

The WTO and Direct Taxation: Direct Tax Measures and Free Trade

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I. INTRODUCTION

The power to tax is one the highest privileges of sovereignty. Therefore, one might ask how the World Trade Organization (WTO), a supranational body, far from relying on a solidarity like in the EU or even the US, might dare to rule on direct taxes. Yet, membership in the WTO is voluntary. Today's globalized world grants more wealth to all states and their citizens than any other period in human history.¹ The foundation of this freedom, wealth, and of those opportunities is efficient world-wide trade. If a WTO member state abuses its power to levy direct taxes in order to put obstacles in the way of trade, the WTO has not only the right, but the duty to level the playing field between its members.

A. MOTIVATION

Efficient world-wide trade in a globalized world requires that all economic actors are subject to the same rules and merits the least obstacles possible. The WTO is the most important multilateral organization regulating international trade.² Its objective is to “provide[...] a forum for negotiating agreements aimed at reducing obstacles to international trade and ensuring a level playing field for all.”³ Its main goals, namely

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¹ Andreas Bergh & Therese Nilsson, *Is Globalization Reducing Absolute Poverty?*, 64 *WORLD DEV.* at 42 (2014); ANGUS DEATON, *GREAT ESCAPE: HEALTH, WEALTH, AND THE ORIGINS OF INEQUALITY* 23-58 (2013).

² Antonio Grimaldo Monroy, *The Relevance of WTO Law for International Tax Law*, in *THE RELEVANCE OF WTO LAW FOR TAX MATTERS* 19, 19 (Judith Herdin-Winter & Ines Hofbauer eds., 2006).

³ *What is the WTO?*, WTO (last visited July 8, 2017), https://www.wto.org/english/thewto_e/whatis_e/wto_dg_stat_e.htm.

raising global living-standards by promoting the exchange of goods, services, and capital, are the same as those of international taxation.⁴ Therefore, the WTO treaties contain different regulations regarding indirect taxation. Direct taxation, on the other hand, is officially only regulated by the Agreement on Subsidies and Countervailing Measures (SCM Agreement). Yet, one might argue that direct taxes have an impact on trade that is similar to the obstacles the WTO's main treaties are meant to reduce. The motivation of this study is to inquire whether the WTO is authorized to rule on direct taxation and, if so, if this is desirable from an economic point of view.

B. RESEARCH QUESTION

The question as to whether direct taxes should be exempt from WTO rules is twofold. First, direct taxes are only within the WTO's jurisdiction if they are part of the WTO treaties. If the principles of international law do not allow an interpretation of the WTO treaties which gives the WTO jurisdiction over direct tax matters, economic considerations cannot give it jurisdiction in this area. However, if the WTO cannot achieve its goals without at least partial control over direct taxation, direct taxes cannot reasonably be entirely exempt from WTO rules. Still, a special jurisdiction granted by the secondary treaties would leave the question of whether the WTO has broader general jurisdiction in the field of direct taxation derived through its main treaties.

Second, if the treaties do permit the WTO to rule on direct taxes from the legal perspective, the question arises whether this should be recommended from an economic point of view. The WTO promotes trade between its members. If the impact of direct taxes is restricted to the members' national economies, international trade would not benefit from their inclusion under WTO rules. Moreover, if it is more reasonable to let other supranational bodies preside over questions of direct taxation, the WTO might be wise to abstain from doing so.

C. DELIMITATION

In this study, I am going to presume the legitimacy of the WTO and its positive impact on world economics. While the WTO has been criticized since its establishment,⁵ arguing its legitimacy *per se* would go beyond the range of this paper. Furthermore, if the WTO does not have a positive impact on world economics, its rules would have to be revised in their

⁴ MICHAEL DALY, THE WTO AND DIRECT TAXATION 16 (2005).

⁵ Michael Fahkri, *Reconstructing the WTO Legitimacy Debates*, 2 NOTRE DAME J. OF INT'L & COMP. L. 64, 64-100 (2011).

entirety. Answers to questions of whether those revised rules should regulate direct taxation could only be speculative. Thus, in this study I will assume that the WTO has a positive impact on world economics.

As shown above, this study focuses on direct taxes and their interference with WTO rules. Therefore, I will not discuss the interference between WTO rules and indirect taxes. Furthermore, other supranational regulations, e.g. directives and regulations of the European Union (EU), are relevant to this study only insofar as they might regulate direct tax measures instead of the WTO. Finally, while tax treaties are an important part of the reality of modern tax planning, they are not in the focus of this study.

