BOSTON UNIVERSITY Global Development Policy Center

Domestic Resource Mobilization and the Trade and Investment Regime

The Need for Policy Coherence

A GDP Center Report

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REPORT AUTHORS

Devika Dutt
Rashmi Banga
Rick Rowden
Andrew Kerner
Vahini Naidu
Reuven Avi-Yonah
Sonia Rolland
Manuel Montes
Todd Tucker
Jane Kelsey
Rachel Thrasher

REPORT EDITORS

Rachel D. Thrasher
Kevin P. Gallagher

The **Global Development Policy (GDP) Center** is a University-wide center at Boston University in partnership with the Frederick S. Pardee School for Global Studies and the Vice President and Associate Provost for Research. The GDP Center conducts interdisciplinary research to advance policy-oriented research for financial stability, human well-being, and environmental sustainability across the globe.

Global Development Policy Center
Boston University
53 Bay State Road
Boston, Massachusetts 02215
Tel: +1 617-353-7766
www.bu.edu/gdp
Email: gdp@bu.edu
Twitter: @GDPC_BU
Facebook: @GDPCenter

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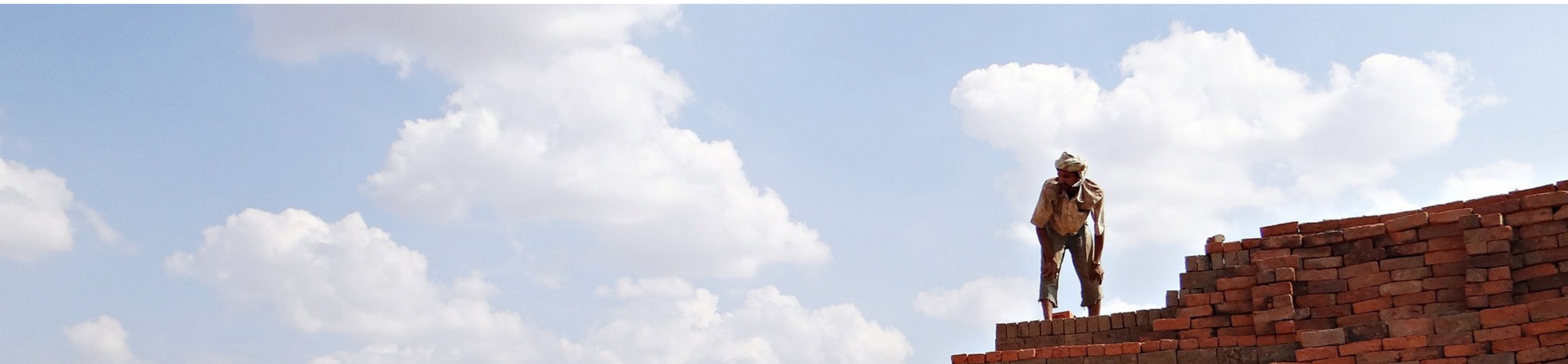
PREFACE AND ACKNOWLEDGEMENTS

In November of 2019 the Global Development Policy Center at Boston University teamed up with the Intergovernmental Group of Twenty-Four on International Monetary Affairs and Development (G-24) to convene a working group of experts to examine the extent to which the World Trade Organization (WTO), free trade agreements (FTAs) and international investment agreements (IIAs) are compatible with domestic tax revenue mobilization in emerging market and developing countries. This interdisciplinary group of experts, from academic institutions, international organizations, and civil society, concluded that the trade and investment regime poses a number of constraints to nations attempting to mobilize their tax system for development.

The Global Development Policy Center would like to thank and acknowledge the participation of the report authors and the Open Society Foundations and Rockefeller Brothers Fund for financial support in this effort. We would also like to thank the G-24 for partnering with us in this effort, and the many GDP Center staff and students that worked hard to make the convening of the workshop and subsequent report a success especially: Sarah Lattrell, Rebecca Dunn, William Kring, Mugda Gurram, Amelia Dangerfield, and Bansari Kamdar.



ACRONYMS AND ABBREVIATIONS

ADA	Anti-Dumping Agreement (WTO)
ASYCUDA	Automated System for Customs Data
AU	African Union
BIT	Bilateral investment treaty
CAD	Computer Aided Design
CCP	Container Control Program
CPTPP	Comprehensive and Progressive Trans Pacific Partnership
EPA	Economic Partnership Agreement
ET	Electronic transmissions
FDI	Foreign Direct Investment
FET	Fair and Equitable Treatment standard
FTA	Free Trade Agreement
FTZ	Free Trade Zone
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
GVC	Global value chains
HS	Harmonized Commodity Description and Coding System
IFFs	Illicit Financial Flows
IIAs	International investment agreements
IMF	International Monetary Fund
ISDS	Investor-state dispute settlement
JSI	Joint Statement Initiative on E-commerce
LDC	Least Developed Country
MC11/MC12	Ministerial Conference(s) (WTO)
MERCOSUR	Southern Common Market
MFN	Most-Favored Nation treatment
MNC	Multinational Corporation
NAFTA	North American Free Trade Agreement
NT	National Treatment standard
NTFC	National Trade Facilitation Committee
OECD	Organization for Economic Co-operation and Development
RCEP	Regional Comprehensive Economic Partnership
RTA	Regional Trade Agreement
SCM	Agreement on Subsidies and Countervailing Measures (WTO)
SDGs	Sustainable Development Goals
SDR	Sovereign debt restructuring
STZ	Special Tax Zone
TFA	Trade Facilitation Agreement (WTO)
TISA	Trade in Services Agreement
TM	Trade mis-invoicing
TPP	Trans-Pacific Partnership
TRIMS	Agreement on Trade-Related Investment Measures (WTO)
UNCTAD	United Nations Conference on Trade and Development
UNODC	United Nations Office on Drugs and Crime
USD	United States Dollar
USMCA	United States-Mexico-Canada Agreement
VAT	Value Added Tax
WCO	World Customs Organization
WTO	World Trade Organization

CHAPTER 1

EXECUTIVE SUMMARY

Kevin P. Gallagher

Trade, Investment, and Domestic Resource Mobilization Policy: The Need for Alignment

The COVID-19 and subsequent global economic crisis had made it imperative it that national governments have the fiscal space to fight the virus and invest in resilient, inclusive, and climate friendly growth for the longer run. These crises must offer governments a renewed motivation to pursue the Sustainable Development Goals (SDGs) and the Paris Agreement on Climate Change. SDG 17.1 articulates a common agreement that domestic resource mobilization is essential to steering the economy toward those goals and to generating the necessary resources to meet them. Unfortunately, the crisis has triggered waves of capital flight from emerging market and developing countries that have depreciated currencies and increased external debt burdens. Thus, precious domestic fiscal space is being diverted to debt service rather than fighting the virus and investing in an equitable and sustainable future.

