicitly-specific features of countries' tax laws are ignored, effective taxation of income from capital varies widely across sectors in most Organisation for Economic Co-operation and Development (OECD) countries.[43] Accelerated depreciation for machinery and equipment, for instance, would tend to reduce taxes, and therefore product costs, differentially across sectors depending on their capital intensity. Interestingly, Canada apparently introduced accelerated depreciation for a particular type of capital used in manufacturing in reaction to quite different US tax provisions – the DISC enacted in 1971 – which were subsequently found to be an illegal export subsidy under the GATT.

In China, 40 per cent of investment involving the purchase of domestically-made machinery and equipment can be deducted from enterprise income tax, thereby favouring domestically-produced machinery over imports. Malaysia and Singapore exempt from tax shipping company income derived from the operations of ships owned by domestic companies; this constitutes an incentive for the use of shipping services provided by resident companies.

[43] See OECD (1991) and Jorgenson and Landau (1993).

D. Direct tax measures to deter or attract foreign investment

Direct tax measures are also used to deter or attract foreign investment. A long-standing potential deterrent to foreign investment is the double taxation by source and residence countries of cross-border investment income flows, which bilateral tax treaties are designed to reduce, if not eliminate (see below).

However, direct tax measures, including tax holidays and tax rate reductions, may also be used to encourage foreign investment. In China, for example, "foreign-invested enterprises" are subject to a 15 per cent corporate tax rate for three years following a two-year tax holiday instead of the standard 33 per cent rate applied to purely domestic firms.[44]

Most OECD countries other than the US have negotiated "tax sparing" provisions with their tax treaty partners as a means of ensuring that the relief associated with tax incentives offered by developing countries to foreign investors is not offset by taxation in those investors' country of residence owing to the latter's use of the credit method of relieving for international double

[44] This discrepancy in tax rates provides an incentive for "round tripping" by Chinese companies, thereby exaggerating the extent of FDI inflows into China.

taxation.[45] In effect, "tax sparing" (and, indeed, the exemption method of providing relief for international double taxation) is a means by which the tax system of the capital-exporting country can be made to accommodate the tax incentives of developing countries (Short, 1966).[46] It results in the capital-exporting country providing a credit for more tax than the investor actually pays in the developing country, and, as such, a subsidy for the export of capital and thus to the production of goods and services in the capital-importing country. Moreover, insofar as the tax incentives offered by capital-importing developing countries are conditional upon exports or aimed at providing assistance to production in specific sectors, and therefore possibly infringe WTO rules, "tax sparing" in respect of these incentives might also be considered an infringement of these rules.

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[45] When a developing country offering such incentives concludes a treaty with a developed country, there would be a risk, without a tax sparing provision, of these incentives being nullified. Suppose, for instance, that the developing country provides a tax holiday to companies engaged in a certain activity. Dividends, interest or royalties paid by such a company operating in the developing country to residents of the developed country would be taxable in their hands and having paid no tax in the developing country, there would be a correspondingly higher amount of tax to pay in the developed country. In other words, the country of residence of the investor (that is, the developed country) "spares" the tax that it would normally impose on the untaxed (or low-taxed) income earned by its resident abroad by granting foreign tax credits equal to, or possibly greater than, the tax that would otherwise have been paid in the developing country. The Commentary to Articles 23 A and 23 B of the OECD Model discusses tax sparing at paragraphs 72 to 78, in the terms of an OECD (1998) Report on tax sparing. It notes some of the difficulties of tax sparing, such as the possibility for tax abuse and issues of its effectiveness as a form of aid to economic development. While not totally rejecting the use by OECD Members of tax sparing provisions, the conclusion is that tax sparing should only be considered for countries at an economic level considerably below that of OECD Members, should be based on objective economic criteria and should take into account the best practices identified in the OECD (1998) Report, such as having time-limited provisions and anti- abuse clauses.

[46] "Tax sparing" is contrary to the principle of capital export neutrality, but consistent with the principle of capital import neutrality (see section 5(c)(iii) below).