The official languages of the WTO are English, French, and Spanish.⁶ In this study, I exclusively rely on the English version of the WTO treaties.

D. METHODOLOGY

To determine whether direct taxes should be exempt from WTO rules, I will determine (1) whether they can be included at all, (2) how they may interfere with each other, and (3) whether giving the WTO the means to regulate them is economically desirable.

First, I will focus on the question of whether and to what extent the WTO treaties allow the WTO to regulate direct tax laws. I will start with the wording of the WTO treaties and how they are interpreted by legal scholars. Then, I will show that the WTO and its member states recognize the WTO's jurisdiction on direct taxation in settlements before the Dispute Settlement Body (DSB).

Second, I will show how WTO rules and direct tax laws can interfere and how they have interfered in the past. I will point out the different ways such interference can occur, as well as discuss the most important settlements before the DSB regarding direct taxation.

Third, I will focus on the economic implications of my research question. Hereby, I will start by investigating whether inclusion of direct taxation into WTO regulations would have a positive impact on the WTO's goals from an economic point of view. I will do so by referencing scholarly opinions as well as arguments brought forth during settlements before the DSB. I will also engage with scholarly opinions on whether the WTO is the best supranational body to rule on this topic.

⁶ WTO, *supra* note 3.

Finally, I will make a conclusion on whether these arguments warrant the WTO to regulate direct taxes or whether direct taxation should be totally exempted from WTO rules.

II. BENCHMARK

In theory, WTO rules should not interfere with direct taxation. The WTO's main objectives are to promote trade between its members, to administer and monitor the application of its rules, and to function as a dispute settlement platform.⁷ The WTO treaties, mainly the General Agreement on Tariffs and Trade (GATT), the Agreement on Trade-Related Investment Measures (TRIMS) the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS), and the General Agreement on Trade in Services (GATS), give the WTO a means to these ends.⁸ Direct taxes give the levying states the means to promote their own goals. Nowadays, these include not only the protection of their citizens from domestic and international violence, but also general and public welfare and other similar goals. Furthermore, unlike indirect taxes, direct taxes are not directly levied on goods and services, with which the WTO is directly concerned.

Direct taxes might have a prohibitive effect on intrastate activities that lawmakers see as undesirable. However, the taxes' effects are limited to activities undertaken inside a state's borders or by that state's citizens. Thus, the levying of intrastate direct taxes and the WTO's rules regarding interstate commerce should not interfere.

Additionally, the right to levy taxes is among the highest privileges of government and a symbol of sovereignty. Thus, the right to rule on direct taxes should remain exclusively with the states and should be totally exempted from WTO rules.

Finally, decentralization tends to increase efficiency.⁹ Therefore, even if direct taxes are regulated on a supranational level, this should be done as locally as possible rather than by the WTO on a global level.

⁷ *Id.*

⁸ MICHAEL DALY, FISCAL AFFAIRS DEP'T, IMF, IS THE WTO A WORLD TAX ORGANIZATION? A PRIMER ON WTO RULES FOR TAX POLICYMAKERS 12 (2016).

⁹ *Decentralization: A Sampling of Definitions* 16-17, 26-28 (UN Dev. Programme & Gov't of Germany, Working Paper), http://web.undp.org/evaluation/documents/decentralization_working_report.PDF.

III. LEGAL BACKGROUND

A. PRINCIPLES

At the foundation of the WTO are the principles of non-discrimination, predictability and stability.¹⁰ The cornerstones of the non-discrimination principle are the Most Favored Nation (MFN) treatment principle and the National Treatment (NT) principle.¹¹ The MFN treatment principle of GATT Article I, GATS Article II, and TRIPS Article 4 require a member state of the WTO to grant all other member states the same concessions.¹² While there is no general MFN principle in international taxation, the MFN principle applies where tax treaties effectively create a diversion for international capital flows.¹³

The NT principle of GATT Articles III, GATS Article XVII, and TRIPS Article 3 prevent WTO members from treating nationals of other member states worse than their own nationals.¹⁴ Thus, just like the MFN principle prohibits international taxation to discriminate between the cash-flow from different WTO member states, the NT principle prevents member states from discriminating between their citizens and other members' citizens by means of internal taxation.¹⁵

B. GENERAL AGREEMENT ON TARIFFS AND TRADE

The GATT is not merely one of the main WTO treaties.¹⁶ It even predates the WTO and constitutes the foundation on which the WTO was built.¹⁷ Initially, direct taxes were not considered to be regulated by the GATT.¹⁸ This was in accordance with the signatory

¹⁰ DALY, PRIMER, *supra* note 8.

