



The WTO as Tax Nanny

CSTR's Tax Policy Wire

April 25, 2006

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In a recent paper published by the WTO, but issued solely under the author's name, Michael Daly (2005) examined "The WTO and Direct Taxation". The paper makes interesting reading, both for its summary of the WTO's role as creeping regulator of direct taxation and for its discussion of the anachronistic distinction between direct and indirect taxation.

Creeping Regulator

The GATT's original (1947) role in tax matters was essentially limited to Article III, *National Treatment on Internal Taxation and Regulation*. Article XVI, *Subsidies*, permitted the rebate or exemption of indirect taxes, but had no teeth with respect to direct taxes until the Tokyo Round Subsidies Code was adopted in 1979 (Hufbauer and Erb, 1984). Beginning with the Tokyo Round code and continuing with the Uruguay Round Agreements on subsidies, investment and agriculture, member countries have expanded the WTO's mandate.

National Treatment. Article III(1) proscribes, in general terms, the use of internal taxes and other charges as a means of protecting domestic production. Article III(2) prohibits the application of internal taxes and other charges on imported products in excess of the amounts levied on "like domestic products". Article III(4) requires that imported products be accorded no less favorable treatment than domestic products with respect to laws, regulations and requirements affecting their internal sale, transportation, distribution or use.

Until the second FSC Appellate Body decision (January 2002), it was widely thought that the proscriptions and requirements of Article III applied to product specific taxes - i.e., indirect taxes -- and had little if any application to direct taxes. There were two reasons for this assumption. First, since the main concern of the GATT-1947 was tariffs, and since internal taxes and other charges and regulations applied to specific products could be easily substituted for a tariff unless disciplined, Article III was seen as a backstop to whatever tariff commitments the contracting parties might make. Second, the language of Article III is replete with references to "products" and "like products", terminology that conjures up indirect taxation.

The FSC Panel Report issued in January 2002 and largely affirmed by the Appellate Body gave a more expansive reading the Article III, especially Article III(4). Finding no explicit exclusion of income tax measures, the Panel reasoned that they were subject to the same national treatment regulation as indirect taxes. While this holding was a minor feature in the

FSC case, it represented a major judicial leap. All national tax systems, as well as other national regulatory systems (e.g., labeling requirements, food and drug standards), are now subject to scrutiny when they discriminate against imported products. It may be a long time before WTO cases are brought against the tax practices of Papua New Guinea or Paraguay, but discrimination by the United States or the European Union is sure to attract legal attention.

Uruguay Round. The Uruguay Round of Multilateral Trade Negotiations, concluded in 1994, greatly enlarged the scope of the GATT-1947 by adding new subjects, such as TRIPs (Trade Related Intellectual Property Rights) and TRIMs (Trade Related Investment Measures), by amplifying the Agreement on Subsidies and Countervailing Measures (SCM), by adding an Agreement on Agriculture (AoA), and by extending the core principles of the GATT to a new agreement on services, GATS (General Agreement on Trade in Services).

GATS. Article XVII of the GATS extends to services the national treatment principles of Article III(4) of the GATT. However, Article XVII only applies to those services and modes of delivery individually scheduled by GATS Members - and so far the schedules have more holes than a Swiss cheese. In principle, the same "equality of income taxation" that the FSC Panel pronounced for imported and domestic goods could be invoked by a future WTO Panel to benefit imported services and foreign-owned service providers, but until more services and modes of delivery are scheduled, that prospect remains an aspiration.

TRIMs. The TRIMs Agreement has more immediate impact on direct taxation - but only for investment in the production of goods (not services) by developed countries. The Agreement applies the obligations of GATT Article III to investment, and specifically prohibits developed countries from applying four kinds of investment measures: (a) benefits conditioned on local content requirements; (b) measures that condition a firm's ability to import on the volume or value of its exports; (c) foreign exchange balancing requirements; (d) domestic sales requirements that involve restrictions on exports. Noteworthy, however, is that the TRIMs Agreement does not preclude the attachment of export performance requirements to tax relief (though such measures might run afoul of the SCM Agreement), nor does it prevent developed countries from insisting on local equity participation or up-to-date technology imports. Moreover, developing country Members of the WTO are free to deviate "temporarily" from the strictures of the TRIMs Agreement. At the Hong Kong Ministerial meeting, in December 2005, it was agreed that the temporary deviation can last another 10 years. The long and short of the TRIMs Agreement is that developed countries can offer all the investment incentives they please, by tax relief or other means, provided they avoid local content requirements. Developing countries can offer all the investment incentives they please, full stop.