> *"The trade and investment regime needs to be recalibrated to ensure that the world's nations can have a broad toolkit at their disposal to mobilize domestic resources for sustainable development."*

A value-based, rules-driven, multilateral trade and investment regime is essential to meeting global goals for stability, development, and the climate. The authors of this new Global Development Policy Center Report stress that trade and investment treaties can be important instruments to advance the mobilization of domestic resources toward the global climate and development agenda, but find that the prevailing model of trade and investment treaties is often misaligned with the ability of emerging market and developing countries to use taxation measures to mobilize resources for development. The trade and investment regime needs to be recalibrated to ensure that the world's nations can have a broad toolkit at their disposal to mobilize domestic resources for sustainable development.

The analyses in this report show that the trade and investment regime currently hinders the ability of emerging market and developing countries to mobilize domestic resources for stable, inclusive, and sustainable development:

1. Trade and investment treaties significantly decrease the amount of tariff revenue, which is not always re-captured by a shift to other forms of taxation. Indeed, increases in the number of trade and investment treaties is strongly associated with increases in external debt burdens.
2. The estimated potential loss in tax revenues due to trade misinvoicing is equivalent to about 20 percent of total revenues collected each year, and was close to USD 1 trillion in 2015 alone.
3. The potential tariff loss from e-commerce moratoriums at the WTO alone is upwards of USD 10 billion per year.
4. Investment agreements and trade treaties with stringent investment provisions further undermine nation-states' ability to generate tax revenue.

Legal analyses find that rectifying these problems within the trade and investment regime also face significant constraints:

1. WTO law puts constraints on taxing certain activities, especially imposing new taxes in service sectors.

2. The WTO restricts developing countries from exploiting their competitive advantages in the manufacturing of goods. At the same time, the current system incentivizes developed countries to implement special tax zones in areas where they have comparative advantages, such as financial services, telecommunications, and banking.

3. Many free trade agreements (FTAs) and bi-lateral investment treaties (BITs) put contingent liabilities on developing countries in the form of obligations to compensate foreign investors plus the costs of the litigation of Investor-State Dispute Settlement (ISDS) systems.

4. The taxation 'carve outs' in FTAs and BITs are becoming increasingly narrow, and double taxation treaties are also increasingly narrow with additional ISDS ramifications.

5. Rules both at the WTO and in FTAs further constrain countries from taxing the rapidly growing digital sector, through various rules prohibiting customs duties on electronic transmissions. New proposed rules are poised to 'lock in' advantages of lead digital firms by reducing or eliminating any restriction on their ability to operate globally while simultaneously restricting the space for governments to regulate the digital economy in the public interest.

6. Many FTAs and BITs accentuate the problems developing countries have in the event of a sovereign debt restructuring.

> *"… it is of paramount importance for the trade and investment treaty regime to be aligned with broader SDGs and Paris Agreement goals"*

In the wake of the COVID crisis, it is of paramount importance for the trade and investment treaty regime to be aligned with broader SDGs and Paris Agreement goals. Multilateral development banks and the international financial institutions have taken significant steps in this direction which should be echoed by the trade and investment regime. Calls for WTO reform offer a potential for concrete and ambitious action. What is more, a number of other trade and investment treaties are under negotiation or renegotiation. While each chapter of this report offers a number of specific policy recommendations, this report offers these general policy recommendations to align the trade and investment regime with SDG 17.1:

1. Countries should commit to aligning new and existing trade and investment treaties with the SDG 17.1 and embark on ex-ante and ex-post analyses to help nation-states and the global community better understand the fiscal implications of trade and investment treaties.

2. WTO reform discussions should have the SDGs and the Paris Agreement at their core with particular attention to SDG 17.1. To that end, the moratorium on e-commerce should be lifted, and negotiations on the digital economy should ensure that developing countries have the right to regulate the digital economy for taxation and beyond. Finally, there should be disciplines making trade misinvoicing actionable and the Trade Facilitation Agreement should be bolstered in order build the capacity of member states to take necessary actions to limit misinvoicing.

3. Regional and bi-lateral trade and investment treaties should also be aligned with the SDGs and the Paris Agreement, and should not limit the ability of nations to mobilize domestic resources for development through taxation. Treaties should provide policy space to tax the digital economy, natural resource based activity, and foreign firms in order to make the transitions necessary to achieve sustainable development without concern for contingent liabilities to the public purse.

A values-driven and rules-based global trade and investment regime can become an important instrument to achieve global prosperity in an inclusive and climate friendly manner. Bold action is needed to align the current system to these ends.

CHAPTER 2

TRADE LIBERALIZATION AND FISCAL STABILITY IN DEVELOPING COUNTRIES

Devika Dutt* & Kevin P. Gallagher†

By design, trade and investment treaties significantly decrease the amount of tariff revenue a member country can collect, a shift that is not always recaptured by other forms of taxation. If not designed properly and coupled with parallel policies, trade and investment treaties can jeopardize the ability of developing nations to mobilize domestic resources for development. Trade and investment liberalization has been associated with not only declines in tariff revenue, but also total tax revenue in some developing countries, as well as an increase in external debt.

There is a renewed global push to mobilize domestic resources to meet glaring global infrastructure gaps, the Sustainable Development Goals (SDGs), commitments under the Paris Climate Agreement, and the broader pursuit to bring sustained economic growth in the developing world. A core component of such resource mobilization will be the generation of resources through efficient domestic taxation. However, as other essays in this report point out, trade and investment treaties may make it more difficult to engage in domestic taxation.

With respect to the trade aspects of treaties, treaties require a reduction in import and export tariffs. Given that tariff revenue can be more than a third of government revenue in some developing country settings, tariff liberalization can potentially have a negative impact on domestic resource mobilization. That said, the modeling studies that analyze the benefits of trade liberalization assume that trade liberalization is 'revenue neutral'—in other words that lost tariff revenue is automatically replaced either through efficiency gains or new domestic taxes.

There are generally two sources of logic to such an assumption. First, if trade and investment liberalization leads to the more efficient allocation of goods and services in an economy, the economy would be expected to grow more and thus, if tax systems are in place outside of tariffs then tax revenue will increase. Second, if nation states see that they will incur large tariff losses then they will act to replace those losses through domestic taxation. Academic literature has observed a number of instances where developing countries may have difficulty in replacing lost tariff revenue however:

- **Informal economies:** Many developing countries have large informal economies, which by definition are difficult for a state to track and tax.
- **Tax competition:** It can be harder for a developing nation to raise taxes if their neighbors or competitors with similar goods do not equally raise taxes because, all other things being equal, firms could move to other countries to avoid the tax.
- **Internal political economy:** Sometimes the stronger firms that will be the new engines of growth may not want to pay higher taxes and could apply political pressure to halt such initiatives.
- **Treaty provisions:** As discussed in other essays in this report, some provisions in treaties may make it more difficult to place new taxes on foreign capital.

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* Devika Dutt is a research fellow at the Global Development Policy Center at Boston University. She is currently a Ph.D. candidate at the University of Massachusetts, Amherst in economics.

† Kevin P. Gallagher is the Director of the Global Development Policy Center at Boston University and Professor at the Pardee School of Global Studies, also at Boston University.

