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# Tax Harmonization and Coordination in Europe and America

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# TAX HARMONIZATION AND COORDINATION IN EUROPE AND AMERICA

*by Stephen G. Utz\**

## I. INTRODUCTION

The countries of northern and western Europe and North America share a common tax policy tradition. It arose in the early nineteenth century, a period of intense interest in free trade,<sup>1</sup> of allegiance to the political importance of nationality,<sup>2</sup> and of secular reverence for the state.<sup>3</sup> Not surprisingly, early nineteenth-century arguments for laissez-faire trade policy and for the replacement of excise and customs taxes with direct taxes — all based on the earliest economic models of national economic systems — took for granted that nations were the natural economic units and that they affected each other in limited ways at best. These models, and views about taxation based on them, have now begun to seem inadequate.

The general view today is that national tax regimes need to take global economic integration into account. In Europe this naturally becomes part of the project of the European Union (EU), the completion of the European Communities. The members of the Organization for Economic Cooperation and Development (the OECD), which include all EU member states as well as Canada, Japan and the United States, exchange information and sponsor studies that are intended to assist them in reach-

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1. See DENIS PATRICK O'BRIEN, *THE CLASSICAL ECONOMISTS* (1975); CARL S. SHOUP, *RICARDO ON TAXATION* (1960); STEPHEN G. UTZ, *TAX POLICY: AN INTRODUCTION AND SURVEY OF THE PRINCIPAL DEBATES* 1-10 (1993).

2. E.J. HOBBSAWM, *NATIONS AND NATIONALISM SINCE 1780: PROGRAMME, MYTH, REALITY* (1990).

3. PHYLLIS DEANE, *THE STATE AND THE ECONOMIC SYSTEM: AN INTRODUCTION TO THE HISTORY OF POLITICAL ECONOMY* 51-71 (1979).

ing consensus on commercial and related tax matters. The North American Free Trade Agreement (NAFTA) rests upon pre-existing coordination of taxation among Canada, Mexico and the United States, whose economic activities have long been broadly intertwined.<sup>4</sup> The Pacific Rim countries are seriously pursuing options that may emulate those of the EU and the NAFTA, though it is too early to tell what the outcome will be. In the United States, growing state tax burdens and their suspected effect on the "rolling recession" that afflicts now one region and then another within the country, have prompted a greater sense of the need for tax neutrality among states — a need made all the more poignant by the veritable jungle of different state tax regimes. Although the problems and interests of the international community and of federal states differ enormously, they now find they have a common policy framework for the discussion, if not solution, of fiscal problems.

The elements of the new framework are shaped by the concepts and strategies implicit in existing tax systems. These systems have of course not been able to ignore the international dimension of taxation. Tax treaties, unilateral measures against tax opportunism, and tax measures designed to provide reasonable allocation of the profits of multi-national firms are among the already well-established responses. But the goal of greater, more deliberate cooperation to neutralize the interaction of different tax regimes has come to the fore; in particular, most experts and many governments consider coordination of taxes on income from capital a priority.<sup>5</sup>

This paper describes the problems of tax design that arise because of global economic integration, examines the means already developed for dealing with these problems, including the chaotic federal approach to taxation that is characteristic of the United States, and looks ahead to new but as yet untried solutions, especially those pioneered by the European Union. Part II provides a brief explanation of the effect of global economic integration on the structure and efficacy of nationally based tax systems. Part III offers an account of the source of problems, both in principle and in practical application, that international tax policy faces. Part IV then discusses the mechanics of international taxation insofar as

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4. Paul R. McDaniel, *NAFTA and Formulary Apportionment: An Exploration of Issues*, in *ESSAYS ON INTERNATIONAL TAXATION* 293 (Herbert H. Alpert & Kees van Raad eds., 1993).

5. Coordination of commodity taxation hardly seems necessary, because the destination principle, which ensures tax neutrality among different taxing regimes, and the tax entitlement rule coincide. For income taxes, tax neutrality requires the application of the residence principle, but the tax entitlement rule points to the source principle. See *infra* text accompanying notes 42-44.

they bear on the problems of harmonization and coordination. Part V considers the significance of the goal of tax neutrality and its relationship with the theoretical concept of economic distortions. Part VI reviews EU efforts to achieve tax neutrality.

## II. GLOBAL ECONOMIC INTEGRATION AND TAX POLICY

Until recently, discussions of tax theory usually assumed that a taxing sovereign could afford to concern itself almost exclusively with the economic conduct of its own citizens.<sup>6</sup> Reality, however, has not been kind to this premise. Interconnecting markets for goods and services, improved communications, an emerging world market for capital, laws that permit and foster transnational enterprises, and other now familiar trends toward globalization have rendered the idea of autarkic economic systems obsolete. The closed economic system was only a theoretical construct, but for tax theory its obsolescence has been very disorienting.

Some rejected corollaries of the "closed economy" assumption are worth noting. It was once commonly said that, under ideal conditions and in the short term, taxing and governmental borrowing are economically equivalent strategies.<sup>7</sup> Now we are much more often concerned with the interaction of taxes and public debt. The size of a country's debt as a percentage of gross domestic product is a closely-watched index of the strength or weakness of the national economy. The relationship of this index to the country's "tax effort" — the ratio of its tax revenues to the gross domestic product — is of practical interest not only to central bankers and currency traders but to ordinary investors and entrepreneurs as well.<sup>8</sup> The reason for the concern is that international economic measures now dramatically vary the real value of a country's debt and annual tax receipts, which in turn affect the strength of currencies and the risk associated with investment in government obligations.

This trenches upon another over-simplification of traditional tax

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6. See, e.g., Roger H. Gordon, *The Role of Corporate Taxes in an Open Economy*, NBER Rptr. 10 (Spring 1994) ("Until recently . . . almost all [work on corporate taxes and their role in the tax structure] has assumed that the economy is closed."). In practice, of course, the designers and administrators of tax systems recognized the oversimplification implicit in closed economy theorizing. That did not prevent them from continuing to attach priority to the assumptions and conclusions of the traditional viewpoint.

7. Admittedly, it has been a while since economists tried seriously to make anything of this idea. *But see* CHARLES M. ALLAN, *THE THEORY OF TAXATION* 23 (1971).

8. See B. GUY PETERS, *THE POLITICS OF TAXATION* 29-35 (1991); RICHARD ROSE & TERRANCE KERRAN, *TAXATION BY INERTIA* (1987).

theory: the integration of the world economy undercuts the hitherto common assumption that domestic saving and domestic investment are equivalent. What is saved in one country can now quite easily elude that country's commercial borrowers through a variety of overseas investment vehicles. Taxed enterprises can go abroad, and money made scarce through government borrowing can distort the domestic tax base, which for political reasons is ordinarily not indexed for fluctuation in the value of the currency. Thus, through taxpayer reaction, the effect of any decision to finance governmental functions through taxes rather than debt or vice versa becomes so ramified as to be uncertain even in broad outline.

The non-separateness of national economic systems upsets traditional tax theory in another important respect. We now routinely doubt the relevance of economic models of national tax systems, to the extent that they treat cross-border transactions as if they were not affected by the character of the national tax system.<sup>9</sup> We now assume that the effect of domestic taxes on international business is not independent of competitive conditions in other countries and taxes on business done abroad, and models must accordingly be transnational.

Conditions that foster tax competition are also part of this more global perspective in tax theory. By "tax competition" I mean both the deliberate attempt by a taxing sovereign to offer tax advantages to mobile taxpayers in order to attract them to its jurisdiction, and the *unintended* creation of such attractions. Examples of deliberate tax competition are few among the more advanced industrial democracies. Such sovereigns can rarely achieve overall economic gains by flaunting the interests of their many trading partners, as they must do in most cases to compete openly with other states by offering tax advantages to investors and firms. But examples of apparently unintended or indirect tax competition are abundant.