¹¹ *Id.* at 13; Thomas Ecker & Franz Koppensteiner, *Anwendbarkeit der WTO-Abkommen auf direkte und indirekte Steuern [Applicability of the WTO Treaties to Direct and Indirect Taxation]*, 3 STEUER UND WIRTSCHAFT INT'L TAX AND BUS. REV. 142, 142 (2009).

¹² Monroy, *supra* note 2, at 25.

¹³ DALY, DIRECT TAXATION, *supra* note 4, at 18.

¹⁴ Monroy, *supra* note 2, at 25.

¹⁵ DALY, DIRECT TAXATION, *supra* note 4, at 19.

¹⁶ Michael Daly, *Is the WTO a World Tax Organization? A Primer on WTO Rules for Tax Policymakers*, 5 (Fiscal Affairs Dep't, IMF, 2016), <https://www.imf.org/external/pubs/ft/tnm/2016/tnm1602.pdf>.

¹⁷ *Id.* at 5.

¹⁸ Stefan Fahlis, *The Applicability of Art. I and III GATT to Direct Taxes*, in THE RELEVANCE OF WTO LAW FOR TAX MATTERS, *supra* note 2 at 37, 40 (Judith Herdin-Winter & Ines Hofbauer-Steffel eds., 2006).

states' intention to limit the GATT application to indirect taxes.¹⁹ Yet, direct taxes can have a severe impact on international trade. Thus, the applicability of the GATT on direct taxes has been highly controversial.²⁰

The language of the treaties alone is insufficient to interpret them. Like other international treaties, the WTO treaties are interpreted according to the principles laid down in Arts. 31–32 of the Vienna Convention on the Law of Treaties.²¹ Therefore, the WTO treaties must in general be interpreted by looking first at their text to evaluate what the signing parties meant to say.²² Hereby, the interpreter has to avoid looking beyond the language of the texts itself and considering the “object and purpose” of the treaties.²³ Rather, he has to analyze the “expressed intent,” that is, he must read the treaty as a third country interested in joining would interpret it without further consultation with the signatory states.²⁴ Yet, when this is insufficient to provide an answer, for example because the treaty does not address the issue, the object and context of the treaty are used in addition to its text.²⁵ Originally, this led to a rather restrictive interpretation. Since direct taxes do not apply directly to goods, they were initially excluded from the range of Articles I, III GATT according to a more textualist approach.²⁶ In contrast, the modern interpretation of the GATT includes direct taxes into the range of Article III (and subsequently Article I).²⁷ This interpretation is based on GATT Article III para. 2, which prohibits the member states from applying higher taxes or other internal charges on imported products than on “like” internal products. This interpretation of Article III would suggest that the signatory states had taxes in mind when drafting the GATT. That they could envision the extent to which indirect, and direct, taxes could influence the trade between member states, is less certain.²⁸ It seems likely that the member states did

¹⁹ See Ecker, *Applicability of the WTO Treaties to Direct and Indirect Taxation*, *supra* note 11; see also Michael J. Graetz, *International Aspects of Fundamental Tax Restructuring: Practice or Principle*, 51 UNIV. OF MIAMI TAX L. REV. 1093, 1097 (1997).

²⁰ Michael Daly, *The WTO and Direct Taxation (Discussion Paper No 9)*, 9 (WTO, 2005), https://www.wto.org/english/res_e/booksp_e/discussion_papers9_e.pdf; Stefan Fahlis, *The Applicability of Art. I and III GATT to Direct Taxes*, in *THE RELEVANCE OF WTO LAW FOR TAX MATTERS*, *supra* note 18 at 37, 40–41 (Judith Herdin-Winter & Ines Hofbauer-Steffel eds., 2006).

²¹ Michael Lennard, *The GATT 1994 and Direct Taxes: Some National Treatment and Related Issues*, in *WTO AND DIRECT TAXATION* 73, 76 (Judith Herdin-Winter & Ines Hofbauer-Steffel eds., 2005).

²² *Id.* at 76–77.

²³ *Id.*

²⁴ *Id.* at 77.