Subsidies Agreement. The SCM Agreement negotiated in the Uruguay Round carries over the anachronistic distinction between direct and indirect taxes on goods, inherited from the Tokyo Round Subsidies Code and prior agreements and reports stretching back to the 19th century. Indirect taxes can be imposed on imported goods and rebated (or exempted) on exported goods, but direct taxes cannot be adjusted at the border. The SCM Illustrative List (drawn almost word-for-word from the Tokyo Round Code) spells out the direct vs. indirect

tax distinction. The bottom line is that the rebate or exemption of direct taxes on exports amounts to a prohibited export subsidy. This is true whether or not direct tax relief has any impact on product prices (the famous bi-level pricing test articulated in GATT Article XVI, and very hard to satisfy in practice). Kindred provisions do not apply to taxes on services, since GATS Article XV on *Subsidies* calls for negotiations, which have yet to occur.

Footnote 59 of the SCM Agreement (drawn from the Tokyo Round Code) attempted to separate the WTO from the domain of foreign source income and double-tax treaties by stipulating that the Illustrative List does not prevent Members from taking measures to avoid double-taxation of foreign source income. Footnote 59, however, proved no obstacle to the second FSC Panel (2002), the one that found fault with the Extraterritorial Income Act (ETI). The ETI was designed as an exemption from double taxation of foreign source export income, with a pattern of benefits similar to those provided by the FSC. The Panel Report, affirmed by the Appellate Body, found that the ETI provision was considerably broader than, and at odds with, customary territorial or foreign tax credit provisions found in statutory schemes and income tax treaties. Hence, like the FSC before it, the ETI amounted to a prohibited export subsidy.

The ETI decision takes the WTO deeply into the domain of foreign-source income and double-tax treaties. Depending on future cases, WTO Panel Reports could challenge other tax practices, such as the US export source rule, or anomalies in the territorial systems practiced by European countries.

Agriculture Agreement. The AoA defines government "outlays" to include revenue foregone, and thereby encompasses not only subsidies but also tax measures that affect farming and forestry. With the expiration of the so-called "peace clause" in January 2005, WTO Members are free to bring cases against agricultural subsidies (including tax relief) that either amount to export subsidies or cause trade injury to other Members. So far, the decided WTO cases (cotton and sugar) deal with subsidies, not tax measures. While WTO Members have broadly committed to reduce their agricultural subsidies during the Doha Development Round, it is worth noting that subsidies and tax relief measures that do not increase production or depress prices (so-called "green box" measures) need not be reduced, and are presumptively insulated from criticism in dispute proceedings.

Trade Policy Reviews. The Uruguay Round Agreements instituted the Trade Policy Review Mechanism (TPRM), under which the WTO Secretariat issues periodic reports on the trade practices of Member countries. While the TPRs are not meant to provide a legal guidepost to WTO violations, they are meant to call out questionable practices. Observing this distinction, the reports are drafted in circumspect language.

Nonetheless, several TPRs have identified questionable direct tax practices. For example, in the European Union and Malaysia, annuities and pensions purchased from locally owned companies qualify for personal tax relief, but not when purchased from foreign-owned companies. (Since these services are not scheduled under the GATS, there is no violation of WTO rules.) Several developing country Members provide corporate tax relief as a means of export assistance (e.g., Bangladesh, China, India, Malaysia, Papua New Guinea). Article

27.4 of the SCM provided an 8-year grace period for developing Members, but that has now expired. However, no cases have been brought and the practices persist.

Many countries provide corporate tax relief for new investment at home but not abroad, purchases of machinery and equipment made domestically, and shipping income earned by domestic flag carriers. Some countries - notably in East Asia - attract foreign investment with preferential corporate rates not available to local firms. China taxes foreign investors at 15 percent, rather than the standard 33 percent, and provides extended reductions even from the 15 percent rate. Some TPRs have questioned "tax sparing" provisions, common in OECD tax treaties with developing countries, inasmuch as these provisions amount to corporate relief for taxes not paid, and the tax incentives offered by developing countries are often targeted at production for export markets.