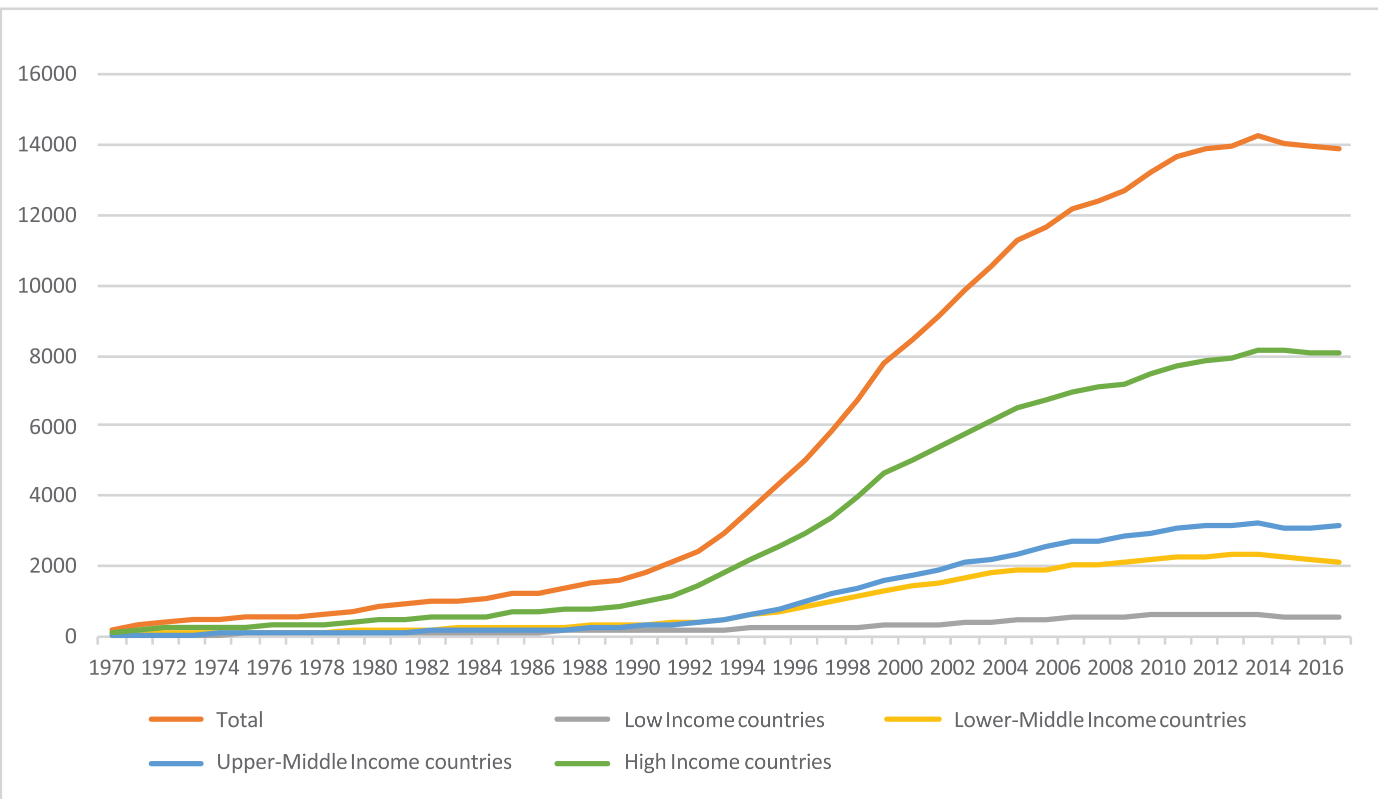
> *"... the literature consistently shows that low-income countries have suffered a decline in trade tax and total tax revenue as a result of trade liberalization."*

While the evidence on revenue implications of trade liberalization is mixed when taking into account all countries, the literature consistently shows that low-income countries have suffered a decline in trade tax and total tax revenue as a result of trade liberalization. Most of the studies to date only analyze the WTO liberalization of the 1990s and have not examined the impact of the thousands of regional and bilateral treaties that have arisen in the system since then. To build on the literature we conducted a study to examine the changes in the trade and investment regime on fiscal stability. Not only do we look at impacts on trade and tax revenue, but also on the accumulation of foreign debt.

Traditional studies measure trade liberalization as the share of trade (exports plus imports) as a percentage of GDP or by measuring the effective tariff rate. Measuring liberalization by trade as a share of GDP is likely to underestimate trade liberalization of large economies like the United States, United Kingdom, and Germany and overestimate in cases in small island economies that have to rely on trade for sustenance. As such, it is not a strong measure of liberalization. On the other hand, measuring liberalization by effective tariff rate is likely to underweight high tariff rates since the corresponding import volume tends to be low.

We use those conventional measures but also construct two new measures of trade and investment liberalization by considering the large number of trade treaties that have been negotiated (Figure 1 shows the total number of trade and investment treaties signed by countries, disaggregated by their per-capita income level) and the 'hub connectedness' of a country's treaties. Hub connectedness is measured by how many times a country acts as a "bridge" on the shortest path between all other