V. RATIONALE AND PRINCIPLES UNDERLYING WTO RULES AND INTERNATIONAL TAXATION

The over-arching goals of the WTO (subject to certain conditions as set forth in the various WTO agreements) and those concerning international taxation appear to be broadly similar, namely the dismantling of barriers to the cross-border flow of goods, services, capital, labour and technology so as to achieve a more efficient allocation of global resources and thereby raise standards of living world-wide. Nonetheless, there are some significant differences between the basic principles underlying the WTO agreements and those applied in international taxation agreements, as well as departures from these principles. This is particularly true of the principles of non-discrimination and reciprocity. To some extent, these principles reflect the underlying economic rationale for these international agreements. There are also major differences in approach to dispute settlement and the extent to which agreements are binding; WTO agreements are subject to binding dispute settlement procedure, tax treaties are not, although private citizens do have greater rights under tax treaties. These differences are in addition to the fact that whereas WTO rules are, by and large, negotiated multilaterally, international tax rules, with a few exceptions, involve unilateral relief from international double taxation in the form of foreign tax credit or exemption arrangements and a network of some 2000 bilaterally negotiated treaties (mostly based on the OECD Model), which lower withholding tax rates on interest, dividends and royalties. Questions have been raised over the economic rationale underlying multilateral trade agreements and bilateral tax treaties.

A. The rationale for the GATT/WTO agreements and tax treaties

One would expect the principles underlying international agreements on trade and taxation to reflect to some extent the economic rationale for such agreements. However, the economic rationale for these agreements is by no means obvious.

It would appear that the WTO agreements and international taxation, notably tax treaties, have broadly similar primary goals. The Marrakesh Agreement (establishing the WTO) states that trade and economic relations "should be conducted with a view to raising standards of living, ... and expanding the production of and trade in goods and services, while allowing for the optimal use of the world's resources ... by entering into reciprocal and mutually advantageous arrangements directed to the substantial reduction of tariffs and other barriers to trade and to the elimination of discriminatory treatment in international relations". Similarly, the introduction to the OECD's model tax treaty states that the primary goal of treaty formation is "removing the obstacles that double taxation presents", thus reducing its "harmful effects on the exchange of goods and services and movements of capital, technology, and persons" (OECD, 1997, p.I-1). Notwithstanding these broadly similar stated goals, doubts have been expressed as to whether such international agreements are necessary for their achievement.

In the case of the GATT and related WTO agreements, for example, standard economic theory suggests that unilateral free trade is the optimal policy for a national welfare maximising government. Indeed, Krugman (1991), *inter alia,* has argued that the GATT "makes no sense in terms of economics". However, another body of literature, notably Bagwell and Staiger (2002), maintains that such agreements do, in fact, make economic sense. More specifically, under this so-called *traditional economic approach to trade agreements*, a government (of a large country) is assumed to set its import tariff, for example, in order to maximize national welfare, while recognizing that some of the burden of the tariff is shifted onto foreign exporters whose products sell at a lower world price (that is, at diminished terms of trade).[47] This "terms-of-trade externality" leads governments to set unilateral tariffs that are higher than would be efficient from a global

[47] Even seemingly small countries may be able to shift the burden of tariffs (and non-tariff barriers) onto foreign exporters insofar as they too can influence the terms of trade where industry is monopolistically competitive or where transportation costs encourage greater trade between proximate countries. A survey of empirical evidence concerning the relevance of terms-of-trade considerations can be found in Bagwell and Staiger (2002).

standpoint.[48] The effect of the GATT and related WTO agreements, therefore, is to eliminate the terms-of-trade driven restrictions in trade volume that arise when policies are set unilaterally, and thereby offer governments a means of escape from a "Prisoners' Dilemma".[49] This rationale for multilateral trade agreements has become the conventional wisdom among international trade theorists.[50]

Similarly, in view of the fact that relief for international double taxation under the credit or exemption systems is currently provided by most countries around the world on a unilateral basis[51], the question arises as to why treaty relief in the form of the mutual lowering of withholding taxes (on interest, dividends and royalties) needs to be negotiated bilaterally between the "source" and "residence" countries. In the case of the predominant credit system, if unilateral relief already exists in each country, a negotiated reduction in tax rates on bilateral flows of income from capital may have little, if any, effect on the economic behaviour of foreign investors. Bilaterally negotiated reductions in tax rates will tend more to generate lump sum transfers between governments than to affect the behaviour of foreign investors (Whalley, 2001).[52] Indeed, Dagan (2000) maintains that the use of tax treaties to promote FDI is "a myth". Empirical support for this conclusion can be found in a recent study by Blonigen and Davies (2002) using data for OECD countries. Instead, the rationale underlying tax treaties may lie more in preventing "aggressive" tax planning, if not evasion (often by means of deferral, transfer pricing or treaty shopping), which, if not addressed, could result in little, if any, taxes being paid in either the "source" or "residence" country. If investors could avoid taxes altogether, this would tilt the playing field in favour of FDI rather than against it, which would also tend to distort international investment flows. Thus, bilateral tax treaties attempt to strike a balance between the alleviation of international double taxation and the enforcement of single international taxation. Given the wide differences in countries' tax systems, it is argued that the elimination of international double taxation and effective enforcement of single taxation requires bilateralism and therefore some degree of discrimination between countries. As predicted by arguments that treaties are intended more to reduce tax evasion than to promote FDI, Blonigen and Davies (2002) find that under certain circumstances, bilateral tax treaties may actually *reduce* FDI.