Consider the case of the United States in the early 1980s. On taking office, the Reagan administration immediately proposed and won legislative approval for what was called "safe harbor leasing." A safe harbor lease was in effect a transfer of tax losses from one U.S. corporation to another, and by approving such leases the U.S. tax code authorized the virtual elimination of the corporate tax — so many losses were available

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9. See M. Boskin & W. Gale, *New Results On the Effects of Tax Policy on the International Location of Investment*, in *THE EFFECTS OF TAXATION ON CAPITAL ACCUMULATION* 201 (Martin Feldstein ed., 1987); Martin Feldstein & Charles Horioka, *Domestic Saving and International Capital Flows*, 90 *ECON. J.* 314 (1980); Hans-Werner Sinn, *Taxation and the Cost of Capital: The "Old" View, the "New" View, and Another View*, 5 *TAX POL'Y & ECON.* 25 (1991).

in corporate solution for other corporations to buy, that soon no corporation had net income for tax purposes.<sup>10</sup> This thinly veiled repeal of the corporation-level tax, along with relatively generous withholding provisions in U.S. tax treaties with a number of its more prosperous trading partners drew a huge flow of foreign direct investment to the U.S. private sector.<sup>11</sup> The U.S. temporarily became a tax haven. Needless to say, the proponents of safe harbor leasing did not call attention to its tax competitive effect on the world capital market. The ostensible purpose was to stimulate the U.S. economy by reducing the corporate tax burden. Presumably, in the world of diplomacy, it does make some difference that this domestic political goal could be cited in justification for what was in fact a tax competitive measure. But there is no a priori difference in economic effect between seemingly unintended tax competition and tax competition that is blatantly intended as such. Hence, my use of the term to cover both.

Tax competition as such is neither good nor bad.<sup>12</sup> It can conceivably eliminate economic distortions due to national tax laws but it can also undermine legitimate goals of supporting government and stabilizing or stimulating domestic economic activity. Whatever its consequences, tax competition is not under government control. The alternative is the conscious mutual adjustment of tax systems to eliminate differences that might make one tax jurisdiction more attractive than another as a place for investment or business activity. If the tax laws of all countries were harmonized, *i.e.*, had similar effect on commercial and investment decisions, tax competition would obviously be avoided. Assuming that the absence of economic distortions due to taxation would assure a general gain in wealth or welfare, tax harmony would clearly be a good thing. Something less than complete harmonization might be sufficient, though;

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10. See CATHIE MARTIN, *SHIFTING THE BURDEN* (1991).

11. Not that foreign investors sought to invest in U.S. corporations that had substantial losses, but the possibility of shelter corporate income from the U.S. corporation tax made the United States a tax haven, by enabling corporations to enjoy a *negative* tax rate, *i.e.*, to obtain refunds of taxes paid in previous years. The phenomenon of increased FDI in the United States during the early Reagan years has been noted generally, although it is sometimes attributed exclusively to the generous depreciation schedules and investment tax credits of the 1981 U.S. tax legislation. See A. Lans Bovenberg et al, *Tax Incentives and International Capital Flows: The Case of the United States and Japan*, in *TAXATION IN THE GLOBAL ECONOMY* 283, 303-03 (Assaf Razin & Joel Slemrod eds., 1990).

12. See Sijbren Cnossen, *More Tax Competition in the European Community?*, in *Public Finance, Trade, and Development*, Proceedings of the 44th Congress of the International Institute of Public Finance 153 (1990) (arguing that more competition rather than less would be good for the European Community).

"tax coordination" is the term often applied to more selective mutual adjustment of potential competitive tax systems. The paradigm of tax coordination is the bilateral tax treaty.

### III. SOURCES OF PROBLEMS FOR INTERNATIONAL TAX POLICY

Most states claim full taxing authority over people, property and transactions "within" their territory. If the people, property, and economic transactions of different countries could be kept separate — if national economic systems and national tax jurisdictions were closed to each other in relevant respects — jurisdictional rules would dictate more or less straightforward principles for coordinating different countries' tax systems. But while it is easy to determine whether a human being is in or out of a country, it is not always easy to determine the situs of property or transactions for tax purposes. Most national economic spheres, unlike national borders, are fairly open, and not only to the free movement of things and services, but open too in the sense that some things and events have no clear place within or beyond any territorial boundary. Issues of line-drawing and issues concerning the effect of taxes on the mobility of capital are not surprisingly the two main areas into which discussion of international tax policy falls.

These issues have obvious equity and efficiency dimensions. Indeed, all line-drawing for tax purposes is essentially directed toward achieving equity, usually equity among residents of the taxing country and its treaty partners. And efficiency, in the form of various conceptions of what is good for domestic and supra-national capital markets, seems to prompt tax laws designed to control out-bound or in-bound investment.

If the classical economic tradition slighted the interaction of national economies, heirs to that tradition also had little to say about it until fairly recently. The most respected analytical successes of the classical and neo-classical traditions in economics merely reinforced the tendency of economists and those they advised to think in terms of closed economic systems. Now, even simple questions about how taxes affect investment within a country can require answers to novel, and by their nature complex, non-tax economic questions.

Something else complicates the task of designing tax measures that will take the international context into account. People do not generally agree on principles that might define good or even acceptable behavior from an international perspective. What consensus about international morality and good politics there is can scarcely support discussion of the fair play and affirmative desirability of tax measures that affect many



Tax administrators regard the accounting problems raised by multinational corporations (MNCs) as another problem. The most notorious of these problems concerns transfer pricing—the pricing of goods and services in transactions between members of the same corporate group. Since the parties to these intra-group transactions do not act at arm's length, they may be suspected of pricing goods and services so as to minimize income or maximize deductions in high-tax jurisdictions, when the transaction involves corporations in different jurisdictions.

Finally, legislative tax policy officials and tax administrators may consider the goal of harmonizing or coordinating their respective tax systems with those of common market treaty partners as responsive to yet another sort of problem. Indeed, from the standpoint of implementing a rational and effective national tax system, these are more or less distinct problem areas. It is easy to see, however, why some countries think the problems are connected.<sup>16</sup> The purpose of double tax treaties is to coordinate the taxes imposed by the treaty partners on various aspects of the economic lives of their citizens. If an individual citizen of one treaty partner resides in the other treaty partner's jurisdiction, coordination may be achieved by exempting that citizen from the usual tax claims of the host country. The same is true for a business formed under the auspices of one treaty partner and doing business only in the other's territory. Often, however, business entities are active both at home and abroad. When treaty partners have overlapping jurisdiction over a firm that is the creature of one of them, the immediate effect of a double tax treaty is to

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and perhaps others, appear to be particularly concerned to thwart tax competition that results from the opportunism of private firms that detect weaknesses in the formulation of the anti-discrimination clauses themselves. See Richard L. Doernberg, *Legislative Override of Income Tax Treaties: The Branch Profits Tax and Congressional Arrogation of Authority*, 42 TAX LAW. 173 (1989); Richard G. Minor, *Germany*, 8 TAX NOTES INT'L 76 (1994) (discussing the German Anti-Abuse and Technical Corrections Act of 1994, passed on December 17, 1993, which includes anti-treaty-shopping provisions).

16. The United States embarked several years ago on a campaign to rid the world of treaty-shopping, at least if the treaty-shopping took advantage of a U.S. treaty. A host of recent U.S. treaty revisions give a conspicuous place to the limitation of treaty benefits to individuals and firms that can claim a substantial nexus with the treaty partner. See Tax Notes International stories concerning late 1993 treaty hearings for a discussion of same. Recently, Germany has adopted an anti-treaty shopping statute that may herald a similar renegotiation of its tax treaties. See Richard G. Minor, *Overview of New German Anti-Abuse and Technical Corrections Act*, 93 TAX NOTES INT'L 243-47 (1993). Other countries remain skeptical if generally conciliatory towards the goal of eradicating treaty-shopping. Leif Muten, *Inspiration or Desperation — European Reactions to US Tax Thinking*, in ESSAYS ON INTERNATIONAL TAXATION: TO SIDNEY I. ROBERTS 311-13 (Herbert H. Alpert & Kees van Raad eds., 1993).

allocate taxing jurisdiction between them. One treaty partner is entitled to tax certain transactions, involving specified nationals of the two treaty partners, and the other is entitled to tax other transactions, involving specified nationals. Hence, it is sometimes said that the main purpose of double tax treaties is to resolve conflicts of taxing jurisdiction.<sup>17</sup>

The notional contrast between problems of jurisdiction and problems of economic distortion due to tax competition can be misleading. It is sometimes important to resolve rivalry among taxing authorities in order to avoid other problems, including deliberate tax competition. States whose tax jurisdictions do not overlap may find incentives to engage in tax competition. Therefore, it may be tempting to suppose that the task of the double tax treaty is to de-fuse a diplomatically troubling situation before tax competition begins. I want to explain why friction related to overlapping tax jurisdiction may already *be* tax competition and is dangerous not only because it may lead the states affected to initiate tax competition in reaction to that friction.