WTO Tax Cases. Some 34 tax disputes have been brought to the WTO since its inception in 1995; 24 of the cases deal with indirect taxes and 10 involve direct taxes. By and large, the indirect tax cases raise the issue of differential and unfavorable treatment of imported products (periodicals, spirits, beer, cigarettes, autos, integrated circuits), and are decided under Article III. The WTO decisions have articulated in considerable detail the definition of "like products" and the requisite elements of discrimination.

The granddaddy direct tax cases were, of course, the FSC/ETI Panel Reports and Appellate Body decisions.¹ Other cases have involved, for example, Turkey's taxation of royalties earned by foreign films, Canada's exemption of the Export Development Corporation (a crown corporation), US federal and state tax relief for the production of large civil aircraft, and European tax measures relating to income earned through exporting or foreign production. Apart from the FSC/ETI cases, and the Canadian exemption, the other cases were either settled or are subject to on-going consultations.

Anachronistic Distinction

The last two sections of Daly's paper (prior to his conclusion) examine the history and justification of the distinction between direct and indirect taxes articulated in the SCM Agreement.

Incidence Assumptions. When the distinction between direct and indirect taxes arose in the 19th century, the common indirect taxes were tariffs and excise taxes on luxury and sin goods, such as whisky and tobacco, and the common direct taxes were property taxes and estate duties. European countries were just beginning to experiment with corporate income taxes, while personal income taxes, social security taxes, and value added taxes were all unknown. In that bygone world, it was easy to assume that indirect taxes were passed forward into the price of products, and direct taxes were borne by property owners. Accordingly, it was natural to write rules in bilateral trade treaties that permitted the exemption of indirect taxes on exported merchandise, and the imposition of such taxes on imported merchandise. Otherwise producers of high-taxed goods would be at a great disadvantage when they exported, or when they faced competition from imported products that did not bear the same tax.

Even though the tax world after the Second World War bore no resemblance to the 19th century, these historic assumptions about tax incidence were implicitly adopted in GATT Article XVI which expressly permitted the remission or exemption of taxes "borne by the like product". While Article XVI said nothing about direct taxes, the assumption that direct taxes are not, in the main, reflected in product prices was explicitly adopted by a GATT Working Party Report issued in 1970. The 1979 Tokyo Round Code on Subsidies classified taxes into direct and indirect categories, based on legal analogy not economic observation, and the distinctions were carried *verbatim* into the 1994 Uruguay Round SCM Agreement. By these agreements, adjustment at the border for any tax classified as a direct tax became a prohibited export subsidy. Any factual determination of the supposed depressing impact of direct tax relief on the prices of exported products - the famous bi-level pricing test enunciated in GATT Article XVI - was dropped as a legal test.

Empirical Evidence. The incidence assumptions underlying the GATT distinction between direct and indirect taxes have long been questioned by economists. Today, it is fair to say that the old incidence assumptions have scant theoretical or empirical support. Depending on the peculiarities of the market in question, and the openness of the economy, direct taxes can be shifted forward into product prices and indirect taxes can be shifted backwards into factor incomes.

Moreover, there is a further anomaly in the WTO rules. One rationale for prohibiting an export subsidy is that such measures reduce prices in the world market, thereby injuring foreign producers. This was the rationale articulated in GATT Article XVI. According to historic incidence assumptions, relief from direct taxes only increases factor incomes; it does not reduce product prices. Under this assumption, how can direct tax relief in country A harm foreign producers in country B?

In sum, the WTO rules rest on a massive contradiction. To the extent direct taxes are passed forward in product prices, there is no rationale for disallowing the same border adjustments permitted for indirect taxes. To the extent direct taxes are passed backwards to factor incomes, there is no rationale for characterizing tax relief as an export subsidy.

Michael Daly surveys the literature and reaches a conclusion that is hardly startling, but one that breaks new ground for a document published under the imprimatur of the WTO:

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 this regard might be warranted.

End notes

1. The reports are critically reviewed in Hufbauer (2002).

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