Figure 1: Number of Trade and Investment Treaty Connections

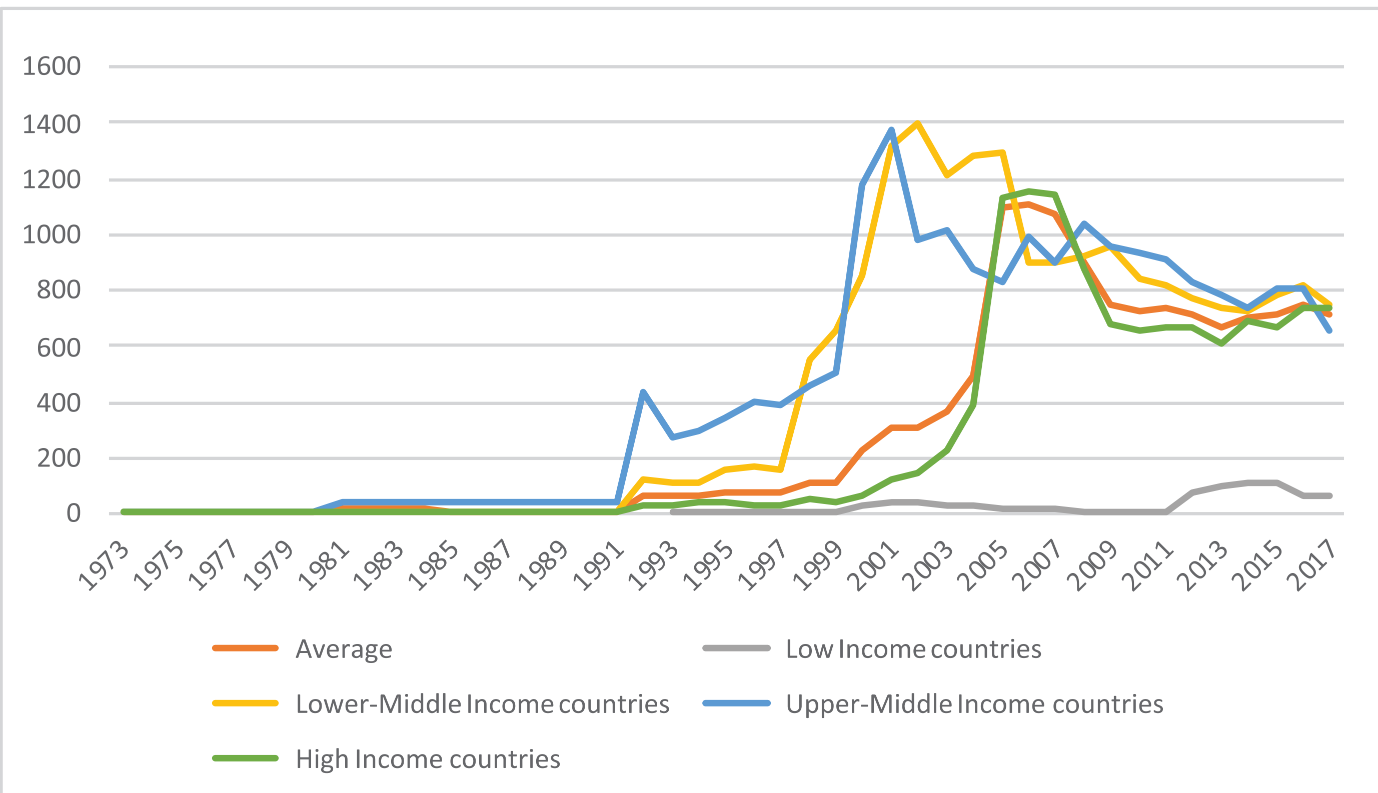


country pairs. It represents the extent to which a country stands as a link between larger trading countries in the trade network. Theoretically, a country with a high hub connectedness will have greater importance in the network as more trade would flow through this country in their trade path between other countries. This accounts for the importance of certain large economies in the trade network, as not all trade treaties are equal. For instance, countries that have many treaties with small open economies do not necessarily have more open trade as compared to a country that has treaties with a few key large core economies. Our hub connectedness measure encapsulates this factor. Figure 2 shows the trends in trade openness measured by hub connectedness, disaggregated by their per capita income level.

Using these new measures of trade openness, we examine the relationship between tax revenue, government expenditure, and government debt, controlling for per-capita income levels, share of digitizable products in total trade, inflation, presence of an IMF program, WTO membership, real exchange rate, inequality measured by the Gini coefficient, and global liquidity conditions in the case of government debt. In general, we find that trade and investment treaties are associated with:

- **Significant evidence of losses in tariff revenue:** Regardless of how we measure trade openness (number of trade treaties or hub connectedness), trade liberalization is associated with a decrease in trade tax revenue. A 1 percent increase in the number of treaties is associated with a 0.13 – 0.20 percent decline in trade tax revenue as a share of GDP, and a 1 percent increase in hub connectedness is associated with a 0.01 percent decline in trade tax revenue. The decline in tariff revenue in upper-middle income countries is particularly pronounced, with a 0.02–0.15 percent higher decline relative to high-income countries for a 1 percent increase in trade liberalization.

Figure 2: Hub Connectedness:
Number of Times Countries Act As "Bridge" Between Two Others



- **No evidence of increase in indirect tax revenue:** Trade theory tells us that any loss in tariff revenue can be made up by imposing indirect taxes like Value Added Taxes (VATs). However, we find that this trade liberalization is not associated with an increase in indirect tax revenue. When we disaggregate by country-group, we also find that while lower-middle income countries have gained indirect tax revenue with trade liberalization (0.1–0.18 percent increase), Least Developed Countries (LDCs) have actually lost indirect tax revenue with trade liberalization (0.05–0.59 percent decrease).
- **Some mixed evidence of losses in total tax revenue:** When measured using traditional indicators, we find a negative and significant relationship: a 1 percent decline in effective tariff rate is associated with a 1.56–1.82 percent decline in total tax revenue. When measured by the number of treaties and hub connectedness, total tax revenue does not exhibit a significant change in response to trade liberalization. However, when we disaggregate by country group, we find that lower-middle income countries gained total tax revenue, while LDCs lost total tax revenue as a result of trade liberalization. We find that a 1 percent increase in the number of treaties is associated with a 0.06–0.1 percent increase in total tax revenue in lower-middle income countries, but a 0.16–0.25 percent decline in total tax revenue in LDCs.
- **Some mixed evidence of increase in government budget deficit:** We find that an increase in trade liberalization is associated with a worsening of the government's budget in some country groups. Using our new measures, a 1 percent increase in hub connectedness of a country in the treaty network is associated with a 0.04–0.22 percent worsening of the government budget in Least Developed countries and a 1 percent increase in the number of treaties is associated with a 0.004–0.007 percent decline in budget deficit in upper-middle income countries. Furthermore, when we consider the full sample, we also find that there is a negative relationship between a countries per-capita income and budget deficit: this means, richer countries have higher budgetary balance than poorer countries. Furthermore, a presence of an IMF program is also associated with a worse budget deficit.
- **Significant evidence of increases in government debt:** we find that trade liberalization is associated with an increase in government debt: a 1 percent increase in the number of trade treaties is associated with a 0.05–0.16 percent increase in the government debt to GDP ratio. This increase in debt is higher for upper-middle income countries and LDCs: a 1 percent increase in number of treaties is associated with a 0.05–0.23 percent increase in government debt in upper-middle income countries as compared to High-Income countries, and a 1 percent increase in hub connectedness is associated with a 0.03–0.13 percent increase in government debt in Least Developed countries as compared to other countries.

> *"… we find that trade liberalization is associated with an increase in government debt."*

These results are concerning in an era where developing nations are renewing their push for sustainable and inclusive economic growth. It is clear that further integration with the world economy may come at the cost of fiscal stability, especially for upper-middle income countries and Least Developed countries. Nations need to design integration strategies that enable global market access and stimulate domestic revenue mobilization at the same time.

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CHAPTER 3

THE TAX IMPLICATIONS OF TRADE MISINVOICING AND HOW THE WTO COULD RESPOND

Rick Rowden*

Tax Revenue Losses from Trade Misinvoicing

Even as developing countries have suffered tremendous financial losses from trade liberalization over the last few decades, they also suffer losses from illicit financial flows (IFFs). One of the major types of IFFs is trade misinvoicing, in which value is illicitly transferred across international borders by falsifying the stated prices on the invoices for imports or exports. On average, estimated potential losses in tax revenue through trade misinvoicing reach about 20 percent of total revenues annually and, in 2015 alone, amounted to almost USD 1 trillion. This value can be illicitly moved out of countries by either over-invoicing imports or under-invoicing exports. Conversely, value can be illicitly moved into countries by either over-invoicing exports or under-invoicing imports.