B. Reciprocity

Broadly speaking, mutual adjustments in trade policy conform to the principle of reciprocity if these policy adjustments result in a roughly similar changes in a country's import and export volumes. In other words, governments seek to achieve a "balance of concessions" in their negotiations (Bagwell and Staiger, 2002). In this way, reciprocity tends to neutralize externalities

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[48] While the terms-of-trade externality is not the only possible cross-border externality, it is the externality that has figured most prominently in the theoretical literature. Even in the absence of terms-of-trade movements, unilateral tariff choices can be inefficient in the presence of monopolistic competition (Helpman and Krugman, 1989). A "scale externality" may arise if production technologies exhibit increasing returns to scale, in which case the value of the trade agreement can be influenced by the volume of trade between other countries (Ethier, 1998). Ethier (2004) also considers the possibility of "political externalities" based on imperfect or asymmetric information endowing lobbies with distinct abilities to lobby governments about different policies.

[49] The Prisoners' Dilemma, attributed to A.W. Tucker, involves a strategic interaction in which two players both gain individually by not cooperating, leading to a Nash equilibrium in which both are worse off than if they cooperated. It explains why countries may choose protection, even though all lose as a result.

[50] The terms-of-trade consequences of trade policy can be expressed equivalently in the more familiar language of "market access", which dominates real-world trade negotiations. When a country raises its tariff, the loss in market access that home country exporters experience is simply the "quantity effect" that accompanies the "price effect" of a deterioration in the home countries terms of trade. Hence, the terms-of-trade consequences and the market access implications of trade policy choices are different ways of expressing the same thing (Bagwell and Staiger, 2002).

[51] Whereas the more pervasive credit system involves the "residence" country granting a foreign tax credit against domestic taxes for all (or part of) taxes paid in the "source" country, the exemption system involves the "residence" country exempting foreign source income from domestic taxes if taxes have been paid in the "source" country.

[52] Hartman (1985) and Sinn (1993) have argued that withholding taxes are irrelevant for expanding multinational firms as it is cheaper for them to expand their overseas affiliates through retained earnings than through repatriated and re-exported funds. This is because retained earnings avoid the withholding taxes applied to repatriated funds.

transmitted through world prices. Insofar as countries are able to use trade barriers to shift the terms of trade in their favour, multilateral trade liberalization in accordance with the principle of reciprocity is especially important, as such countries will be less inclined to reduce trade barriers if other countries were unwilling to do so as well.

The principle of reciprocity is also a fundamental aspect of bilateral tax treaties. It is manifest in the mutual reduction of source country withholding taxes on income.

C. Non-discrimination

Several different concepts of non-discrimination (or "neutrality") underlie international agreements concerning trade and taxation. The main concepts involve most-favoured-nation (MFN) treatment, national treatment (NT), capital import neutrality (CIN) and capital export neutrality (CEN). The MFN and NT obligations are the cornerstones of the GATT/WTO agreements, with the MFN obligation applying to border measures and the NT obligation to internal measures. The principle of NT also underlies international taxation. In addition, international taxation reflects CIN and CEN, each with distinct implications for global efficiency. Opinions differ as to which of the these two latter concepts of non-discrimination is the most appropriate basis for international taxation, with both being found in countries' tax laws. Whereas economists, by and large, prefer CEN, multinational enterprises (MNEs) tend to stress the importance of CIN owing to the importance they attach to non-discrimination at the corporate level.

1. Most-favoured-nation (MFN) principle

In the context of international trade, the MFN principle, as defined in Article I of the GATT and Article II of the GATS, for example, embodies the notion of non-discrimination as far as imports of the same products and services from different sources are concerned, the intent being to avoid trade diversion. One of the main arguments against bilateral or regional trade agreements is that they could divert more trade than they create and thus be detrimental to global efficiency. Although the ultimate goal of multilateral negotiations under the GATT/WTO is presumably to eliminate tariffs as well as non-tariff barriers to trade, in the meantime, the MFN principle governs the manner in which such taxes on imported goods and services may be used.