²⁵ *Id.* at 76.

²⁶ Servass van Thiel, *General Report*, in *WTO AND DIRECT TAXATION*, *supra* note 21 at 13, 19 (Michael Lang, Judith Herdin, Ines Hofbauer eds., 2005).

²⁷ See Ecker, *Applicability of the WTO Treaties to Direct and Indirect Taxation*, *supra* note 11.

²⁸ *Id.*

not want to exclude direct taxes from the GATT, but rather that they merely did not think of them as being important to the WTO's goals. Additionally, the WTO's power to rule on disputes concerning direct taxation is accepted as part of the GATT at least since the decision on the dispute between the European Community (EC) and the USA regarding the USA's Foreign Sales Corporation (FSC) Scheme.²⁹ This decision was highly controversial between the EC and the USA. Yet, the USA appealed only the decision, not the DSB's broader jurisdiction on direct tax matters. Thereby, it acknowledged the DSB's jurisdiction over direct tax matters. The DSB can only have jurisdiction in this field if it is within the scope of the WTO's power. Initial doubts notwithstanding, the GATT now does give the WTO the power to rule on direct tax questions.

C. AGREEMENT ON SUBSIDIES AND COUNTERVAILING MEASURES

The SCM Agreement on the other hand sets limits on how WTO member states may subsidize products and how member states may counteract subsidies by other members.³⁰ The SCM Agreement acknowledges direct taxes in footnote 59 and gives several examples in Annex I. Thus, this Agreement gives the WTO the legal power to rule on direct tax matters.³¹

D. GENERAL AGREEMENT ON TRADE IN SERVICES

The GATT and SCM Agreement, as well as most other WTO treaties exclusively deal with goods. To fill the resulting gap and regulate the trade of services, the WTO members signed the GATS. In contrast to the other WTO treaties, the GATS excludes direct taxes in several cases from its scope in Article XIV.³² These exemptions, however, imply that direction taxes are otherwise included.³³ Additionally, the MFN and NT principle are of paramount importance in the GATS because they acknowledge not only the origin of the service, but also of the supplier.³⁴ Even if the NT is according to GATS Article XXII not

²⁹ Michael Daly, *Is the WTO a World Tax Organization? A Primer on WTO Rules for Tax Policymakers*, 2 (Fiscal Affairs Dep't, IMF, 2016), <https://www.imf.org/external/pubs/ft/tnm/2016/tnm1602.pdf>.

³⁰ Art. 3-4 SCM Agreement.

³¹ Michael Daly, *Some Taxing Issues for the World Trade Organization*, Vol. 48, No.4 CANADIAN TAX J./REVUE FISCALE CANADIENNE 1053, 1059 (2000); see also Ecker & Koppensteiner, *Applicability of the WTO Treaties to Direct and Indirect Taxation*, *supra* note 11 at 142, 146-147.

³² Michael Daly, *Is the WTO a World Tax Organization? A Primer on WTO Rules for Tax Policymakers*, 27 (Fiscal Affairs Dep't, IMF, 2016), <https://www.imf.org/external/pubs/ft/tnm/2016/tnm1602.pdf>.

³³ Appellate Body Report, *United States – Tax Treatment for “Foreign Sales Corporations,”* ¶119, WTO Doc. WT/DS108/AB/RW (adopted Feb. 13, 2006). See Panel Report, *United States – Tax Treatment for “Foreign Sales Corporations,”* WTO Doc. WT/DS108/R (adopted Jan. 29, 2002).

³⁴ DALY, PRIMER, *supra* note 8, at 27.

applicable to disputes regarding treaties meant to avoid double taxation, it still generally applies to services under the GATS.³⁵ Therefore, the GATS excludes certain direct tax measures from WTO rules, yet in general allows the WTO to rule on them.

E. CONCLUSION

From the legal point of view, direct taxes may be included in WTO rules. At its origin, the member states did not intend the GATT or the WTO to rule on direct taxes. Yet, over time the WTO members accepted the WTO's jurisdiction on this matter. They showed this not only by acknowledging the WTO's jurisdiction on direct tax matters, but also by explicitly mentioning direct taxes in the SCM Agreement. Furthermore, the very foundation of the WTO treaties is the non-discrimination principle. As shown above, direct tax measures can lead to legal discrimination. Thus, from the strictly legal point of view, the prevention of discrimination speaks for the inclusion of direct taxation into WTO rules. The GATS excludes certain areas of direct taxation from WTO jurisdiction, but generally allows the WTO to rule on direct tax matters to advance its goals of efficient world-wide trade. Finally, within the scope of the SCM Agreement, the member states explicitly gave the WTO the legal power to rule on direct taxes.

