# Editorial

## Taxation and international economic policy

Historically countries have always regarded their rights to tax not merely as a way to raise revenue, but also as an important instrument of international economic policy. The unfortunate role of custom duties as a protective device in the international trade policy during the interwar period is still well known.

After the war, especially during the late sixties and part of the seventies, the issue of the so-called 'border tax adjustments' became a hotly debated issue between the United States and the countries of the European Community.[1] Border tax adjustments are fiscal features which put into effect the destination as opposed to the origin principle. The distinction is between taxes imposed on goods according to the location of their consumption (destination) and goods taxed according to the location of their production (origin). The GATT rules allow a country to rebate indirect taxes, such as the value added tax, on exports and levy a tax on imports equal to the indirect tax burden in the country. This practice rests upon the assumption that direct taxes do not influence prices whereas indirect taxes are shifted forward to the consumers, hence the adjustments are made for indirect taxes only. The key to the United States case against the practice is that these shifting assumptions are inaccurate. For some time it is generally accepted by economists that the corporate income tax is at least partially shifted forward and that there is some backward shifting of indirect taxes. For this reason, it is argued, the present rules favour countries which rely heavily on indirect taxes and discriminate against the United States which relies predominately on direct taxes.

In the context of this column I do not want to discuss the merits of this argument.[2] What matters here is that in the late sixties the advent of the VAT as the EC's new tax system marked a breakingpoint. With the changeover from the old cumulative turnover tax to the VAT, the rate of border tax adjustments increased dramatically simply because of the different mechanism of the tax. Under the old system, a large part of the total tax burden was due at the wholesale and retail level, i.e. after the importation and exportation. The VAT shifted the center of gravity to the earlier stages in production where most of the value is added. As these stages are before exportation, the rate of the border adjustments naturally had to increase. Economists would argue that this apparent change is only an optical illusion since there would occur no change in the relation between the tax burden of domestic, exported and imported products, and, therefore, no change would occur in the price ratio between domestic and imported goods. Nevertheless, it mattered for the American exporter who suddenly saw the whole iceberg instead of only its tip. The subsequent increase of the VAT rates in the wake of its first introduction in the EC countries, did also not help to ease the tension.

The reaction of the United States was interesting. The country did not try to achieve the same advantages by relying more on indirect taxes, but rather tried to adjust its system of direct taxation by allowing a special treatment of export earnings. The 1971 Revenue Act introduced a special corporate entity, the Domestic International Sales Corporation (DISC) – in almost all cases a 'paper' company without any substance – through which export earnings of domestic corporations can be channeled. The DISC itself is not subject to federal income tax and most of its income may be deferred until distribution to its shareholders in the form of dividends. This 'deferral' of income tax allowed to domestic exporters is contrary to the US income tax system, which, in general, allows only a deferral of taxation for the income of foreign companies until repatriated to the US parent company.

The DISC facility is nothing less than an effort to introduce the destination principle into a direct tax system and, under GATT rules, clearly represents an export subsidy.[3] In 1973 the

[1] *See* for instance, Melvyn B. Kraus, 'Border-Tax Adjustments: A Potential Trans-Atlantic Trade Dispute', *Journal of World Trade Law*, Vol. 10 (1976), p. 145.

[2] *See* for a discussion: Michael von Steinaecker, *Domestic Taxation and Foreign Trade: An Evaluation of the International Law of Border Tax Adjustments in the Light of Economic and Legal Theory*, Cornell University, 1971.

[3] *See* Thomas W. Anninger, 'DISC and GATT: International Trade Aspects of Bringing Deferral Home', *Harvard International Law Journal*, Vol 13 (1972), p. 391.

French, Belgian and Netherlands government brought action under GATT to have DISC declared a violation of GATT rules and, not surprisingly, the GATT Panel, which considered the complaints, decided that DISC was inconsistent with GATT rules (*see Intertax* 1977/1).

More interesting was the action simultaneously brought by the United States to have GATT void certain provisions of French, Belgian and Netherlands law, which were charged to constitute export subsidies. It was claimed that the effect of the territorial principle applied in these countries – not taxing income of foreign (sales) subsidiaries – was substantially the same as the DISC treatment in United States law, so if DISC was inconsistent with GATT, so were the tax measures of these countries. Much to the surprise of the European countries involved, the GATT Panel reported that also the specified European tax practices were inconsistent with GATT (*see Intertax* 1977/2). The essential point was that a subsidy could be seen to apply in what was really part of a linked cycle of operations originating in the home country. One link was cut off from another by the practice of setting up sales subsidiaries abroad which received – in the view of the Panel – favourable tax treatment[4].

The European countries involved expressed reservations over these findings and took no action. The United States, however, although not abolishing DISC as such, effectively replaced it in 1984 with the Foreign Sales Corporation (FSC) facility. The FSC is an imitation of the European territorial tax practices, as the United States understand these, in that the income of a foreign sales company with minimum 'substance' would be exempt from US income tax when distributed to the US parent company.

Although disliked by the European Community, no formal action has yet been taken, perhaps because the FSC has not been a success. Even more important may have been the floating exchange rate system, which came into *de facto* effect after August 1971. It has long been argued that any unfair price advantage, given by border tax adjustments, would be compensated, at least in a general way, by an adjustment in the rate of exchange.[5] Any remaining effects may seem insignificant when compared with the impact on international trade of the hectic currency movements during the last decade.

The discussion has now moved away from the effect of direct and indirect taxation on international trade to the effect of taxation on direct investments. Foreign direct investment and multinational enterprises have replaced traditional trade as the primary source of international economic exchange.

In the struggle for the international location of production, tax subsidies and other incentives are frequently used to attrack direct investments by multinational enterprises. Especially in the United States these efforts by other countries are seen as an action to 'pull jobs and exports away from the United States'. It may once again revive the political discussions to achieve 'capital export neutrality' by abolishing deferral for the taxation of the income of foreign subsidiaries. Such legislation, increasing taxation of the foreign income of US corporations with the specific purpose to offset tax inducements offered by host countries, has been justified as representing a precise analogy to present laws, in the trade field, that provide for counter vailing duties against export subsidiaries by other countries.[6]

These measures by home countries could also easily lead to a series of retailiatory and counter-retailiatory steps between them and host countries, replicating the trade wars in the 1930s mentioned at the beginning of this column.

The above may make clear that the international economic aspects of domestic taxation concepts are not to be overlooked. On the other hand taxation, both at the domestic and international level, is not only a matter of economic policy. There are important principles of fairness and justice, in other words, of law, involved. Where both groups, economists and lawyers, usually do not bother to pay much attention to each other's views, it must be refreshing to read, for a change, the comprehensive and important essay by Professor Vogel on the fundamentals of international taxation. This month we also add a new monthly feature. 'Investing and doing business in the US', will comment on selected tax developments of interest to those investing or doing business in the United States and will be written by Paul McDaniel, a member of our editorial board, and Miriam V. Sheehan.

Amsterdam, 15 September 1988
Fred C. de Hosson

[4] For a discussion of the Panel reports by one of the Panel members, *see* A. R. Prest, 'GATT and Company Taxation', *British Tax Review*, 1977, p. 201, 212.
[5] *See* Roger W. Rosendahl, 'Border Tax Adjustments: Problems and Proposals', *Law and Policy in International Business*, 1979, p. 85, 142.
[6] *See* C. Fred Bergsten, *Coming Investment Wars?, Foreign Affairs*, 1974, p. 135, 151.