The 4 Main Types and Common Purposes of Trade Misinvoicing

IFF Outflows	Import Over-Invoicing	• to shift money abroad (evade capital controls, shift wealth into a hard currency, etc.); • to reduce income tax liability; • to avoid anti-dumping duties
	Export Under-Invoicing	• to shift money abroad (evade capital controls, shift wealth into a hard currency, etc.); • to evade income taxes (lowering taxable income levels); • to evade export taxes
IFF Inflows	Import Under-Invoicing	• to evade customs duties or VAT taxes; • to avoid regulatory requirements for imports over a certain value
	Export Over-Invoicing	• to exploit subsidies for exports; • to exploit drawbacks (rebates) on exports

Trade misinvoicing is a well-established method of hiding illicit financial flows within the conventional commercial trade system. There are many reasons for engaging in trade misinvoicing, including evading tax and/or customs duties, laundering the proceeds of criminal activity, circumventing currency controls, and hiding profits offshore, among others. With the World Trade Organization (WTO) estimating a global value of merchandise trade of nearly USD 18 trillion in 2017, less than 2 percent of all shipping containers are searched each year. As the volume of global trade has increased in recent decades, the opportunities for trade misinvoicing have increased as well (Moiseienko, Reid & Chase 2019).

* Senior Economist, Global Financial Integrity (GFI) in Washington DC, rrowden@gfintegrity.org

Many developing countries are caught in between two contradictory forces pulling them in different directions. On the one hand, there is tremendous pressure placed on developing countries to remove restrictions and impediments to free trade and to facilitate and expedite the movement of goods across borders. At the same time, developing countries are being called on take steps to stop illicit financial flows, smuggling and terrorist financing, which can sometimes require slowing down the movement of goods.

TRADE MISINVOICING: KEY FACTS

- It involves the deliberate falsification of the price, quantity, or commodity of an international trade transaction;
- It comprises the largest component of illicit financial flows (others include tax evasion, the proceeds of criminal activities and bribes);
- According to research by Global Financial Integrity, the estimated value of misinvoiced trade in 148 developing countries (in their trade with 36 advanced economies) was close to USD 1 trillion in 2015;
- On average, trade misinvoicing among all developing countries is equivalent to about 18 percent of the value of developing countries' total trade with advanced economies;
- On average, the estimated potential loss in tax revenues due to trade misinvoicing is equivalent to about 20 percent of total revenues collected each year;
- These estimates are considered conservative, because of difficulties in detecting trade misinvoicing in trade in services and intangibles.

> *"On average, the estimated potential loss in tax revenues due to trade misinvoicing is equivalent to about 20 percent of total revenues collected each year."*

Key Challenges: Customs Enforcement

Customs authorities are responsible for the collection of duties and a number of other trade-related taxes from importers and exporters at the borders of countries. Often these taxes are a critical source of government revenues, particularly for least-developed countries (LDCs) – even as import tariff rates have been cut around the world. For example, a 2014 survey of 34 of LDCs by the World Customs Organization (WCO) found that duties and other taxes collected at borders accounted for 45 percent of government tax revenue, of which 19 percent were customs duties (WTO 2015).

While the task of combatting illicit financial flows is most often placed on tax authorities, the police and financial regulatory institutions, the task of combatting trade misinvoicing is placed with customs agencies. Yet, customs agencies typically represent the weakest link in the fight against IFFs. Typically, their priority is revenue collection, not law enforcement. And where they do engage in combatting IFFs, they often focus such efforts on detecting smuggling of cash or gold, not trade misinvoicing.

Furthermore, when customs authorities do engage in efforts to audit the value of traded goods, they often focus primarily on under-invoiced imports, in line with their traditional mandate to maximize customs duties. Even the WTO's Valuation Agreement sets customs valuation standards for imported goods only, and not for exported goods. As a consequence, the three other types of trade misinvoicing (over-invoiced imports, under-invoiced exports, and over-invoiced exports) have not been the main focus of customs authorities (Mikuriya 2018).

The problem of insufficient detection of trade misinvoicing by customs authorities is further compounded by the large role of free trade zones (FTZs). Often national customs authorities exercise very limited control or oversight over cargo moving in and out of FTZs, which were originally designed to facilitate the movement of trade. A 2018 study by the World Customs Organization (WCO) found that customs procedures/controls were so limited inside FTZs, combined with insufficient integration and utilization of information technology (IT), that the resulting lack of the requisite data concerning cargoes inside the zones rendered customs agencies' risk-management controls "virtually useless" (Omi 2019; Chase, Moiseienko & Reid 2019).

> *"… in order to effectively combat trade misinvoicing, effectively monitor invoices and detect irregularities in both export and import declarations, customs authorities require both a sufficient legal mandate and adequate resources to match."*

According to the African Union Commission, in order to effectively combat trade misinvoicing, effectively monitor invoices and detect irregularities in both export and import declarations, customs authorities require both a sufficient legal mandate and adequate resources to match (African Union Commission 2019).

There is a tension between the WTO's Trade Facilitation Agreement (TFA), which seeks to speed up the movement of goods across borders, and the WCO protocols, which advocate for countries to adopt a comprehensive and effective valuation control program which involves controls being carried out at three stages; pre-clearance, at the time of customs clearance and post-clearance. However, the WTO's TFA does in fact provide specific provisions aimed at avoiding or recovering revenue loss. These include provisions in Article 3.9(b), which address the pre-clearance stage, when customs agencies have the opportunity to provide advance rulings on cargo valuation, as well as provisions in Article 7.5, which address post-clearance audits. Most importantly, the TFA includes provisions in Articles 12.2–12.12 for the exchange of information between importing and exporting countries and procedures for verification of shipment valuations. It is this process of information exchange between countries where much more support is needed.

Since its development in 1981 by UNCTAD, many countries have benefited from the adoption of the Automated System for Customs Data, known as ASYCUDA. The system is a computerized customs management tool which covers most foreign trade procedures and enables customs authorities to more quickly process documents with automatic verification and accounting of customs declarations, and to share this information with other government agencies and with other trading partners. However, the ASYCUDA system is limited in its ability to detect trade misinvoicing.

Key Steps Necessary to Improve Customs Enforcement and Combat Trade Misinvoicing

- *Make trade misinvoicing illegal*

  Among the many constraints faced by customs agencies are that in many countries falsifying trade invoices is simply not illegal. Therefore, one of the most important steps countries can take is to adopt legislation that clearly prohibits trade misinvoicing and to ensure the associated penalties are adequate. For example, in 2013 Korea revised its customs act to criminalize the manipulation of invoices (values), irrespective of the impact on customs revenue. This revision encouraged customs officers to examine misinvoicing more comprehensively.

- *Strengthen the law enforcement capacities of customs authorities*

  A second step that can be taken by countries is to establish Specialized Asset Forfeiture and Recovery Units at the national level and/or advocate for the creation of a Special Office of Asset

Recovery within regional organizations such as the African Union. This is because, as noted above, typically customs agencies have prioritized revenue collections, not law enforcement, so the enforcement capacities of the agencies must be strengthened with adequate capacities and resources.