IV. INTERFERENCES

As shown above, the range governed by WTO rules has continuously expanded. This led to more possible interferences between these rules and direct taxation laws *inter alia*. Some of these interferences have already led to disputes before the DSB. However, the DSB did not come to a decision in all of these cases, and some possible interferences have not yet been brought before the DSB.

A. PROMOTION OF EXPORTS

Direct taxes can interfere with the NT principle by aiding exports. The disputes between the US and the EC regarding the FSC and Extraterritorial Income (ETI) schemes are considered to have the furthest-reaching implications.³⁶ Initially, the US exempted the income generated by sale and lease of "export property" from taxation if significant parts

³⁵ *Id.* at. 27–28.

³⁶ Yariv Brauner, *International Trade and Tax Agreements May Be Coordinated, But Not Reconciled*, 25 VA. TAX REV. 250, 295 (2005); DALY, PRIMER, *supra* note 8, at 9.

of the transaction happened outside of the United States.³⁷ The legal basis was the “Deficit Reduction Act”, which set the rules for FSCs. “Export property” comprised products that an FSC held for sale or lease, that were produced in the US by a company other than the FSC, that were intended to be used or re-sold outside of the US, and that did not consist of more than 50% “foreign content”.³⁸ In combination with specific pricing rules regarding FSCs, the exemptions lead to a tax reduction of 15–30%.³⁹ The US perceived this tax advantage to be necessary for two reasons. First, unlike the European “territorial” system, under the American “world-wide” system, the residents’ world-wide income is taxed.⁴⁰ Second, unlike the EC, the US did not and does not levy a value-added tax (VAT) on imports.⁴¹ From the US’s point of view, the rules regarding FSCs were only meant to exclude (some) foreign economic activities and to compensate for these disadvantages.⁴² The WTO agreed that the US does not have to tax world-wide income. Yet, doing so in general, while excluding some economic activity, effectively creates a subsidy for that activity.⁴³ Therefore, the FSC rules constituted prohibited export subsidies. Subsequently, the US enacted the “FSC Repeal and Extraterritorial Income Exclusion Act of 2000” (ETI Act). However, the WTO found the ETI Act to be also in violation of its rules. Its reasoning relied on four main rules. First, the ETI Act still constituted a specific exception from the US’s tax system and thus a subsidy. Second, those exceptions were “dependent or contingent upon export” according to Article 3.1 (a) of the SCM Agreement. Third, the scope of the ETI Act was too broad to merely prevent double-taxation. Fourth, the limitation of imported parts to 50% discriminated against foreign goods.⁴⁴ Consequently, the US repealed the ETI Act by enacting the “American Jobs Creation Act of 2004”.⁴⁵

Seemingly in retaliation, the US requested consultation with Belgium,⁴⁶ the Netherlands,⁴⁷ Greece,⁴⁸ Ireland,⁴⁹ and France⁵⁰ concerning certain income tax measure

³⁷ JOHANN WAGNER, *DIREKTE STEUERN UND WELTHANDELSRECHT: DAS VERBOT ERTRAGSTEUERLICHER EXPORTSUBVENTIONEN IM RECHT DER WTO* [Direct Taxes and World Trade Law: The Prohibition of Corporate Tax Related Export Subsidies in WTO Rules] 77 (2006).

³⁸ 26 U.S.C.S § 927(a) – Repealed.

³⁹ DALY, PRIMER, *supra* note 8, at 35, n.86; WAGNER, *supra* note 37, at 78.

⁴⁰ DALY, PRIMER, *supra* note 8, at 36.

⁴¹ *Id.*

⁴² WAGNER, *supra* note 37, at 81.

⁴³ *Id.* at 81–93.

⁴⁴ DALY, PRIMER, *supra* note 8, at 37.

⁴⁵ 108 P.L. 357.

⁴⁶ Request for Consultations by the United States, *Belgium – Certain Income Tax Measures Constituting Subsidies*, WTO Doc. WT/DS127/1 (May 5, 1998).

by these countries. No dispute panel was established, however, and the parties did not notify the WTO that they came to a solution.

