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TOMORROW'S CHALLENGES

TAXES, TRADE AND INVESTMENT IN A GLOBALIZED WORLD

THE INTERPLAY BETWEEN TRADE AGREEMENTS AND TAX LAWS IS CONVOLUTED. DO WE NEED A WORLD TAX ORGANIZATION?

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As the saying goes, the only two things in life that are certain are death and taxes. Debates about the economic impact of taxes and their fairness are as old as civilization itself. Practices in tax collection can be traced back to the writings of the Babylonian king Hammurabi in the 18th century B.C. Unfortunately, the complexity of administering tax systems in an efficient and fair way has only increased over time, as government responsibilities have expanded and the world economy has become more interdependent.

Taxation is considered a basic sovereign right. The economic rationale for taxation is typically built around three functions: to fund government activities, to influence incentives for consumption or production (to control pollution, for example), and for redistributive goals. Different societies approach these functions in different ways, reflecting distinct preferences about them. Not surprisingly differences in tax practices across jurisdictions – not only in terms of the level of taxation, but also with respect to the complexity of tax procedures – abound. Accordingly, there is a great deal of potential for conflict across countries and a wide scope for strategic behavior by economic actors.

The “Babel Tower” of Tax Treaties

This is not a new problem. The recognition that differences in corporate taxation could generate friction and distort economic incentives led the League of the Nations to investigate the topic in the 1920s. The basic principles recommended at that time (source-based taxation and arm’s length treatment to differentiate profits from parent and subsidiary companies) remain important pillars of international tax treaties. At the same time, driven by fiscal sovereignty considerations and recognizing the difficulties of framing multilateral solutions, the strategy adopted was to rely on bilateral treaties. These have proliferated over time and currently there are roughly 3,600 bilateral tax agreements.

Attempts to promote coherence, to minimize double-taxation, and to constrain tax-avoidance practices have been promoted by the OECD and, more recently, by the G20. The challenges, however, continue to escalate. This reflects not only the increase in international links (for example, the share of profits earned abroad by US multinationals grew from roughly 5% in the 1940s to more than 30% nowadays) but also the multiplication of other international agreements, both bilateral and multilateral, covering trade and investment issues that have implications for tax practices.

In what follows, I briefly describe the potential conflict between tax and non-tax international agreements and the challenges to promote coherence.

Trade, investment and taxes

WTO disciplines impact tax policies. The focus of these disciplines is to promote freer trade in goods (via the GATT) and services (via the GATS) by imposing non-discrimination obligations. These obligations are embedded in the most-favored nation principle (that is, trade concessions granted to a country’s goods and services should be accorded equally to all WTO members) and the national treatment principle (that is, no “behind the border” discrimination between foreign products and “like” domestic products). The logic of these disciplines is that domestic taxes and subsidies can have a trade-restricting impact, hampering the goal of freer trade. Over the years, several tax-related disputes have been brought to the WTO Dispute Settlement Body.

These disputes have dealt with issues such as excise taxes on alcoholic beverages in Japan, tariff and tax exemptions for the car industry in Indonesia, and value added tax on cigarettes in Thailand. Although most of these disputes have focused on indirect taxes, over time GATT jurisprudence has evolved to encompass direct taxes, as illustrated by the case against the US Tax Treatment of Foreign Sales Corporations, which conditioned access to income tax advantages in a discriminatory fashion.

Preferential trade agreements have also influenced tax procedures as illustrated by the dispute between Mexico and the US regarding bilateral sugar and non-sugar sweeteners trade. This became a WTO dispute, but Mexico argued that its discriminatory tax on sweeteners was required to guarantee access of Mexican sugar to the US market under NAFTA. The “revenge tax” argument was not accepted by the WTO's dispute settlement body, but it further illustrates how the interplay between trade agreements and tax laws can be a convoluted process.

A new chapter in these interactions is being written right now in the context of negotiations on new mega-preferential agreements such as the Transatlantic Trade and Investment Partnership (TTIP). TTIP negotiations are providing a forum for lobbies to push for tax coherence across the Atlantic (as in the case of the different treatment for tax relief for small brewers in the US and in the EU). And the heated debate about the inclusion of Investor State Dispute Settlement (ISDS) procedures – enabling private investors to bring a case against a host country to an international arbitral court – in the TTIP further illustrates the potential for encroachment of trade rules on national fiscal policies.

It is also important to remember that there are today more than 3,000 bilateral investment treaties (BITs). They are focused mainly on the protection of foreign investment against expropriation and fair rules for profit repatriation. They typically maintain policy space for tax authorities, either by explicitly excluding taxation from their coverage or by mandating that eventual disputes be presented first to the tax authorities for analysis before initiating arbitration procedures. There is, however, a fear that new generation ISDS practices in BITs and mega-preferentials may further erode fiscal sovereignty.

One has to recognize that the threat of tax avoidance practices will only grow as investment flows and the role of multinational companies in the world economy increase. Attempts to constrain these practices via trade or investment agreements have to be carefully coordinated with fiscal authorities. There is a danger that the cacophony of different approaches may actually increase transaction costs for all involved without addressing the key distortions behind these problems. As long as countries keep different practices – for example, significant differences in corporate tax rates and on how profits of subsidiaries are taxed – incentives for arbitration across tax jurisdictions will remain. Creative treatment of intangible capital, as illustrated by Google's practices in selling its intangibles to offshore subsidiaries in low tax environments, is also here to stay, adding "heat" to the debate. International cooperation – as is being advanced by OECD's Base Erosion and Profit Shifting project – may help, but it may also have unintended consequences on investment decisions around the world. It is clear, however, that any hope that a multilateral World Tax Organization could be put together to coordinate such efforts is at best a vision with no chances of implementation – in other words, a hallucination.

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