- *Strengthen customs oversight of free trade zones (FTZs)*

  For free trade zones (FTZs), countries should consider adopting the WCO's voluntary SAFE Framework of Standards to Secure and Facilitate Global Trade in FTZs, which includes a set of global recommendations designed to strengthen the effectiveness of customs controls. As of November 2019, 171 states had signaled their intention to apply the SAFE Framework but the degree of actual implementation remains unclear (WCO 2019).

- *Establish National Trade Facilitation Committees in every country*

  The WTO's TFA is supposed to set up National Trade Facilitation Committees (NTFCs) in each country, however sufficient financing for such national bodies has been lacking. A 2014 study by UNCTAD found that adequate financing for NFTCs was available in only 18 percent of developed countries, 36 percent of developing countries and 21 percent of LDCs (UNCTAD 2014). This suggests that for governments to fulfil their TFA commitments, particularly with efforts that can combat trade misinvoicing such as Article 3.9(b) for pre-clearance, Article 7.5 for post-clearance audits and Articles 12.2–12.12 for information exchange between countries, much more financing is needed. Where countries cannot afford to adequately finance their NFTCs, additional donor aid must be forthcoming.

- *Expand information-sharing between importing and exporting countries*

  The WCO and the United Nations Office on Drugs and Crime (UNODC) have established a joint container control program (CCP), which establishes inter-agency units within countries for exchanging information with their counterparts in other countries, allowing customs agencies and port authorities to share information about high-risk containers and verify their identification numbers, etc. However, so far only about 50 countries have adopted this system. The WCO also recommends that countries establish a legal basis and/or develop administrative arrangements for the exchange of information between and among customs administrations in trading partner countries for purposes of compliance and enforcement using WCO instruments and tools such as the revised Model Bilateral Agreement, the Guide to the Exchange of Customs Valuation Information, etc.

In addition to the steps listed above, the WCO also recommends that its members do the following:

1. Ensure that customs authorities have sufficient mandate to tackle not only under-invoiced imports, but all four channels of trade misinvoicing;

2. Allow customs agencies to access foreign exchange transactions databases, and equip customs agencies with a mandate to examine whether 'financial transactions' between traders correspond to the 'value of traded goods';

3. Provide capacity building including financial and human resources for customs authorities to combat IFFs/TM;

4. Promote a shared sense of responsibility between the private sector and customs administrations and effective information exchange between them to tackle IFFs/TM;

5. Expand information sharing among customs, tax, financial investigation units (FIUs) and other government agencies and develop joint risk management, joint investigation teams, joint audit programs, joint intelligence centers, etc.;

6. Exchange information on the beneficial ownership of traders with tax authorities;

7. Exchange customs records on the trade and financial records of the matched trade.

With the adoption of such recommendations, as well as additional donor funding where needed, countries would be able to better combat the problem of trade misinvoicing and the associated revenue loss.

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CHAPTER 4

WTO MORATORIUM: *TIME TO TAKE A DECISION*

Rashmi Banga*

The e-commerce sector has played a major role in contributing to tariff losses from trade liberalization. In 1998, on the basis of a proposal submitted by the United States, WTO members adopted a Declaration on Global Electronic Commerce. The proposal included a two-year moratorium stating that "Members will continue their current practice of not imposing customs duties on electronic transmissions" ("Moratorium"). Since 1998, this Moratorium has been renewed every two years (except for 2003-2005 when the members failed to reach a decision in Cancún). As a result of this Moratorium, potential tariff losses are upwards of USD 10 billion annually.

"While countries like India and South Africa argue in favor of removal of the Moratorium, many developed countries want to extend the Moratorium and some are insisting in making the Moratorium permanent

Nevertheless, the debate on whether the Moratorium on custom duties on electronic transmissions (ET) should be removed or made permanent has remained inconclusive even after twenty years of discussions in the WTO. The two-year extension to the Moratorium on ET expired in December 2019 and a decision was taken by the member states to extend it until the next Ministerial Conference in June 2020 (now postponed to 2021 due to the COVID-19 crisis). Countries will then decide on whether to continue the Moratorium, remove it or make it permanent. While countries like India and South Africa argue in favor of removal of the Moratorium, many developed countries want to extend the Moratorium and some are insisting in making the Moratorium permanent. A primary reason that developing countries argue against the extension of the Moratorium is the loss of tariff revenue due to rapidly increasing product digitalization and trade via ET.

What are Electronic Transmissions

There is no consensus on the scope and definition of ET in the WTO. The debate since 1998 has focused on whether ET should be treated as 'goods' and be exposed to custom duties as defined under Article II of the General Agreement on Tariffs and Trade (GATT) 1994, or as services where the General Agreement on Trade in Services (GATS) schedules apply. However, the literature has identified the online trade of 'digitizable products' as ET. Digitizable products are those products which are traded both in the physical form as well as 'online' i.e., downloaded from the internet. Accordingly, five categories of digitizable products have been identified, namely, films, music, printed matter, computer software and video games. According to the WTO Note (2016), which was prepared on the request of the member states to provide fiscal implications of a customs moratorium, ET includes cinematograph film; books, pamphlets and maps; newspapers, journals and periodicals; postcards, personal greeting message or announcement cards; other printed matter; video games; computer software; musical records, tapes and other sound or similar recordings; and other recorded media. Using these descriptions and earlier literature on ET, UNCTAD (2019) identified 49 HS 6-digit tariff lines as ET.

* Senior Economic Affairs Officer, Unit on Economic Cooperation and Integration among Development Countries (ECIDC), GDS, UNCTAD. Rashmi.banga@un.org

Moratorium and Tariff Revenue Loss

There is a fierce debate taking place in the WTO on the extent of tariff revenue loss resulting from the Moratorium. According to studies like Pérez-Esteve and Schuknecht (1999), Mattoo and Schuknecht (2000) and the WTO (2016) as the products are becoming digitalized, and more and more trade is shifting online, many countries' tariff revenue has fallen anyway, suggesting that the Moratorium does not lead to additional significant losses in tariff revenues for developing countries. WTO (2016) estimates the loss of tariff revenue to be around USD 756 million, only a minor share of customs duties from all imports (0.26 percent) and even lower if taken as a share in total government revenues. Of course overall averages conceal inequalities and this is no exception. According to the same study, developing countries lose 92 percent of that tariff loss while developed countries only experience 8 percent of the loss.

Moreover, UNCTAD (Banga 2019) presents a detailed critique of WTO (2016) and argues that the Moratorium applies to the 'online' trade and not physical trade, therefore any estimation of tariff revenue loss to the government based on physical trade are biased.