By contrast, there is no general MFN obligation in international taxation. Neither the OECD Model, the United Nations Model Tax Convention nor most tax treaties based on these Models contain an MFN article.[53] The reason for the absence of such a provision is that tax treaties, unlike WTO agreements are negotiated bilaterally. Such treaties seek not only to alleviate international double taxation but also to achieve an equitable distribution of tax revenues between the "source" and "residence" countries in the face of bilateral capital flows.[54] Hence, they are tailored to the domestic tax systems of the two negotiating countries and the particular investment and wider relation between them.[55] Nonetheless, bilateral tax treaties create the potential for diversion of international capital flows, which would counteract the benefits from any increased capital flows. To the extent that more foreign investment is diverted from one destination to another than is created, such treaties could conceivably contribute to an inefficient world-wide allocation of capital.

[53] There are some exceptions, where States provide, in view of the long life of most tax treaties, for a form of MFN treatment if the treaty partner gives a more generous deal to future treaty partners. For example, Norway insisted on the insertion of a clause in its tax treaty with Australia that if the latter reduced its rates of withholding tax further in a treaty with another OECD Member, Australia was obliged to notify Norway and to review the relevant provisions in order to provide Norway with the same treatment as that accorded to the third country. This clause was in fact triggered in 2003 when a new protocol to the Australia-United States Double Taxation Convention came into effect, lowering withholding tax rates in certain circumstances (Lennard, 2004). Such clauses are relatively common in one form or the other.

[54] The standard division of the income tax base between the two taxing jurisdiction is as follows: the source country is accorded primary (or exclusive) jurisdiction to tax corporate business income, while the residence country is given primary (or exclusive) jurisdiction to tax investment income (such as dividends, interest and royalties). This division is accomplished by the combination of domestic tax law and bilateral tax treaties. The domestic law of the source country typically taxes all business income arising within its jurisdiction.

[55] See Lennard (2004) for a more detailed discussion of this and related points..

2. National treatment (NT)

The principle of NT (found in Article III of the GATT and Article XVII of the GATS) entails the commitment by a country to treat imported goods and services as well as those produced by foreign-owned or -controlled enterprises operating in its territory no less favourably than goods and services produced by domestically-owned or -controlled enterprises. Thus, whereas border taxes such as tariffs, for example, must be levied in accordance with the MFN notion of non-discrimination alone, internal taxes should be consistent with both NT and MFN. In other words, internal taxation discriminates neither against imports nor among sources of imports.

The principle of NT also underlies the OECD and United Nations Model Tax Conventions and most tax treaties based on these Models. According to Article 24 of the OECD Model, for example, "Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to nationals of that other State *in the same circumstances*, in particular with respect to residence, are or may be subjected" (italics added for emphasis). However, the scope of NT in tax treaties falls far short of that provided under the GATT/WTO agreements as regards internal direct taxes.[56] Not only is NT usually implemented solely on a bilateral (and reciprocal) basis in tax treaties, the distinction in Article 24 between residents and non-residents permits countries to treat the former differently from the latter.[57] Thus, although bilateral tax treaties are designed to remove tax impediments to international investment, they do so in a non-neutral fashion. As a consequence, they may divert rather than foster international investment. The bilateral nature of tax treaties also tends to confer an unfair bargaining advantage on a large capital-exporting (capital-importing) country in negotiations with a small capital-importing (capital-exporting) country.

[56] Moreover, not all bilateral tax treaties conform with Article 24.

[57] Such a distinction is justified by tax authorities on the grounds that cross-border investment and income flows increase the opportunities for avoiding or evading taxes and makes enforcement more difficult, particularly in the case of portfolio investment.

3. CIN and CEN

International double taxation has long constituted a potentially important barrier to market access, impeding not just to the free movement of goods and services where indirect taxes are concerned, but also capital and other factors in the case of direct taxes. It thus constitutes an impediment to the efficient world-wide allocation of resources. Double taxation arises in connection with indirect taxes insofar as goods and services are taxed in the country where they are produced and also in the country to which they are exported; by and large, border tax adjustment consistent with WTO agreements ensure that this is not the case, particularly as far as value-added taxes are concerned. The interaction between the source and residence countries' direct tax systems may be such that they discriminate not just against inward and outward FDI generally, but also among countries depending on the source or destination of outward and inward FDI, respectively. In other words, Member countries' direct tax systems may diverge from both CIN and CEN, two distinct notions of economic efficiency often used as benchmarks for countries' tax laws. Differences among Members over the appropriateness of their choice of method to alleviate, if not eliminate, double taxation of income from cross-border investment was, as discussed earlier, at the root of the dispute between the EU and the US over the latter's FSC/ETI scheme.