The mobility of business vehicles figures large in the problem. Corporations and their like enjoy the ability to create and abandon jurisdictional ties virtually at will, without regard to the encumbrances of employment and residence that prevent individuals from easily changing their nationality. Lower tax rates and convenient peculiarities of the tax structure may provide tax motives for choosing to locate in one tax jurisdiction rather than another. But the availability of a treaty between the jurisdiction of choice and another jurisdiction may provide just as strong a motive. As international tax advisors are too well aware, picking the most advantageous place in which to form a corporation or other entity is sometimes precisely a question of ascertaining how treaties will permit the entities of that jurisdiction to pay lower taxes in a treaty partner's jurisdiction. The phrase "treaty shopping" was coined to describe this phenomenon.<sup>18</sup>

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17. See, e.g., J.A. KAY & M.A. KING, *THE BRITISH TAX SYSTEM* 206 (5th ed. 1990); PAUL R. McDANIEL & HUGH J. AULT, *INTRODUCTION TO UNITED STATES INTERNATIONAL TAXATION* 173 (3d ed. 1989).

18. Perhaps the example that most influenced U.S. thinking about the phenomenon of treaty-shopping was the so-called "Dutch sandwich," an investment structure that made opportunistic use of the Netherlands' treatment of dividends received by a Netherlands company from a Netherlands Antilles company. Under this scheme, U.S. royalties flow tax-free to an Antilles company (because the U.S.-Netherlands Antilles treaty exempts such royalties from withholdings of tax by the U.S. payor), are paid as dividends to a Netherlands company (which again is free from tax under Netherlands Antilles law and Netherlands law), and then are returned to a second Antilles company, from which the amounts can be distributed with only a nominal tax to foreign shareholders.

Those of us, however, who are primarily concerned with tax policy should not lose sight of the distinct influence of non-tax considerations on choice of jurisdiction for the siting of corporations. Corporate managers are at least as impressed by the procedural advantages and disadvantages of different countries' legislation, where the governance of internal corporate affairs are concerned. Shareholders' voting rights, shareholders' right to inspect the company books, minimum capital requirements, the definition of matters requiring shareholder approval, the requirement in some countries of employee representation in management, and other aspects of company law are scarcely uniform even among countries with such close ties as those of Europe or North America. Long before the current climate of interest in the coordination of EC direct taxation arose, the EC member states struggled long to forge a moderately coherent pattern of shared company law that would foster free migration of enterprises within Europe.<sup>19</sup>

### B. *Treaty-Shopping*

While the domestic politics of a taxing authority often dictates harsher treatment for foreigners than for its own residents, foreigners can sometimes mobilize tax retaliation by their own (or even other) countries. Tax treaties, often called "double tax" treaties because they are designed in large part to prevent double taxation of the same income, grow out of or anticipate the problems of tax evasion and inter-governmental retaliation. They are deliberately more favorable to the citizens and resident corporations of the treaty partners than to others, in order to secure cooperation against tax opportunism. They usually require a great deal of rather technical negotiation because of differences between the party states' tax systems. They are perhaps for that reason hard to amend. They also require standing arbitral arrangements, access to which, by international legal custom, is limited to citizens represented by state sponsors. In view of the difficulty of negotiation and the cumbersomeness of arbitration, it is not surprising that a country's tax treaties are often out of sync with its international tax policy for long periods of time.

Bilateral treaties are still the principal means by which states sort out potential or current tax conflict. They are, however, no longer the only or

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19. See Clark D. Smith, Note, *Federalism and Company Law: A "Race to the Bottom" in the European Community*, 79 GEO. L.J. 1581 (1991).

most powerful means. Trade pacts can easily do far more than treaties limited to the settling of tax issues to establish the terms and conditions on which national trading partners shall influence commerce within their combined territories. Although it was once common for trade pacts, like the General Agreement on Tariffs and Trade or GATT, to ignore tax aspects of national trade policy — pretending, as it were, that states did not protect their agricultural sectors through tax subsidies that were not traditionally considered “state aids” — no such myopia is likely in the hot light of today’s trade negotiations and agreements.

The anti-discrimination clause, a mutual promise by the treaty partners to treat each other’s citizens and corporations no differently than their own for tax purposes, is in some ways the core of a double-tax treaty.<sup>20</sup> The members of the European Union, the members of the OECD,<sup>21</sup> and other advanced industrial democracies have created among themselves a thick network of tax treaties in which anti-discrimination provisions of various sorts are to be found. The United States has negotiated an almost standard form of anti-discrimination clause, different in many respects from United Nations model provisions, in its tax treaties since 1980.<sup>22</sup> Typically, the U.S. clause has the consequence that if, for example, the United States imposes a ten percent excise tax on domestically produced heavy trucks, it may not impose a higher excise tax on heavy trucks produced in this country by an individual citizen of a treaty partner. It may not allow a state to collect higher death taxes from the estate of a treaty partner’s deceased citizen than would be due from the estate of a U.S. citizen.

Eliminating discrimination against individuals who happen to be nationals of the treaty partners is a relatively simple goal to achieve.<sup>23</sup> It

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20. See KEES VAN RAAD, *NONDISCRIMINATION IN INTERNATIONAL TAX LAW* (1986).

21. Cf. Nigel Tutt, *Scrivener Calls For Environment and Savings Tax Harmonization at OECD Level*, 8 TAX NOTES INT’L 911 (1994) (EU Commissioner for Fiscal Policy Christiane Scrivener has called for environmental and savings tax coordination within the OECD rather than the EU). Although the GATT has lacked the means of enforcing its articles of agreement, including those which might require tax coordination, the Uruguay Round will, if ratified, provide binding inter-nation arbitration that will change all that.

22. United States Dept. of Treasury Model Income Tax Treaty, Tax Treaties (CCH) ¶ 1022 (June 16, 1981) [hereinafter 1981 Model Treaty].

23. Not that the elimination of double taxation is automatic, even under double tax treaties, at least those of the usual sort. If I am taxed heavily in the country where I earn (because it relies heavily on income taxes) and again heavily taxed in the country where I spend my earnings (because it relies heavily on consumption taxes), I am surely taxed twice. Double tax treaties are generally designed only to eliminate double taxation resulting from the imposition by two different taxing jurisdictions of taxes on the same tax base.

countries at once. There is no broad normative standard for assessing, say, how Switzerland taxes the business activities of multinational corporations (MNCs). It is as if we had to discuss domestic tax rules without even the shared presumption of equal treatment of individuals.

This lack of principles is, as I have argued elsewhere,<sup>13</sup> due in part to the fact that we are not very good at making moral judgments about the behavior of groups, as distinguished from individuals; another is that international law has traditionally taken a minimalist or agnostic attitude towards most questions of transnational right and wrong. And the setting in which international tax policy must be implemented does not tend to supply answers to these questions. Differences in national standards of living, cultural differences that affect how law is regarded, and so on are just too great.

Social and political variety in a moral and political vacuum accounts for the rudderless quality of much thought about international tax policy. Those few familiar moral or political standards that arguably apply to domestic and international relations alike, being all we have, take on what is arguably too much significance. These include rudimentary notions of economic efficiency and justice. Because more sensitive appraisal of how many countries are faring at once seems impossible, economic efficiency is often, even usually, identified with capital accumulation measured in crude terms. Any sort of equal treatment of equals seems a decent enough approximation of justice in this setting that is both luxuriant with relevant factual differences and barren of shared moral standards.