Another example of the promotion of exports may be seen in China's tax laws regarding foreign-invested enterprises (FIE). FIEs in China get a 50% tax reduction if they export at least 70% of their production, and a 100% reduction for the amount of profits they re-invest in export-oriented activity for at least five years.⁵¹ This can *in praxi* be seen as having the same effects export subsidies have in a tax system with a non-discriminatory corporate income tax.⁵²

B. PREVENTION OF IMPORTS

Nonetheless, direct tax laws may also have a prohibitive impact on imports which counters the aims of the NT principle. A direct way to reduce imports and support local production is the Korean rumor that the purchase of a foreign-produced car leads to a tax audit.⁵³ The tax laws do not even have to actually be in force if the rumor of their existence is enough to further their goals. On the one hand, such a rumor does not increase the sales price of imported cars. On the other hand, it does raise the price from the buyer's point of view. If the buyer thinks that buying an imported car might or even necessarily will lead to a tax audit, he will take the costs related to the audit into consideration when buying such a car. Furthermore, the threat of a tax audit may even prevent buyers from purchasing foreign cars at all. Supporting such a rumor therefore reduces imports.

Another example of a way in which direct tax laws may negatively impact imports, which is more similar to tariffs, is the Malaysian treatment of insurance companies. Several countries, including member states of the EU, grant income tax relief for pension plans and life insurance supplied by domestic companies.⁵⁴ The Malaysian treatment differs from the European policy in that Malaysian "reliefs" only apply to annuities

⁴⁷ Request for Consultations by the United States, *Netherlands – Certain Income Tax Measures Constituting Subsidies*, WTO Doc. WT/DS128/1 (May 5, 1998).

⁴⁸ Request for Consultations by the United States, *Greece – Certain Income Tax Measures Constituting Subsidies*, WTO Doc. WT/DS129/1 (May 5, 1998).

⁴⁹ Request for Consultations by the United States, *Ireland – Certain Income Tax Measures Constituting Subsidies*, WTO Doc. WT/DS130/1 (May 5, 1998).

⁵⁰ Request for Consultations by the United States, *France – Certain Income Tax Measures Constituting Subsidies*, WTO Doc. WT/DS131/1 (May 5, 1998).

⁵¹ DALY, DIRECT TAXATION, *supra* note 4, at 13.

⁵² *Id.*

⁵³ *Id.* at 13, n. 37.

⁵⁴ *Id.* at 13.

purchased from domestic companies if they are domestically owned.⁵⁵ Conversely, European countries grant these measures of relief to any domestic companies. Both approaches do not legally apply import duties to pension plans and life insurance policies. However, the Malaysian approach has a similar effect and does effectively discriminate between companies on the basis of their ownership.

Both measures, supporting the rumor of an impending tax audit, as well as the different treatment of FIEs, interfere with the NT.

C. SUPPORT OF DOMESTIC PRODUCTION

Furthermore, direct taxes may be used to further domestic production more directly. In the fields of “agriculture, manufacturing and various services”⁵⁶ and for certain activities, e.g. research & development, this is long-standing practice.⁵⁷

An example for the support of domestic production by direct tax laws is the Chinese rules regarding appliances. If these products are made domestically, 40% of the corresponding investment can be deducted from corporate income taxes.⁵⁸ This effectively reduces the costs of domestically produced appliances. If a domestic and a foreign-produced appliance have the same nominal price, a Chinese company would have to pay the full price for the foreign-produced appliance, while the effective price for the Chinese one would be only 60% of the nominal price. Hence, to be able to compete on the Chinese market, a foreign company would have to be able to either produce appliances of the same quality 40% cheaper or produce 40% more durable appliances for the same price. Moreover, the tax deductibility might incentivize debt-based purchases of domestically-made machinery and equipment beyond the company’s actual needs. This also would only benefit Chinese manufacturers. Foreign-based companies could not profit from these investments but would have to encounter the reduced demand later when the additional appliances are needed. Thus, foreign manufacturers are severely disadvantaged compared to Chinese ones.

V. ECONOMIC REASONING

⁵⁵ *Id.*

⁵⁶ *Id.* at 14.

⁵⁷ Junxue Jia & Guangrong Ma, *Do R&D Tax Incentives Work? Firm-Level Evidence from China*, 46 CHINA ECON. REV. at 50, 50-51 (2017); Boris Lokshin & Pierre Mohnen, *Do R&D Tax Incentives Lead to Higher Wages for R&D Workers? Evidence from the Netherlands*, 42 RES. POL’Y at 823, 823 (2013).