Under CIN, no distinction would be made between residents and non-residents. For CIN to prevail with respect to direct taxation, the total marginal effective tax rate on income from an investment undertaken in a given country (inclusive of taxes in both the source and residence countries) must be the same, irrespective of where the recipient of such income resides. Hence, direct taxation would not influence *who* invests in a particular country. CIN would ensure that, as far as taxation is concerned, domestic MNEs are not placed at a competitive disadvantage compared to foreign MNEs in markets abroad. Such a situation could arise if (in accordance with CEN) a domestic MNE investing in a relatively low-tax country had to pay tax at the higher domestic rate on the income generated. This could be considered "unfair" to MNEs because it would impair their ability to compete with local firms, or with MNEs based in other countries that levy lower rates of tax on foreign-source income. Since competition among

MNEs is desirable on economic efficiency grounds, it follows that Members' tax policies should not distort global investment flows by discouraging the most efficient firms from operating in what would otherwise be their least-cost location. No such tax distortion would arise if CIN were the basis for Member' income tax policy with respect to MNEs. CIN is therefore concerned with "competitive" neutrality. In the absence of any tax discrimination between domestic and foreign firms in the capital-importing country, CIN would be accomplished if income from investment abroad were entirely exempt from taxation in the capital-exporting country. This approach reflects what is known as the "source" (or "territorial") principle of taxation, according to which, national governments tax all income originating within their jurisdictions, regardless of whether that income accrues to residents or to non-residents. It thus embodies the principles of strict NT and MFN treatment as far as taxation in the source (capital-importing) country is concerned, but not with regard to taxation in the residence (capital-exporting) country.

By contrast, the principle of CEN reflects the view that direct taxation ought not to influence the decisions of businesses or individuals residing in a country as to *where* to invest. CEN is thus concerned with "locational" neutrality and thereby reduces the threat of tax competition among different jurisdictions for FDI. It is accomplished by ensuring that the same total amount of domestic and foreign taxes are paid on an identical investment, irrespective of the country in which that investment is undertaken and the amounts of taxes levied by the foreign country. Under such circumstances, and other things being equal, free mobility of capital would tend to equalize required risk-adjusted pre-tax "hurdle" rates of return[58] on investment across countries, thereby eliminating differences in the cost of capital, and thus international distortions in the demand for capital. If "hurdle rates" of return were equalized across countries, no gain in global output could be accomplished by reallocating capital from one country to another. CEN would be achieved if income were taxed only in investors' country of residence, and if there were no discrimination in that country between domestic and foreign-source income. Such a basis for taxation is known as the "residence" (or "world-wide") principle. According to this principle, tax is levied on all income received by domestic residents, regardless of whether that income is from domestic or from foreign sources. It follows that neither NT nor MFN treatment with respect to taxes levied in the source (capital-importing) country are necessary conditions for the achievement of CEN. CEN does require strict NT and MFN treatment with respect to taxes levied by the residence (capital-exporting) country.

Despite the extensive network of bilateral tax treaties designed *inter alia* to mitigate, if not eliminate, international double taxation, according to evidence reported by the OECD (1991), OECD member countries' tax systems are characterized by a marked lack of both CIN and CEN. The average tax-inclusive hurdle rates for a typical investment in manufacturing undertaken at home by domestic investors tend to be considerably lower than the corresponding rates for outbound and inbound FDI, thus violating the principle of NT. Moreover, hurdle rates vary widely depending on the destination of outbound FDI and the origin of inbound FDI, thereby violating the MFN principle as far as the tax treatment of FDI is concerned and hence possibly diverting FDI from some locations to others. Whether or not such differences in hurdle rates and associated effective tax rates actually influence investors' location decisions is rather uncertain, however.

[58] In general, the "hurdle" (or break-even) rate is defined as the minimum pre-tax rate of return (adjusted for risk and inflation) that is required in order for an investment project to be profitable (after payment of taxes).

[59] Of course, the estimated hurdle rates for inbound and outbound FDI reported by the OECD (1991), and thus the magnitudes of the departures from CIN and CEN, may be more apparent than real insofar as international investors can circumvent countries' tax laws by means of "creative" accounting and international tax planning, if not outright tax evasion. The effects of taxation on the financing of investment could mitigate those on real investment. Indeed, the reality of the tax laws as they are actually enforced suggests that multinational firms can, and often do, pay less tax than their domestic counterparts. Most analytical models used to measure hurdle (and marginal effective tax) rates, including the one used by the OECD, do not capture the complex interaction between real investment decisions and the various devices that enable multinational firms to shift their tax bases from relatively high- to low-tax countries. The estimated hurdle rates are nonetheless indicative of the potential bias inherent in the design of those tax laws, especially for small and medium-sized firms, which may not have the means to fully exploit international tax planning opportunities.