#### IV. MECHANICS OF TRANSNATIONAL TAXATION

Countries levy and collect taxes from citizens and others, on the basis of a network of traditional legal assumptions about sovereigns and their authority over people within their respective territories. Treaties sometimes refine or replace these assumptions. But neither the traditional bedrock nor the treaty superstructure has so far been especially well suited to the transnational coordination of tax systems. Now that the distinct economic lives of prosperous industrial countries have become very highly intertwined, old principles of international jurisdiction and sovereignty simply do not provide an adequate basis for the preservation of national tax systems.

Thus, the EU principle of subsidiarity is a manifestly complex mech-

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13. UTZ, *supra* note 1, at 195-97.

anism for preserving the sovereignty of the member states while essentially dictating to them on matters of national legislation; such national identity as the member states' tax systems retain is largely at the sufferance of the community and in spite of the community's declared purposes. Compare that with the volatile legal fiction of state "sovereignty" within the United States, or what has sometimes been called the "dual sovereignty" of the states and the federal entity. While the federal government, through Supreme Court decisions concerning the sweep of the Commerce Clause, has virtually claimed for itself the power to obliterate the tax and trade initiatives of the individual states, enforced coordination is unnecessary because of the comparatively small scale of state tax levies, when compared with federal tax burdens, and because the states are strictly forbidden any individuality in trade matters.

#### A. *Three Reasons For the Awkwardness of Sovereignty*

If the traditional legal framework of sovereignty has proved awkward, a pressing reason for this is the world-wide emergence of profoundly serious free-trade pacts. While it may be too early to say that the political goal of radically national sovereignty is on the wane, the idea of nationally self-contained economic activity is no longer appealing. The example of the European Union has of course been mentioned. Canada, Mexico and the United States hope to create a similar union. "Most favored nation" status, a creature of increasingly comprehensive treaties of friendship, trade and communication, is of the highest significance to other trading partners of the economic leaders.<sup>14</sup>

Those who formulate tax legislation and administer it have generally dealt with problems that flow from the globalization of formerly domestic economic systems as distinct from other national tax issues, even though economic integration makes the distinction increasingly artificial. For example, the anti-discrimination clause of a double tax treaty is generally conceived of as the means for thwarting unintended tax distortions, whether resulting from over-taxation or from tax competition between the treaty partners.<sup>15</sup>

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14. See Guy T. Petrillo, *Free Trade Area Agreements and U.S. Trade Policy*, 18 N.Y.U. J. INT'L L. & POL. 1281 (1986); see also Mark S. Bergman, *Bilateral Investment Protection Treaties: An Examination of the Evolution and Significance of the U.S. Prototype Treaty*, 16 N.Y.U. J. INT'L L. & POL. 1 (1983).

15. Tax competition between otherwise friendly countries can occur in a variety of ways, some intentional and some not, as the text at notes 10-11 *supra* indicates. The United States and Germany,

can be decided unambiguously whether a natural person is in a country or not, and there are comparatively stable assumptions concerning the situs of transactions to which natural persons may be parties. The objective of prohibiting discrimination against the corporate citizens of treaty partners, on the other hand, is quite a problem. International law has not settled on a single test for determining whether a corporation or similar juridical entity is a national of (or otherwise belongs to) a given state.

In the past, anti-discrimination clauses typically left it to the law of each treaty partner to decide which non-natural persons and associations including non-citizens should be accorded the treaty privilege of nondiscrimination. The want of consensus as to grounds for recognizing the "nationality" of corporations or its equivalent provided a sufficient reason for this reticence, at least as long as the consequences of not solving the conceptual puzzle were not pressing.<sup>24</sup> Times have of course changed. The manipulation of corporate nationality or its counterpart by any other name (nexus, siège morale, etc.) has become a regular feature of international business tax planning. The point of choosing carefully where to incorporate is often if not invariably to take advantage of the disparate benefits of tax treaties — in a word, "treaty-shopping."<sup>25</sup>

Apprehensions about treaty-shopping — that it may siphon off government revenues or disrupt cordial relations among treaty partners — have begun to penalize this generous approach to the geographical situs of corporations. Evidence that tax evasive business planning poses a threat to international relations is found both in the United States' recent threat to break faith with its tax treaty partners over this form of corporate tax evasion and in the indulgent response of its treaty partners to that threat.<sup>26</sup> Germany, though it condemned the United States' selective abrogation of its treaty obligations as a means of combatting treaty-shopping, has now adopted its own anti-treaty-shopping legislation.<sup>27</sup> The U.S. Treasury has announced its intention to escalate its fight against treaty-shopping by revising its treatment of corporate intermediaries in

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24. RESTATEMENT (SECOND) OF THE LAW, FOREIGN RELATIONS LAW OF THE UNITED STATES § 27 cmt. c (1965).

25. "Treaty-shopping" is a "premeditated effort to take advantage of the international tax network and careful selection of the most advantageous treaty for a specific purpose." See H. David Rosenbloom, *Tax Treaty Abuse: Policies and Issues*, 15 LAW & POL'Y INT'L BUS. 763, 766-68 (1983).

26. I.R.C. § 884 (1986); UTZ, *supra* note 1, at 197-205.

27. See Richard G. Minor, *Overview of New German Anti-Abuse and Technical Corrections Act*, 7 TAX NOTES INT'L 1539 (1993).

international transactions.<sup>28</sup>

Not everyone agrees that treaty-shopping is that much of a problem. Some, for example, argue that opportunism of the usual sort MNCs engage in is a small and not particularly demoralizing part of the price treaty partners pay to assure equity as well as transparency in their exercise of overlapping tax jurisdiction.<sup>29</sup> It is at least worthwhile to be clear about what the worry is that prompts United States and German concern.

Global economic integration means that much of the world today is willy nilly a single economic community, with as much to gain from internal regulation as consciously formed free trade areas like the European Union and its imitators. A natural objective of an economic community is to ensure an efficient allocation of investment resources within the community. To avoid economic distortion, taxes on income from capital should neither dictate nor heavily influence capital flows. Danger therefore lurks in investment flows that reflect not the real potential for economic growth of some country's economy but only an overstatement of the return on some otherwise less productive enterprise. Efficient allocation of investment resources ideally means equalizing the marginal rate of return on investment in each country of the relevant economic community.<sup>30</sup>

If the tax treatment of income from capital is on a residence basis, i.e., the tax liability of a resident of any country on a unit of investment income is independent of the country in which the income originates, then efficient mobility of capital has the consequence that the pre-tax interest rate be the same in all countries (real interest rate, adjusted for differences in money supply). It won't be the same if the pre-tax rates of return on similar corporate enterprises depends on the country in which the enterprises are carried on. The structure of the applicable corporate tax is what governs this rate of return, for our purposes. Either a classical corporate tax — one comprising two layers of tax at whatever rates — with true

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28. Lucinda Harper, *'Treaty Shopping' Is Target of IRS Crackdown*, WALL. ST. J., Oct. 12, 1994, at A2.

29. Leif Muten remarks:

In the area of treaty-shopping, most Europeans again tend to see [at best a dangerous case of fiscal] perfectionism. While few of us lost any sleep over treaty shopping abuses, we tend to be sleepless when trying to understand what we are in for once the US-Dutch treaty sets the pattern around the world. Was the system as broke as to need all that fixing? Indeed, was it broke at all?

Muten, *supra* note 16, at 311-13.

30. Rates of return depend on the structure as well as the rate of capital taxation, which in most cases is corporate taxation. KAY & KING, *supra* note 17, at 201-02.



economic depreciation, or a cash flow corporate tax with integration will do, if all countries concerned use the same structure in measuring the corporate tax base. (This, by the way, is the announced goal of EC and OECD theorists — everyone seems to agree that similarity of tax structure is in the common international interest.<sup>31</sup>)

Treaty-shopping exaggerates the current variety of corporate tax bases in the world economic community. Governments everywhere are seeing strong proof of this, either in the flight of capital from their own best enterprises or in the unwanted influx of de-stabilizing investment in unworthy, already overbid markets — sometimes in both. A tax on treaty-shopping enterprises could be designed not to punish or to raise revenue but simply to remove distortive tax incentives for inefficient investments. Needless to say, other political pressures work alongside whatever idealism there may be concerning the pursuit of more efficient capital markets. People in business, the trade unions, and farmers everywhere seem to favor transnational trade protectionism or retaliation therefor, and taxes are often the chosen means.