⁵⁸ DALY, DIRECT TAXATION, *supra* note 4, at 14.

Economically, the WTO needs to be able to rule on direct taxes to achieve its goals of providing for efficient trade world-wide; moreover, the WTO is the only supranational body able and willing to achieve these goals.

As shown above, direct tax measures are *in praxi* capable of interfering with the WTO's goal of attaining a level playing field and ensuring the MFN and NT principles, just like those measures the WTO treaties aim to prevent. While legally there is a difference between promoting exports through subsidies or through tax incentives, from an economic point of view both measures have similar effects. The support an activity receives from further income because of subsidies is *de facto* the same as that from lower expenditure due to tax incentives. Yet, if production for export purposes receives governmental support, the affected companies have an economic advantage over their competitors in the destination countries, as well as those from third countries wherein the government does not support production in such a way. Thus, to ensure equal rules for all economic actors, the WTO needs to be able to rule on direct taxes in this regard.

Additionally, international trade is similarly distorted, whether a WTO member prevents imports through tariffs or by collecting higher taxes from FIEs. Tariffs have a distorting effect on cross-border trade.⁵⁹ Imposing higher taxes on foreign companies' products has the same effect as tariffs, and thus doing so similarly distorts the playing field.⁶⁰

The Chinese support for domestic manufacturers shows that income taxes may have a high impact on the competitiveness of manufacturers. If part of the investment for machinery can be deducted only if the machinery was made domestically, foreign manufacturers can compete only in exceptional cases. In the Chinese example, foreign producers had to be 40% more efficient, and thus had to offer 40% lower prices, just to be on par with Chinese producers. Such a tax incentive is not only incompatible with a common set of rules for domestic and foreign companies and therefore with the NT principle.

Double taxation does not necessarily involve laws even recognizing cross-border trade. Rather, it can be the result of tax rules aimed exclusively at domestic economic actions. Yet, as shown above, these policies may have a prohibiting effect on cross-border

⁵⁹ Przemyslaw Kowalski, *Impact of Changes in Tariffs on Developing Countries' Government Revenue*, 18 OECD WORKING PAPER SERIES, May 2006, at 109, 110.

⁶⁰ Luosha Du, Ann Harrison & Gary Jefferson, *FDI Spillovers and Industrial Policy: The Role of Tariffs and Tax Holidays*, 64 WORLD DEV. at 366 (2014); see also Kenji Fujiwara, *Tax Principles and Tariff-Tax Reforms*, 71 FINANZARCHIV/PUB. FIN. ANALYSIS 360 (2015).

investments. Tax holidays, on the other hand, attract foreign investment. Both effectively lead to a different treatment between the countries' own residents and those of other states. For all of these abovementioned reasons, the WTO could not effectively advance its goals while lacking jurisdiction over direct taxation.

Having said that, one might argue that the WTO would not be the right body to rule on direct taxes. It might be more economically sound to leave the regulation of direct taxes to other supranational bodies. For example, the EU recognizes the subsidy-like nature of certain direct tax measures, as well.⁶¹ Yet, its goals are to promote the European market, not world-wide trade. Where EU member states' interests collide with world-wide trade, the former prevails. For example, the EU supports companies in its member states by state aids and subsidies.⁶² While the exact impact of these measures on businesses is disputed,⁶³ they enhance the economic capabilities of EU companies, possibly to the detriment of overall world trade. Christina Davis even says the EU was "notorious for delaying tactics" and showing a "pattern of non-cooperation" regarding WTO rules and the ensuing disputes.⁶⁴

Similarly, the North American Free Trade Agreement (NAFTA) also acknowledges subsidies and has its own dispute settlement mechanism.⁶⁵ However, the US, Canada, and Mexico signed NAFTA to promote trade between them, not to promote world-wide trade *per se*. While other supranational bodies might rule on direct taxes as well, only the WTO intends to do so for world-wide trade instead of the well-being of a closed group. Therefore, the WTO cannot rely on them to rule on direct taxes, but must be able to do so itself.

VI. CONCLUSION

The WTO's objective is to provide a level playing field for international trade. This cannot be archived if the member states discriminate between their own and foreign nationals or between foreign nationals depending on their states of residence. Tariffs,

⁶¹ John Temple Lang, *EU State Aid Rules – The Need for Substantial Reform*, EUROPEAN STATE AID QUARTERLY no. 3, 2014, at 440, 446-447.