While taxation may not necessarily be one of the main determinants of investors' decisions regarding FDI, it would be surprising if such differences did not have some influence on those decisions, an influence that is bound to increase as other impediments to FDI are dismantled.[59]

D. Other principles: stability and transparency[60]

The GATT/WTO agreements provide benefits beyond non-discrimination. Through "bindings", they also impart a degree of stability and predictability to Members' trade policies, thereby fostering international trade. In the case of tariffs, for example, the purpose of "bound" rates is to establish a ceiling on tariff rates that cannot be breached without an offer of compensation to affected trading partners. In addition, the WTO notification process together with periodic reviews of Members' trade policies, practices and measures by the Trade Policies Review Body contribute to the transparency of Members' trade policies.

Tax treaties also offer benefits beyond relief for international double taxation. By establishing a framework for taxation in the source country, foreign investors can make decisions with some confidence about how taxes will continue to be levied in the future. The investment is thus less exposed to dramatic changes in tax policy by the source country, thereby reducing country risk.

E. Dispute Settlement

GATT/WTO agreements and international taxation have also evolved differently with respect to dispute settlement. The GATT/WTO agreements now provide for binding adjudication. Indeed, as discussed earlier, a considerable number of trade disputes, including a few notable ones involving direct taxation, have been resolved by WTO panels, whose decisions are binding on all parties to the dispute. By contrast, disputes between contracting parties about the application of tax treaties are resolved by mutual agreement between the "competent authorities" of each country.[61] The latter procedure is more diplomatic than legal because these authorities are the tax administrations of the signatory countries. A few bilateral tax treaties (and regional agreements) do provide for arbitration, but binding dispute settlement remains the exception in international taxation (Warren, 2000). However, private citizens do have greater rights under tax treaties than under WTO/GATT agreements. More specifically, there is a taxpayer initiation process for the Mutual Agreement Procedure and, perhaps more relevantly, as tax treaties become part of domestic law, taxpayers can invoke the treaty terms as part of domestic law and have a court decision that effectively binds the State.

[60] The rules embodied in GATT/WTO agreements and those of international taxation are also designed to address somewhat similar concerns, namely so-called "unfair" trade or competition", in the case of GATT/WTO rules, and "harmful" tax competition, in the case of international tax rules.

[61] See Article 25 of the OECD Model Treaty.

VI. INCIDENCE OF DIRECT TAXES [62]

The terms-of-trade rationale for international trade agreements is closely related to the incidence of tariff and non-tariff measures; that is, the extent to which such measures are passed on as higher prices to domestic consumers. In fact, there is a large body of empirical literature suggesting that tariffs are not fully passed on the domestic consumers, but borne partly by foreign exporters, thereby supporting the terms-of-trade argument.[63]

The dispute over the FSC/ETI (as well as its DISC predecessor) raises a broader empirical issue concerning the incidence of corporate taxes, which is one of the most controversial matters in tax policy analysis. As noted above (in Section 2(c)), whereas WTO rules allow an exported product to be relieved of all indirect taxes levied in the exporting country, thereby allowing border tax adjustments, as in the case of VAT, for example, no such relief is allowed in respect of direct taxes payable by the producing enterprise. The SCM Agreement clarifies that "full or partial exemption, remission or deferral specifically related to exports, of direct taxes or social welfare charges paid or payable"[64] by the producing enterprise constitute a prohibited export subsidy. The economic rationale for this rule apparently arises from the assumption that the burden of indirect taxes is generally shifted forward onto the product and is thus reflected in its price, whereas direct taxes are not so shifted, but instead absorbed largely by the owners of the producing enterprise.[65] The implication is that whereas indirect taxes have trade effects, direct taxes (or relief therefrom) do not. However, this assumption does not explain SCM rules, where it is precisely the exemption of export income from direct taxes that is prohibited, presumably because it is believed that such measures may well have trade effects.