If these pressures continue to influence policy-makers, the goal of frustrating treaty-shoppers and of making corporate tax bases more closely comparable from country to country will loom ever larger on the agenda of tax treaty negotiators — even at the expense of nondiscrimination. Before the defects of anti-discrimination clauses were felt, the United States had been engaged in, and had almost completed, a long series of treaty re-negotiations, with the broad purpose of unifying its international tax policy with respect to principal trading and investment partners. While the effort was successful in most respects, it also underscored the awkwardness and delay that will inevitably attend any attempt to rationalize international tax policy by traditional means. It also exposed the existence of vastly different national needs and wants on opposite sides of the negotiating table, especially when the United States was seeking to limit the tax-haven status of a smaller or Third World state.<sup>32</sup> Thus, the legal process is centrally affected by the *lack* of a genuinely international tax policy agenda.

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31. See KAY & KING, *supra* note 17; Sijbren Cnossen, *Tax Harmonization Issues in the European Community*, 8 AM. J. TAX POL'Y 259 (1990).

32. Paul D. Reese, *United States Tax Treaty Policy Toward Developing Countries*, 35 UCLA L. REV. 369 (1987).

### C. *The Variety of National Attitudes Towards Tax Exploitation*

Problems due to the awkwardness with which international business transactions fit traditional legal concepts of international sovereignty and jurisdiction crop up in a variety of ways and, given the inventiveness of tax advisors, can be expected to continue to do so. The phenomenon of tax havens — taxing jurisdictions whose laws invite residence and accord a lower tax burden than do jurisdictions from which the tax haven residents are fleeing — has recently taken on a new look. Given the wealth gap between the prosperous industrial democracies and the poorest countries of the world, there has always been a temptation for the have-not jurisdictions to become tax havens, if possible, for ventures to be carried on in their wealthier counterparts. Today, however, wealth and democracy no longer coincide as unswervingly as heretofore. Prosperous countries that do not have to raise revenue by the same comparatively passive means adopted by democracies can serve as tax havens and tax powers at the same time.<sup>33</sup> Within the EU, a relevant contrast is that between capital-exporting and capital-importing countries, because the tax systems of the two sorts of jurisdiction can naturally be expected to differ in their treatment of dividends or interest paid by foreign corporations to domestic recipients.

Many countries have adopted laws that deny tax preferences to or impose heavier taxes on enterprises with tax haven residence, defining that concept largely in terms of tax rates.<sup>34</sup> Such anti-tax-haven legisla-

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33. The term "tax haven" is actually used in two ways in discussions of international tax planning. The more inclusive application of the term extends to all taxing jurisdictions that provide an advantage for individuals or businesses whose income or wealth would be taxed more heavily if they fulfilled the requirements for residence in another jurisdiction. Thus, for example, since 1986 the United States has been a tax haven for some corporate enterprises with European links because U.S. marginal tax rates on corporate income have been reduced to a level below that of several European countries. A U.S. corporation that could, for example, provide services in Great Britain without establishing itself there (in the sense defined by the relevant British tax law) would stand to pay less tax on marginal profits than a British corporation would if it provided the same services in that country.

Sometimes "tax haven" is used more restrictively to describe those comparatively few countries that openly foster efforts by their residents to attract tax avoiders. Tax havens in this sense are identifiable by characteristics like a relatively low rate of taxation, high levels of secrecy for banking and other financial transactions, a financial sector disproportionately large for the business operations actually carried on in the country, well-developed communications networks, lack of currency control, political and economic stability, liberal commercial laws, limited participation in tax treaties (because potential treaty partners shun them), and the availability of competent lawyers and accountants to staff tax avoidance operations. Vincent P. Belotsky, Jr., *The Prevention of Abusive Tax Havens*, 17 CAL. W. INT'L L.J. 43 (1987).

34. ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, TAX HAVENS: MEASURES

tion would thus apply to countries that openly assist tax avoidance schemes as well as to those that inadvertently or in the pursuit of other ends happen to do so. One of the elementary goals of double tax treaties has been to eliminate the unintended use of treaty partners as tax havens. An important element in treaty defenses against unwitting susceptibility to the treaty partners to use as tax havens is the mutual exchange of taxpayer information between the relevant governments, sometimes in exchange for financial aid.<sup>35</sup>

#### D. *Transfer Pricing*

"Transfer pricing" is the allocation of costs, revenues, and related items among the entities that make up a multinational enterprise. Most countries profess adherence to an "arm's length" standard for appropriate international transfer pricing, so that treaties should be interpreted accordingly and the business affairs of MNCs regarded as subject to reclassification if the arm's length standard is violated by treaty partner enterprises. U.S. tax authorities, for example, take that position in support of currently proposed transfer pricing regulations.<sup>36</sup>

The trouble with this simple view of how multinational corporate groups ought to allocate their earnings for tax purposes is that MNCs, in particular, are characterized by idiosyncratic exploitation of intangible business assets — patents, know-how, customer lists, and good will in a host of forms. Unrelated corporations rarely share intangibles in a manner that permits clear comparison with the practice of these related entities.<sup>37</sup> The exploitation of intangibles is often not a matter of separate contractual agreement among related or unrelated parties, and when contracts do commemorate the "transfer" of some or all the value of an intangible, the accounting aspect of the transfer may offer no insight into the ultimate division of profits among the parties.<sup>38</sup>

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TO PREVENT ABUSE BY TAXPAYERS: INTERNATIONAL TAX AVOIDANCE AND EVASION 21 (1987).

35. See Gregory P. Crinion, *Information Gathering on Tax Evasion in Tax Haven Countries*, 20 INT'L LAW. 1209, 1235 (1986).

36. See U.S. TREASURY DEPT. & INTERNAL REVENUE SERVICE, REPORT ON THE APPLICATION AND ADMINISTRATION OF SECTION 482, at 1-3 (April 9, 1992) ("every major industrial nation accepts the arm's-length standard as its frame of reference in transfer pricing cases").

37. This, at least, is the plausible thesis of recent scholarship on the subject. R. CAVES, *MULTINATIONAL ENTERPRISE AND ECONOMIC ANALYSIS* (1982); ALAN SHAPIRO, *MULTI-NATIONAL FINANCIAL MANAGEMENT* (1989); Michael Granfield, *An Economic and Strategic Evaluation of the Proposed 482 Regulations*, 92 TAX NOTES TODAY 121-31 (June 11, 1992).

38. Hugh Ault & David Bradford, *Taxing International Income: An Analysis of the U.S. System*

The obscurity of the transfer pricing or, more accurately, the profit allocation problem for MNCs affects all other aspects of international tax policy that have been mentioned earlier in this article. Anti-discrimination provisions in tax treaties are worthless if they do not take into account the possibility that there may be no ultimate way of analyzing the profitability of corporate groups that do business in several countries at once. If corporations can disguise what really generates profits for them by dividing aspects of their operations among corporations of different nationality or residence for treaty purposes, then nationality or residence is irrelevant, and the attempt to police it by subtle treaty classification is doomed to irrelevance too. Similarly, even cooperation and mutual information exchange among all the countries in which an MNC does business cannot illuminate the rights of those countries to tax the respective parts of the enterprise, if there are no ultimate parts to begin with.

Unfortunately, the only purely diplomatic way out of this theoretical and factual wilderness is arbitrary agreement by taxing jurisdictions to apportion MNC profits so that suitable parts will be taxed by each jurisdiction. And since advance agreement by taxing authorities without the cooperation of the affected corporations might also be futile, because the taxpayers would remain free to change plans and reap profits elsewhere or in a different manner than the governmental negotiators had foreseen, the agreements should, if possible, include the MNCs themselves as parties. The recently announced *advance pricing agreement* (APA) procedures are a step in this direction.<sup>39</sup> But since they involve only the taxpayer corporations as parties, it was quickly recognized by commentators here and abroad that APAs may provoke retaliation from other taxing jurisdictions if they appear to overreach the "correct" economic result.