Using the average annual growth of global physical imports of digitizable products (49 HS 6-digit tariff lines) in the period 1998-2010, the study predicts the global physical imports of digitizable products in the period 2011-2017. The difference between the actual global physical imports of digitizable products in the period 2011-2017 and their predicted imports is used to estimate the 'online' imports of digitizable products (that is, the actual electronic transmissions during that period). The study argues that in the period 2011-2017, online imports were much easier to transport and sell than physical imports therefore the average growth rate of imports of digitizable products would have been much higher than the earlier period. Therefore, using the same average growth rate of 8 percent per annum in the period 1998-2010 for the period 2011-2017 to estimate the global online imports, as do previous studies, gives 'conservative' estimates. Using similar methodology, the study estimates global and regional 'online' imports of electronic transmissions. Similar estimates are also undertaken for 91 countries.

According to these estimates, the actual global physical imports of these 49 digitizable products in 2017 were USD 116 billion. Using the average annual growth rates of physical imports in the period 1998-2010 (8 percent) and applying it to the period 2011-2017, the estimated global physical imports in 2017 ought to have been USD 255 billion. The difference, then, provides our estimate of global 'online' imports of **ET: USD 139 billion**. These calculations demonstrate that 55 percent of global imports of the identified digitizable products are electronic transmissions, while 45 percent are physical imports.

> *"… the potential tariff revenue loss to developing countries is estimated at USD 10 billion per annum."*

Following the Moratorium on custom duties of ET, the study estimates the potential tariff revenue losses for developing and developed countries. Using Bound duties, **the potential tariff revenue loss to developing countries is estimated at USD 10 billion per annum**. Tariff revenue loss to WTO LDCs is estimated at USD 1.5 billion while African countries' lose around USD 2.6 billion. WTO high-income countries experience a tariff revenue loss of only USD 289 million, as their average Bound duties are at 0.2 percent. Notably, the potential tariff revenue loss to Sub-Saharan African countries is twice that of the WTO high-income countries and even WTO LDC member countries lose more tariff revenue than developed economies. Alternatively, it can be said that, using bound duties, WTO LDCs can generate five times more tariff revenue on electronic transmissions than the developed countries if the Moratorium is removed.

We undertake a similar exercise for 91 countries for the year 2017. The top five countries which will face the maximum tariff revenue loss from the Moratorium using Bound duties are Mexico followed by Thailand, Nigeria, India, China and Pakistan. Tariff revenue losses for small countries like Fiji, Guatemala and Malawi can be more than USD 100 million. Overall, the tariff revenue loss under the Moratorium on custom duties for online imports of digitizable products for developing countries is 30 times more than for the developed countries. Meanwhile developing countries can potentially generate 40 times more revenue by imposing custom duties on ET as compared to the developed countries, many of which have almost zero bound duties on physical imports of digitizable products.

3D Printing and Future ET: Implications for Digital Industrialization

The implications of Moratorium go far beyond potential tariff revenue losses for the developing countries. The upcoming digital technologies need data and software, both of which are electronically transmitted. It is often argued that 3D printing cannot assist mass production and therefore will not be able to capture substantial market share, however recent technological advances, namely high-speed sintering, indicate that high speed and mass production is becoming possible with 3D printers where mass-producing up to 100,000 (smaller) components in a day will be possible at a speed which is 100 times faster (Ing 2017). While 3D printing is still considered to be at a nascent stage in developing countries, its market has grown annually by 22 percent in the period 2014-2018 (Statista 2017). If current growth of investments in 3D printing continues, some estimate that 50 percent of the manufactured goods will be 'printed' in 2060, and if investments in 3D printing doubles, this target will be achieved in 2040 (Ing 2017). This will wipe out almost 40 percent of cross-border global physical trade. With the Moratorium, foreign firms will be able to export, duty free, any software to developing countries to 3D print products which are currently manufactured. The most affected sectors will include textiles and clothing, footwear, auto-components, toys, mechanical appliances and hand tools, which generate large scale employment for low skilled workers.

The Moratorium combined with the growth of 3D printing can also jeopardize two decades of negotiated tariffs on industrial products under the GATT. 3D printers with duty-free electronic transmissions of CAD files can be used to 'print' manufactured products in any country, irrespective of the protection given by the governments to the sectors in the developing countries through well-negotiated tariffs under the GATT. For example, if a country is protecting its footwear industry by having relatively higher custom duties on shoes, with the use of a 3D printer and duty-free electronically transmitted CAD files, a foreign firm can have mass production of shoes within the national boundary of the country, without exporting shoes or even having a physical presence there. Anti-dumping measures may also not help as it will be difficult to prove that 3D printed products are imports since they have not crossed borders, and it will be difficult to categorize them as 'like' products with different cost structures. While developed countries are fast developing this technology, developing countries like India are still at a nascent stage.

Further, the protection given by developing countries to some of their services sectors under the GATS may also be lost. For example, if some country has protected its construction services by not allowing foreign direct investment in the sector or regulating the sector through other conditions, 3D printing technology may enable a foreign firm to 'print' a house in the country, with no substantial presence of foreign service suppliers.

Conclusion and Way Forward

Electronic transmissions have been identified in the literature as 'online' deliveries of products which also have an existing international trade in physical form. These include primarily five broad categories of products which are music, films, software, printed matter and video games. The on-going rapid product digitalization is leading to more and more physical products being delivered 'online.'

The Moratorium on custom duties on electronic transmissions does not allow developing countries to apply custom duties to 'online' imports of ET, while duties are levied on their physical imports. Most of the exporters of 'online' deliveries of physical products or electronic transmissions are from the developed countries, while developing countries are the primary exporters of the corresponding physical products. Moreover, in 2017, 86 out of 95 developing countries were net importers of ET, which has led to a substantial squeeze on tariff revenues of developing countries.

> *"Developing countries may be losing policy space to develop their digital capabilities and infrastructure, which can have important implications for their manufacturing and industrialization processes."*

UNCTAD (Banga 2019) estimates that the 'online' global imports of digitizable products are around USD 139 billion, which accounts for 55 percent of global imports of digitizable products. According to those estimates, developing countries experience per annum tariff revenue losses of USD 10 billion, while WTO high-income countries lose only around USD 212 million per annum. Furthermore, using Bound duties, developing countries have the potential to generate much more tariff revenue from online trade in digitizable products given that their bound rates are so much higher. WTO LDCs, for example, can generate five times more tariff revenue than the developed countries on ET. The Moratorium has broader implications as well. Developing countries may be losing policy space to develop their digital capabilities and infrastructure, which can have important implications for their manufacturing and industrialization processes. Moreover, the scope of the ET is not clear to the WTO member states as it has never been defined. Some studies aim at including services in ET which can have far-reaching implications for the developing countries as it would imply losing all control over the imports of services in their countries including giving up the negotiated flexibilities of GATS schedules.

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CHAPTER 5

BITS AND TAXATION: DO INVESTMENT AGREEMENTS CONSTRAIN REVENUE MOBILIZATION FOR DEVELOPMENT?