The presumption of forward shifting in the case of indirect taxes and backward shifting in the case of direct taxes may be questioned on empirical grounds. Indirect taxes are thought to be fully shifted forward, and therefore affect trade, although the extent of such forward shifting (or "pass through") clearly depends on the demand and supply elasticities of the taxed goods and services (Whalley, 2002). The incidence of capital income taxes is much more controversial. In the case of corporate income tax, on the basis of an econometric study in the US by Kryzaniak and Musgrave (1963), it was thought that during the 1950s the tax was fully shifted forward to consumers in the form of higher product prices, which could have implications for the terms-of-trade insofar as the products are exported.[66] However, academic thinking on the incidence of the corporate tax during the 1960s and early 1970s came to be dominated by the general equilibrium model of a two-sector closed economy developed by Harberger (1962), who concluded that the tax fell completely on capital, implying no forward shifting and consequently no trade effects of the tax. By the mid-1970s, however, most major studies[67], which relaxed the closed economy assumption, concluded instead that in an open economy with capital mobile internationally, immobile factors (labour, especially unskilled, and/or land) rather than capital bear most, if not all, of the burden of the tax in the long-run. While there is little debate among economists that

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[62] The matter of incidence is also relevant to subsidies.

[63] See Bagwell and Staiger (2002) for a review of this literature.

[64] See item (e) of Annex 1 of the SCM.

[65] For example, in a GATT Working Party on border tax adjustment, most delegations' opinion was that "direct taxes – even assuming that they were partly passed on into prices – were borne by entrepreneurs' profits or personal income." See GATT (1970).

[66] Also, by reducing a country's reliance on the international capital market, taxes on capital income have the effect of reducing the present discounted value of future exports and thereby improving the terms of trade (Burgess, 1988).

[67] See in particular Bradford (1978), Kotlikoff and Summers (1987), Mutti and Grubert (1985), and Harberger (1995).

capital, being immobile in the short-run, bears most of the burden of the corporate income tax in the short run, most economist now seem to believe that capital escapes most of the burden of the tax in the long run. Indeed, Fuchs, Krueger and Poterba (1997) reported that economists at the top 40 universities estimate, on average that capital bears only 40 per cent of the tax. The question arises, therefore, as to who else bears the burden of such taxes and to what extent.

In a more recent study, using a multi-sector general equilibrium model of two open economies (the domestic economy and the rest of the world) that allows for imperfect substitution between domestic and foreign products as well as between domestic and foreign capital, Gravelle and Smetters (2001) conclude that little of the burden of the corporate income tax is borne by either domestic labour or landowners. Instead, under plausible assumptions involving parameter values, the burden of the tax is borne typically by domestic capital, as argued originally by Harberger (1962). For those parameter values in which the burden is not borne by labour, most of the incidence is instead exported through higher prices[68]; the more a country engages in trade, the more the corporate tax is exported. It follows that the extent to which the burden of the corporate is borne by domestic capital or exported through higher prices depends on the relative importance of trade in countries' economies. Whereas in large economies, such as the United States, the tax is borne largely by the owners of domestic capital, in smaller open economies the burden is exported. On the other hand, using aggregate consumption Euler equations to describe the capital income tax burden in the US, Mulligan (2004) concludes that capital income taxes seem to be passed on to consumers and workers through higher price mark-ups or lower capital accumulation, or some combination of the two.

Insofar as they are indeed direct taxes, rather than charges related to benefits, payroll taxes are usually viewed in the literature as taxes on labour. The extent to which they affect production costs depends again on the elasticities of demand and supply in the domestic labour market. It is commonly assumed that half these taxes are shifted forward (Whalley, 2002).[69]

Clearly, the incidence of various taxes has a bearing on existing WTO rules concerning tax adjustments at the border in respect of exports. With recent empirical evidence suggesting that the distinction between direct and indirect taxes on businesses for purposes of such adjustment has become rather blurred, a review of WTO rules in the regard might be warranted.[70]

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[68] This outcome is more likely the higher the substitutability between domestic and foreign investments and the lower the substitutability between domestic and foreign products.

[69] As regards, taxes on natural resources, to the extent that these involve taxes on pure rent, then the burden of the tax is borne solely by the owners of such resources (Whalley, 2002). In the long-run, however, such taxes may adversely affect new resource exploration activity and thus curtail supply.

[70] Hufbauer (2002), for example, has argued that the SCM Agreement should be renegotiated so as to achieve greater parity in rules applied to direct and indirect taxes in the belief that the present distinction between these taxes is artificial. More recently, at the WTO, the United States, in its submission to the Negotiating Group on Rules, has argued that an essential part of the Group's work should involve greater equalization in the treatment of various tax systems that, at least with regard to their subsidy-like effects, have only superficial differences. It believes that the current distinction risks ignoring the potential trade-distorting effect that certain practices involving indirect taxes may have on trade, and may unfairly disadvantage competitors under a direct taxation system (see WTO document TN/RL/W/78, 19 March 2003).