## V. ECONOMIC DISTORTION AND TAX HARMONIZATION

It has always been one of the goals of tax design to minimize the effect of taxes on private economic decisions, a goal usually described as that of tax neutrality. Both direct and indirect taxation can fall short of neutrality. Indirect taxation has often been thought to distort private economic decisions unless it is very broadly based — the more universal its application, the less substitution it can cause<sup>40</sup> — while direct taxation

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and *Its Economic Premises*, in TAXATION IN THE GLOBAL ECONOMY 11, 30-33 (Assaf Razin & Joel Slemrod eds., 1990).

39. U.S. TREASURY DEPT. & INTERNAL REVENUE SERVICE, *supra* note 36, ch. 3.

40. See the discussion of optimal tax models and their implications for substitution effects in Chapter 14. These considerations are sometimes collectively represented by the so-called "Ramsey

may on some assumptions interfere less and on other assumptions interfere more. Contemporary worries over the distortions caused by multi-jurisdictional taxation have oddly enough reversed the balance of advantages and disadvantages associated with direct and indirect taxation.

If tax policy rests on the assumption that the market achieves the most efficient allocation of resources, it follows that a tax system should not interfere with the market. A market shared by several countries, each of which possesses the power to tax some of the same transactions or person, complicates the goal of tax neutrality. Neutrality is all-encompassing. It is not simply limited to events or persons within the territory of single taxing authorities. In the context of an economic community, it is not limited to relations between member states. The shared goal of neutrality therefore requires cooperation and mutual adjustment of tax legislative choices by the countries that would preserve, even for their own purposes, pre-tax competitive conditions.

If indirect taxes can be made broadly applicable, their inherent simplicity of administration and transparency to the persons who must pay these taxes are advantages over at least some direct taxes. Income taxes, in particular, though more neutral than indirect taxes on selected commodities or transactions (the customs and tariffs of the eighteenth century were typically selective in this way), are notably less simple to administer and less transparent to non-experts, the more carefully attuned they are to the task of leaving competitive conditions unchanged.

Direct taxes pose much greater problems for enforcement in the global context. The avid tax-avoider may be willing to sacrifice his or her citizenship for, say, Liechtenstein citizenship in order to pay less in taxes. Conveniently for tax policy, most people would find this form of tax avoidance impractical. Investment income is unfortunately not linked to the residence of the investor. Someone who cannot shelter his or her wages can choose to invest in enterprises in a jurisdiction that does not tax business profits as heavily as the home jurisdiction does. The internalization of the market for investment capital has made this a practical reality for even the smallest investors. Distributions and the proceeds from the sale of corporate shares are likely to be taxed at the rates normally applicable to other income in the investor's country. But a country

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rules," which say roughly that commodity taxes should be designed to reduce demand for all commodities in equal proportions. Frank Plumpton Ramsey, *A Contribution to the Theory of Taxation*, 37 ECON. J. 47 (1927).

that must import capital can easily be tempted to exempt income from that capital from taxation at its source, thereby offering foreign investors relief from at least one layer of taxation.

Some countries deliberately take advantage of gains by tax competition. U.S. tax law provides a tax holiday for U.S. corporations that establish business operations in Puerto Rico or another U.S. possession.<sup>41</sup> Domestic corporations appear to have taken relatively cynical advantage of the possession tax credit by transferring the manufacturing aspect of a business to a possession corporation controlled by a mainland parent. Most of the gains from these tax competitive measures are at the expense of the economy of other areas. In some instances at least, established manufacturing enterprises have transferred operations from an original location on the U.S. mainland to Puerto Rico, taking away jobs from specific groups of workers on the mainland. Such tax-motivated geographical moves can have relatively high costs elsewhere in the economy.

Accordingly, the general welfare may be diminished if potentially competitive taxing jurisdictions do not refrain from the practice of undermining one another's tax regimes. The EU has in particular agreed to avoid the use of "state aids" for the purpose of intra-community competition and is seeking, still with little success, to persuade recalcitrant members to bring their corporate tax systems into rough conformity. Simultaneously, and with greater success, the EU has by negotiation among its members achieved a reasonable degree of uniformity in the adoption of value-added taxes as partial surrogates for corporate taxes,<sup>42</sup> and more recently other members of the OECD have followed suit. Only the United States, Switzerland, and Australia have not yet done so.

Most European countries that once had "classical" corporate tax structures — tax systems that impose a tax on corporate profits *and* on distributions out of those profits — have now moved to various forms of dividend relief, so that corporate income is roughly taxed at rates corresponding to the marginal tax rates of their shareholders (the Netherlands is the most important exception). The imposition instead of a value-added tax, which operates as a tax on consumption rather than on production or profits, is considered by many economists a more neutral way to skim a governmental share from the net product of an economy in close interac-

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41. I.R.C. § 936. The provision allows a credit for that portion of the corporate tax attributable to income from Puerto Rico or another possession of the United States, if 80% of the gross income of the corporation came from sources in a possession for the preceding three years and 75% from the active conduct of a trade or business for the year for which the credit is to be claimed.

42. KAY & KING, *supra* note 17, at 209-17.

tion with other economies.<sup>43</sup> EC tax theorists generally argue that such neutrality follows from the way in which a consumption tax of this design (not all consumption taxes would share the relevant feature) takes geography into account.

What suits the VAT to the purpose in question is primarily the invoice method of collection that is generally used in Europe. (Other methods of VAT collection could achieve the same advantage only by greatly added complexity.) The European VAT is imposed on producers as products are sold (services are taxed in the same way) and collected by reference to invoices filed with the tax authorities. Exports are exempted from the tax by the simple expedient of refunding the tax to purchasers as they cross the border (or thereafter). Importers pay tax on the full value of imports at the VAT rate. The result is that only goods and services consumed in the taxing country are in principle subject to the tax. It is said therefore that the tax is imposed on a destination basis. By contrast, eliminating the special provision for imports and exports would have the effect of taxing goods and services where they originate and not necessarily where they are consumed. They would then be said to be taxed on a source basis. What makes the VAT attractive for the purpose of frustrating tax competition is that it is both a consumption (not a production) tax and destination based. If different countries within an integrated trading community impose taxes at different rates on a destination or residence basis and on the same tax base (e.g., consumption or individual, as opposed to corporate, income), taxes should have no effect on consumer choices.

In contrast, flat taxes on consumption tend to be regressive with regard to income levels and may adversely influence choices between labor and leisure because they "favor" purchases of goods that are in some respects substitutes for work — like camping and sports products. The high cost of administering a European-style VAT has been widely discussed, not always on the basis of adequate data. In Great Britain, the cost was estimated to be as great as ten percent of revenues in the 1970's, when the rate of the tax was relatively low (eight percent).<sup>44</sup> A part of the cost may have been attributable to the "zero-rating" or exemption of a variety of goods and services. More recent estimates for OECD country

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43. See HANS-WERNER SINN, *CAPITAL INCOME TAXATION AND INTERNATIONAL RESOURCE ALLOCATION* (1989); Sijbren Cnossen, *Coordination of Sales Taxes in Federal Countries and Common Markets*, 9 CONN. J. INT'L L. 741 (1994).

44. C.T. SANDFORD ET AL., *COSTS AND BENEFITS OF VAT* (1981).

administration of VAT are considerably lower, and it is possible that estimates for both earlier and more recent periods have been too high.<sup>45</sup> The demoralization associated with yet another layer of paperwork for sellers may constitute a smaller portion of the total cost of VATs in Europe than would be the case in this country.