⁶² Romualdas Ginevičius & Šarūnas Bruzgė, *Evaluation of the Effect of State Subsidies on Business*, BUS, MANAGEMENT AND EDUC., no 1, 2013, at 50, 51.

⁶³ *Id.* at 50-76.

⁶⁴ Christina L. Davis, *A Conflict of Institutions? The EU and WTO/GATT Dispute Adjudication 2*, <https://www.princeton.edu/~cldavis/files/euwt0.pdf> (last visited February 18, 2018).

⁶⁵ Stephen Joseph Powell & Ludmila Mendonca Ribeiro, *Managing the Rule of Law in the Americas: An Empirical Portrait of the Effects of 15 Years of WTO, MERCOSUL, and NAFTA Dispute Resolution on Civil Society in Latin America*, 42 U. MIAMI INTER-AMERICAN L. REV. no. 2, 2011, at 197, 218-220.

subsidies, and equally direct tax measures might lead to discrimination. When the GATT was originally signed, this fact was not obvious to its signatories. Yet, over time it has become abundantly clear. Therefore, the WTO members accepted the WTO's jurisdiction on direct taxes. They made this clear not only by accepting the DSB's decisions regarding direct taxes, but even by acknowledging direct taxes in the SCM Agreement. The legal perspective not only allows their inclusion into WTO rules, but even promotes it.

From the economic point of view, the WTO cannot reach its goals without ruling on direct taxes. Direct taxes can interfere with cross-border trade in a way similar to tariffs. They also can have a subsidy-like effect. Furthermore, other supranational bodies intending to promote trade between their member states might even actively support companies therein. For example, while the proposed common consolidated corporate tax base (CCCTB) in the EU is meant to ease the regulatory burden for all companies doing business in the EU,⁶⁶ some benefits will apply only to companies that are resident in EU Member States.⁶⁷ The WTO is the only supranational body that promotes world-wide trade instead of supporting the economies of certain countries. Thus, the economic point of view demands the inclusion of direct taxes into WTO rules.

The WTO's member states and their people profit highly from their WTO membership and the corresponding increase in trade on sectors covered by the WTO treaties.⁶⁸ Not being able to levy taxes to put obstacles in the way of world-wide trade and thereby gain an advantage over other members does not limit their sovereignty. That states abide to the treaties they signed as long as they are party to them, the principle of *pacta sunt servanda*, enables them to act reliably not only within their borders, but with each other, as well. If international treaties were not binding to signatory states, they would lose their meaning. Only reliability and adherence to treaties signed allows states to coordinate on an international level. As long as a state is party to a treaty, it has to execute it in good faith.⁶⁹ Having said that, WTO member states always are free to leave. While an exit from the WTO is a complicated process with severe consequences that strips the exiting state from WTO benefits, it is possible.⁷⁰ Membership in the WTO is voluntary. During

⁶⁶ Commission, *Proposal for a Common Consolidated Corporate Tax Base*, COM(2016) 683 final, Consideration 1.

⁶⁷ Christian L.J.O.J. Neufeldt, *The Influence of Brexit on CCTB/CCCTB and British Companies*, 2017, <http://arno.uvt.nl/show.cgi?fid=143916>, at 35.

⁶⁸ Myeong Hwan Kim, *Does the WTO Promote Trade? Further Evidence*, 19 (3) J. INT'L TRADE & ECON. DEV. at 421 (2010).

⁶⁹ Art. 26 of the Vienna Convention on the Law of Treaties.

⁷⁰ Brian Hindley, *New Institutions for Transatlantic Trade?*, 75 INT'L AFF. at 45, 49 (1999).

the termination process, states still have to abide to treaties they are party to, yet thereafter they are released from any obligations of the treaty.⁷¹ The ability to participate in bodies such as the WTO is an aspect of sovereignty itself. Therefore, the member states' obligation to comply with WTO rules as long as they are bound by the WTO treaties is not a limitation, but an expression of their sovereignty.

Holistically, the WTO cannot reach its goals, or even promote them in a meaningful way, without being able to set rules regarding certain direct tax measures. Direct taxes should not be totally exempted from WTO rules.

⁷¹ Art. 70 of the Vienna Convention on the Law of Treaties.