The incidence of taxes also has a bearing on the effectiveness of tax measures in achieving their objectives and thus on the amount of retaliatory measures that ought to be authorized by the WTO in respect of measures found to infringe WTO rules. In the case of the FSC/ETI, for example, countermeasures (in the form of tariffs) amounting to the full value of the subsidy in terms of forgone tax revenue were assessed by the WTO arbitrator, even though the assumption underlying WTO rules is apparently that direct taxes are generally shifted backward rather than forward, which means that relief from such taxes would have little, if any, trade effects. The FSC/ETI would tend to reduce the before-tax rate of return required of investment in the export sector, thereby attracting investment to the sector and possibly raising US exports. But the magnitude of the rise in exports depends on the extent to which US exporters pass on the associated income tax relief to foreign consumers in the form of lower prices and foreign consumers' responsiveness to these lower prices. Insofar as foreigners do demand more US exports, this would require them to purchase more US dollars, thereby driving up the exchange rate, which would make those exports more expensive and thereby counteract any export price effect of the FSC/ETI.[71] (At the same time, by making imports cheaper, the rise in the exchange rate would tend to increase imports.) It follows that the actual change in US exports resulting from the measure could actually be quite small. Indeed, according to the Congressional Research Office, the increase in the quantity of US exports owing to the FSC ranged from 0.2 to 0.4 of a percentage point; on the basis of 1996 data, the increase in the value of US exports ranging from US$720 million to US$1.23 billion, much less than the US$3 billion cost of the program in forgone tax revenue (Brumbaugh, 2000).[72] With imports estimated to have risen by a similar magnitude, the FSC's effect on net exports is negligible.[73]

[71] Additional upward pressure on the exchange rate would occur to the extent that increased investment in the exporting sector owing to the FSC/ETI came partly from abroad.

[72] The Joint Committee on Taxation has estimated that the cost of the ETI in terms of tax revenue forgone was US$4.8 billion in 2003.

[73] Interestingly, these estimates by Brumbaugh (2000) are based on the assumption that all the tax relief associated with the FSC is passed on to foreign consumers as lower prices, which is perhaps unlikely given that some of the main beneficiaries of the FSC, such as Boeing and Microsoft, exercise considerable market power.

VII. CONCLUSIONS

Hitherto, rules concerning international trade and taxation have, by and large, evolved quite separately. The GATT/WTO agreements are multilateral, requiring MFN as well as national treatment and subject to binding dispute settlement procedures. By contrast, international taxation, if not decided unilaterally, is agreed bilaterally, requiring national treatment and subject to non-binding (diplomatic) dispute settlement. This separate evolution of the two set of rules is rather surprising in view of the many parallels and overlaps between international trade and taxation and the apparent analytical equivalence between cross-border flows of products and flows of factors.

However, the widely-followed ruling by the WTO's Dispute Settlement Body against the US concerning the latter's FSC/ETI scheme, which led to the largest retaliation award ever authorized in a dispute at the WTO, confirmed (if there were ever any doubt) that, generally speaking, direct taxes, like indirect taxes (including tariffs), are subject to the multilateral rules of the WTO, notwithstanding efforts by tax authorities to secure specific exemptions for certain direct tax measures in these agreements. This ruling against the US reconfirmed the traditional distinction under international trade rules between direct and indirect taxes, particularly with respect to how such taxes should be treated under the subsidy and border tax adjustment rules of the WTO. The WTO's ruling against the FSC/ETI scheme prompted the US Congress finally to pass legislation in late 2004 to repeal the scheme as part of a larger overhaul of the US corporate tax system. The most recent disputes between the US and the EC over assistance to large civil aircraft also encompass direct tax measures. It would not be surprising if other WTO-inconsistent direct tax measures were identified in the future, leading to further disputes among WTO Members. Multilateral WTO rules, which are agreed by consensus, can therefore be expected to continue to be an important factor in how Members' shape their tax policies as they undoubtedly will want to avoid having their tax policies successfully challenged in the WTO.

Finally, the incidence of various taxes has a bearing on existing WTO rules concerning tax adjustments at the border in respect of exports. With recent empirical evidence suggesting that the distinction between direct and indirect taxes on businesses for purposes of such adjustment has become rather blurred, a review of WTO rules in the regard might be warranted. The incidence of taxes also has a bearing on the amount of countermeasures that ought to be authorized by the WTO in respect of tax measures found to contravene WTO rules.

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