From the foregoing, it will be clear that the Commission of the European Community believes tax competition to be harmful to the Community. Whether tax competition is harmful itself, i.e., without regard to political and commercial goals of a community that strives for identical conditions on trade within its domain, is another matter. In the view of public choice theorists, governments, too, are participants in something like a market place that must compete for scarce resources. Their tax structures are the means of their competition. Competition may restrain them from inefficiency as producers of public goods and thereby promote greater efficiency in the public sector.<sup>46</sup>

Those who question the basic premises of public choice theory, who, for example, doubt the significance of speculation about the "efficiency of governmental decisions," will no doubt find less to like about tax competition. They may suspect indeed that tax competition *must* result in an aggregate welfare loss. This could follow for any number of reasons from the basic features of tax competition: that it undermines putatively optimal tax systems, that it induces untimely adjustments of tax systems, etc. Measurement of that loss, if any, however, is not currently available. Even if income were a safe proxy for welfare, the national incomes of different countries cannot necessarily be added if we wish to compute the aggregate income of a community. Several researchers have used general equilibrium models to try to ascertain whether a beneficial tax system,

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45. According to Professor Cnossen:

The . . . opening costs of the VAT . . . can be overestimated. In estimating administrative costs, for instance, the 1993 report of the U.S. General Accounting Office (GAO) seems to place too much emphasis on a high audit presence and the subsequent study of the U.S. Internal Revenue Service (IRS) on educational and collection activities. The underlying assumptions are mainly based on experience in the United Kingdom (U.K.) that, although exceptionally well documented, is not necessarily representative of experiences in other countries. Administrative (and compliance) costs in the U.K. are high on account of inadvisable design features of the VAT such as the zero rate on so-called essentials, and due to a misplaced organizational framework, such as the lack of integration with the business income tax for control and audit purposes. In studying the VAT, the U.S. should probably take its example from countries such as Germany and Sweden.

Sijbren Cnossen, *Administrative and Compliance Costs of VAT: A Review of the Evidence*, 63 TAX NOTES 1609 (Jun. 20, 1994).

46. Cnossen, *supra* note 12, at 154.



viewed from the standpoint of its domestic operation alone, could have such negative effects on incoming foreign investment flows as to make the effects of the tax system bad on the whole, i.e., whether tax effects on foreign investment elasticity could dominate other effects of tax policy on welfare. Their efforts appear to show that the effects of taxes on foreign investment could overwhelm the effects of taxes on domestic welfare, holding foreign investment constant (or assuming no foreign investment).<sup>47</sup> Models thus appear to prove that tax competition can turn an otherwise "good" tax system into a "bad" one.

In order to determine whether that transformation might occur in the real world, much more must be known about actual foreign direct investment (FDI) response to taxes. You might think that in a world as well documented as ours has become, this information would be easy to gather; but it is elusive. One reason is that much of the best data about foreign investment flows is collected by governmental agencies like the Department of Commerce without regard to whether foreign ventures in this country use funds brought in from abroad or instead borrow locally. Balance-of-payment figures do not distinguish local borrowing and hence may be deceptive, yet they are virtually all we have. Scholars have disputed the need for, and indeed the very possibility of, making allowance for this aspect of the balance of payment data.<sup>48</sup> The upshot is that we have little reliable information about the actual effect of recent tax law on FDI. A second problem about measuring the effect of taxes on FDI is that empirical research has generally ignored the effect of taxes in the home country of the foreign investor. One investigation concludes that the evidence supports the conclusion either that U.S. taxation of FDI had a negative effect on such investment *or* that stagnation of the foreign investor's home country economy had a controlling influence on the amount of FDI in the United States. The same study concludes that FDI is not measurably affected by the severity of home country taxation or tax relief for foreign-source income.<sup>49</sup>

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47. See Lawrence H. Goulder et al., *Domestic Tax Policy and the Foreign Sector*, in BEHAVIORAL SIMULATION METHODS IN TAX POLICY ANALYSIS (Martin Feldstein ed., 1983); Lawrence H. Summers, *Tax Policy and International Competitiveness*, NATIONAL BUREAU OF ECONOMIC RESEARCH WORKING PAPER NO. 2007 (1986).

48. Joosung Jun, *U.S. Tax Policy and Direct Investment Abroad*, in TAXATION IN THE GLOBAL ECONOMY 55 (Assaf Razin & Joel Slemrod eds., 1990) (arguing for the need for general correction to take local borrowing into account); Michael P. Dooley, *Comments on Jun's U.S. Tax Policy and Direct Investment Abroad*, in TAXATION IN THE GLOBAL ECONOMY, 74-78 (Assaf Razin & Joel Slemrod eds., 1990) (disputing the significance of local borrowing by foreign concerns).

49. Joel Slemrod, *Tax Effects on Foreign Direct Investment in the United States: Evidence From*

Analysis of the effects of interactive tax systems is just beginning.<sup>50</sup> Nevertheless, the urge to harmonize is strongly felt and has the general support of theorists and others who influence tax legislation. The heat of accelerating economic integration does not afford us the luxury of waiting until theory catches up. Given the sense of urgency conveyed by a changing and exotic world capital market, the experience and experiments of the European Union are dazzling to contemporary tax policy makers.

## VI. FREE TRADE AND TAX HARMONIZATION — THE CASE OF THE EUROPEAN UNION

The European Union is of course the most sophisticated of trade agreements. The goal of removing barriers to the free movement of goods, persons, services and capital defined the early European Economic Community, nominal forerunner of today's European Union.<sup>51</sup> Recent steps towards the completion of the internal European market have openly strengthened the political dimension of what started as a purely economic union of sovereign European states.<sup>52</sup> Closely parallel to this political development has been a deepening of the effort of EU tax policy makers to achieve tax coordination among the member states.

Efforts to unify the tax principles of EU countries have fallen into two categories, whose significance is based in part on the Union's organizing instruments. Article 3(f) of the EEC Treaty calls for "the establishment of a system ensuring that competition shall not be distorted in the Common Market" and article 3(h) mandates "the approximation of the laws of the Members States to the extent required for the proper functioning of the Common Market."<sup>53</sup> Since discordant tax laws were among the more obvious causes of distortion that afflicted the member states when the Treaty was first ratified, it might have seemed obvious that the Treaty contemplated broad efforts towards the elimination of idiosyncracies in the member states' tax systems. But the Treaty expressly provided

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a *Cross-Country Comparison*, in *TAXATION IN THE GLOBAL ECONOMY* 79 (Assaf Razin & Joel Slemrod eds., 1990) (disputing the significance of local borrowing by foreign concerns).

50. See, e.g., Roger H. Gordon, *Taxation of Investment and Savings in a World Economy*, AM. ECON. REV. 1086 (1986).

51. The Treaty Establishing the European Economic Community obligates the EC Member States to abolish barriers progressively to the free movement of goods, persons, services, and capital. TREATY ESTABLISHING THE EUROPEAN ECONOMIC COMMUNITY [EEC TREATY].

52. Peter Jenkins, *There Really Is No Alternative*, INDEPENDENT, Apr. 24, 1990, at 21, col. 6 ("[T]he great dream of the founding fathers of the original European communities [was] a United States of Europe.").

53. See EEC TREATY (as amended 1987).

only for the harmonization of indirect taxes,<sup>54</sup> alluding to direct taxation obliquely at best in a provision that exhorted the members to strive towards the reduction of double taxation.<sup>55</sup>

Harmonization of indirect taxes within the EU has been most dramatically achieved in the replacement of turnover taxes by a common system of value-added taxation.<sup>56</sup> Although the member states devised their own VAT regimes and the results differ significantly from state to state, the overall pattern is remarkably strong. Since January 1, 1993, the EU countries have had a standard minimum VAT rate of fifteen percent, with reduced rates of no less than five percent on specified categories of goods and services.<sup>57</sup> It might be argued that the rate disparities among state sales taxes in the United States have not produced substantial economic distortion and that this EU accomplishment is possibly not so important after all. But the comparatively high rate of the European VAT, roughly twice that of the highest state sales taxes, is significant in itself. By adopting such a high indirect tax, each of the EU member states has effectively curtailed its ability to increase direct tax burdens without risking a strong reaction from its voting public. The European VAT harmonization is therefore a double measure — a unification of an important part of the member states' indirect tax systems and a focal point of pressure upon the institution of direct taxation.

Direct taxation was not ignored, however, during the early years of the European Community. In 1960, the EC Commission appointed a fiscal and financial committee to study the detrimental effect of discordant national systems of direct taxation on the goal of an integrated Community-wide market. The committee reported in 1962 that such inharmonious direct taxation could seriously distort the internal market and recommended that all forms of taxes, except individual income taxes, be centrally regulated. In 1967, the EC Commission submitted to the EC Council a proposal to harmonize corporation income taxes.<sup>58</sup> In response, the commission published a pre-draft for a European convention to eliminate

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54. EEC TREATY art. 99 (as amended 1987).

55. EEC TREATY art. 220 (as amended 1987).

56. See Council Directive 67/227, 1967 O.J. (L 71) 1301 (requiring member states to adopt VAT legislation).

57. Jan E. Brinkmann & Andreas O. Riecker, *European Community Taxation: The Ruding Committee Report Gives Harmonization Efforts a New Impetus*, 27 INT'L LAW. 1061, 1063 n.6 (1993).

58. Commission Proposal for Harmonization of Corporate Income Tax, 1967 BULL. EUR. COMMUNITIES, EOC 104, Supp. No. 8 (June 26, 1967).

double taxation, and in 1969 two draft directives<sup>59</sup> on company taxation were published.<sup>60</sup> These directives were ultimately enacted in 1990, bringing to a head the previously stalled efforts of the Community to do something to coordinate members states' corporate tax regimes.<sup>61</sup> Another important step towards EU coordination of direct taxation also occurred in 1990, with the ratification of a multilateral convention among the EU member states requiring arbitration for transfer pricing disputes.<sup>62</sup>

What now complicates the movement towards unification of tax principles within the EU is the politically sensitive adoption of the procedural principle that community-oriented legal reforms should take place at the lowest level of centralization within the EU — the so-called "subsidiarity" principle. The Council of the European Community has interpreted this principle as requiring that its tax coordination efforts should take the form of "directives" rather than "regulations." Directives require member states to take action themselves to revise their laws to comply with a specified EU objective. Regulations, by contrast, are immediately binding upon the member states. Hence, the Council has issued only general orders — directives — concerning tax coordination, and has

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59. Draft-directives are proposed EC directives, submitted by the EC Commission to the member states, for future adoption by the EC Council.

60. Commission Proposal for a Council Directive on the Common System of Taxation Applicable to Parent Companies and Their Subsidiaries of Different Member States, 1969 J.O. (C 039) 7 (relating to dividends flowing between parent and subsidiary companies of member states); Commission Proposal for a Council Directive on the Common System of Taxation Applicable to Mergers, Divisions, and Contributions of Assets Involving Companies of Different Member States, 1969 J.O. (C 039) 1 (relating to mergers and reorganizations).

61. See David C. Donald, *Taxation For a Single Market: European Community Legislation on Mergers, Distributed Profits, and Intracompany Sales*, 22 LAW & POL'Y INT'L BUS. 37 (1991); Jean-Marie Henckaerts, *Recent Developments in Corporate Taxation in the European Communities en Route to the Establishment of the Internal Market*, 13 N.Y.L. SCH. J. INT'L & COMP. L. 47 (1992). The reason for the long delay was the tension within the Community between adherents of the classical corporate tax and adherents of corporate tax integration. The classical corporate tax is one levied on the company as a separate taxpayer from its shareholders or otherwise designated owners, and allowing no deduction from the corporate tax base for dividends paid out; thus corporate earnings are taxed twice, if they are distributed to shareholders. The United States and the Netherlands are perhaps the principal countries that still follow the classical model. An EC Commission headed by A.J. van den Tempel reported in 1970 concerning the variety of company tax schemes then in force within the Community and expressed a preference for the classical model. A.J. van den Tempel, *Corporation Tax and Individual Income Tax in the European Communities (Studies: Competition-Approximation of Legislation Series, No. 15, Brussels 1970)*.

62. Convention 90/436/EEC on the Elimination of Double Taxation in Connection with the Adjustment of Profits of Associated Enterprises, 1990 O.J. (L 225) 10. An EC Convention is an agreement between the EC Member States; unlike a directive, which is binding when issued by the EC Council, no EC Member State is bound by a convention that has been proposed by the Council until the national parliament of that Member State has ratified the convention.

thus left it to the sovereign taxing authorities that make up the Community to devise their individual versions of any required coordinated legislation. Given the complexity of most tax systems, this approach surely represents as much a concession to potential political intransigence as it does a recognition of the administrative differences among national tax systems.

Where does European tax harmonization stand at the moment? The EU, in typically circumspect fashion, has chosen to ask non-governmental experts, who are nevertheless strongly identified with the tax policy positions of their native lands, to assess the situation. The result has been the 1992 report of a Committee of Independent Tax Experts, called the Ruding Committee after its chairperson, Onno Ruding, former Finance Minister of the Netherlands.<sup>63</sup> The core of the report is its analysis of the economic distortions affecting investment decisions and competition that flow from the member states' substantially uncoordinated systems of direct taxation. The report concludes that the distortion in question is substantial and is not likely to be eliminated through the interplay of market forces and tax competition among member states. The report offered a blueprint for reform based largely on a recommended community-wide shift towards company tax integration (elimination of the double tax on distributed corporate earnings). The recommendations included in the blueprint would be implemented in three phases: one to be complete by 1995; a second to correspond to the second phase of the economic and monetary union set forth in other directives; and a final phase to be simultaneous with full economic and monetary union. A central "concrete" recommendation of the unanimous Committee was the establishment of a minimum corporate income tax of thirty percent and a maximum of forty percent in all member states. Nevertheless, the Committee did not unanimously agree to propose a common system of company taxation. Instead, while a majority of the committee favored Professor Albert J. Rädler's proposal according to which the tax paid by a corporation would be imputed to the shareholder receiving a distribution from the corporation (shareholder relief), one member dissented on the grounds that the goal of complete tax harmonization was not an appropriate one for the Committee to consider at the time.<sup>64</sup>

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63. Commission of the European Communities, *Report of the Committee of Independent Experts on Company Taxation (Ruding Committee Report)*, 92 TAX NOTES INT'L 36-15 (1992); Maarten J. Ellis, *Direct Taxation in the European Community: An Irresistible Force Meets an Immovable Object?*, 28 WAKE FOREST L. REV. 51 (1993).

64. As one summary put it:

In particular, a majority of the Committee favored Professor Rädler's proposal that a tax of at least 30% on interest income received by an EC creditor of a corporation in another EC member state should be withheld, in order to level the tax burden on investors' receipts from corporations, whether the form of the investment be denominated as debt or as equity.

The conception of tax coordination implicit in the Professor Rädler's minority annex to the Ruding Report is obviously one that could be implemented more broadly than within the EU. That such a coordinating effort is politically daunting even for the EU, however, underscores the challenge of achieving anything comparable in weaker trade alliances. Some of the reasons are political; others are perhaps more a reflection of the mechanical problems raised by the goal of tax coordination.

## VII. CONCLUSION

What Europe has achieved by conscious design and what the United States and its North American neighbors have achieved by accident are tantalizing variants on the goal of shared sovereignty. The European Union now provides the astonishing example of many highly developed countries, the inventors of national sovereignty, who are willing to listen to nongovernmental experts for advice on the creation of shared constraints for the achievement of tax neutrality. State tax systems within the United States are only now beginning to acknowledge the need for similar coordination. The future will certainly continue to undermine the assumptions of economic isolation and independence that lie at the foundation of

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Although a majority of the committee favored an EC corporate tax system of shareholder relief proposed by one of its members (and presented in an appendix to the report), unanimous agreement with respect to an ideal corporate tax system was not achieved. Nevertheless, the committee concludes that "the adoption by all member states of a common system is a desirable long-run objective." Accordingly, it is recommended that the commission and member states examine in the course of phase 1 alternative approaches to determine the most appropriate common corporation tax system to be adopted in phase 3.

Conceding that it would be difficult to achieve a consensus among member states regarding which system to adopt in the short term, the committee proposes that member states that apply imputation taxes on the distribution of profits earned in another member state should allow, on a reciprocal basis, such tax to be reduced by corporate income tax paid in the other member state in respect to dividends remitted by a subsidiary, or profits earned by a permanent establishment (phase 1).

For a more detailed account, see Albert J. Rädler, *Einheitlicher europäischer Kapitalmarkt und Besteuerung*, in *FESTSCHRIFT FÜR KARL BENSCH* 675 (Heinrich Beisse et al. eds., 1993).

existing systems of direct and indirect taxation, apart from those pioneered, as the VAT has been, to assure multi-jurisdictional neutrality.