Andrew Kerner*

In addition to the WTO, investment agreements and trade treaties with strict investment liberalization provisions can further limit a country's ability to generate tax revenue. The effect of bilateral investment treaties (BITs) on policymaking is typically studied in the context of "regulatory chill," particularly as it relates to environmental or health-related regulations. Arbitrators frequently find such policies to violate BIT protections against indirect expropriation and/or unfair and inequitable treatment, and it is widely thought that the fear of arbitration is enough to deter risk-averse policymakers. We know less about the effect of BITs on a country's ability to tax. That inattention is perhaps well-grounded. BITs typically exclude (non-discriminatory forms of) taxation from their purview through carve-outs, and arbitration panels routinely set high bars for tax-related challenges.[1] Despite these efforts, we (Cristina Bodea, Fangjin Ye, and Andrew Kerner) argue that BITs have systematically undermined developing countries' capacity to raise revenue, at least under some circumstances (Bodea, Ye & Kerner 2020).

> *"BITs have systematically undermined developing countries capacity to raise revenue."*

Our work is specifically concerned with the impacts of "umbrella clauses" and similar treaty language on developing country governments' ability to raise revenues from their natural resources. Umbrella clauses—which appear in about half of BITs currently in force—extend BIT protections to stabilization agreements between states and investors, allowing firms to enforce those agreements using Investor-State Dispute Settlement (ISDS). Even though BITs typically exclude non-discriminatory taxation, the side agreements that are brought under BITs through umbrella clauses often stipulate allowable levels of taxation. Such agreements are particularly common for investments in resource extraction, where large sunk costs and potential windfall profits can dramatically alter bargaining positions between state and investor post-investment.

Umbrella clauses and similar protections are not the only vehicle through which firms can use ISDS to contest non-discriminatory tax rules. Foreign firms can include recourse to ISDS into the stabilization agreement itself, and several tax-related cases have arisen from such contracts (e.g., *Duke Energy v. Peru*). However, BITs are an important vehicle for establishing that right and, we argue, a consequential one. The motivating question is whether extending ISDS to side agreements dissuades taxation of natural resource development that would otherwise occur. To the extent that it does, it could have substantial implications for the fiscal health of developing countries that rely on those taxes.

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* Andrew Kerner is a researcher in the Political Science department at Michigan State University.

[1] See, for example, *Link-Trading v. Moldova*, *Feldman v. Mexico* & *Encana v. Ecuador.* The judgment from *EnCana v Ecuador* takes a particularly clear stance in finding that: *"From the perspective of expropriation, taxation is in a special category. In principle a tax law creates a new legal liability on a class of persons to pay money to the State in respect of some defined class of transactions, the money to be used for public purposes. In itself such a law is not a taking of property; if it were, a universal State prerogative would be denied by a guarantee against expropriation, which cannot be the case"* (p. 51). The judgment from *EnCana v Ecuador (2002)* takes a particularly clear stance in finding that: *"From the perspective of expropriation, taxation is in a special category. In principle a tax law creates a new legal liability on a class of persons to pay money to the State in respect of some defined class of transactions, the money to be used for public purposes. In itself such a law is not a taking of property; if it were, a universal State prerogative would be denied by a guarantee against expropriation, which cannot be the case"* (p. 51).

We explore the possibility that BITs have limited the revenue generating potential of developing countries' natural resource endowments by examining tax revenue data from 105 developing countries between 1981 and 2009. That analysis strongly suggests such an effect.

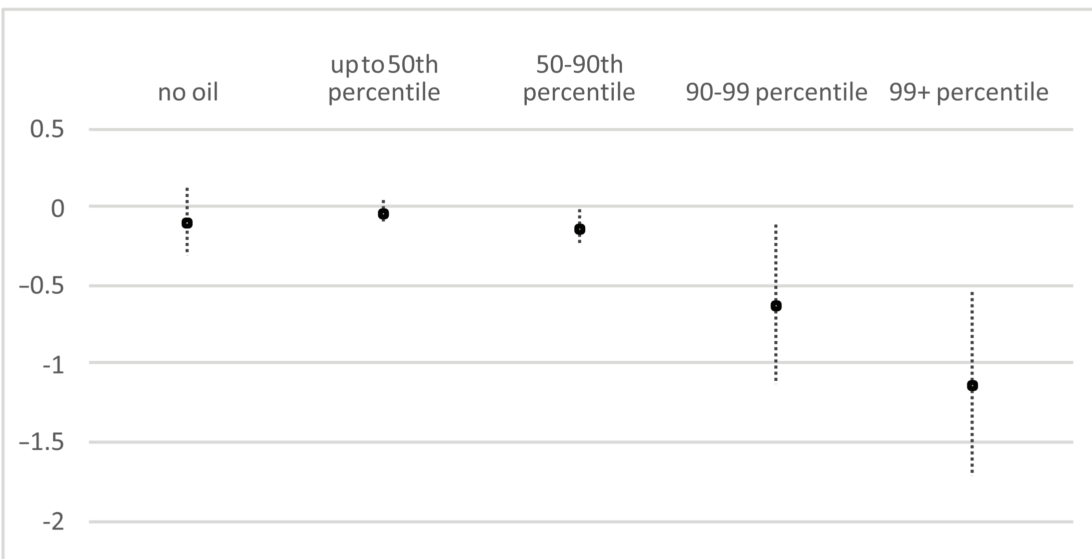
Our core finding, which is robust to a variety of specifications and alternative measurements, is that the capacity of BITs correlate with reduced fiscal revenue in countries with large natural resources and, conversely, that natural resource rents' capacity to generate tax revenue declines in the presence of BITs, and especially BITs with umbrella clauses.

> *"BITS appear to undermine developing country governments' ability (or willingness) to generate tax revenue from their natural resources."*

A succinct presentation of our findings is produced in Figure 1, which reproduces Figure 1 from the referenced paper. Figure 1 shows the results of regressing fiscal intake[2] in a country-year on the one-year lag of the number of BITs, which we interact with a series of dummy variables indicating whether a country-year produced no oil rents, oil rents below the 50th percentile of oil producing country-years,[3] between the 50th and 90th percentile, between the 90th and 99th percentile, or at or above the 99th percentile.[4]

As Figure 1 shows, we find no evidence that BITs affect fiscal intake in country-years with little or no oil production, small but statistically significant effects for country-years with oil rents above the median but below the 90th percentile of oil production, but substantial effects in country-years where oil rents are above the 90th percentile. In the extreme, we estimate that a marginal increase in BITs can affect up to a full percentage point reduction in fiscal revenue as a percentage of GDP. Put succinctly, BITS appear to undermine developing country governments'

Figure 1. Effect of BITs on Fiscal Revenue/GDP by oil rents per capita



Note: Figure 1 shows the conditional effect of ratified BITs on fiscal intake. The solid black dot represents the conditional marginal effect, while dashed lines show 95 percent confidence intervals. These models used to create Figure 1 include country and year fixed effects, standard errors clustered by country and year and a battery of control variables. Fuller details are available in referenced paper.

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[2] We measure fiscal intake using the coding scheme from Bodea & Higashijima (2017) Fiscal intake is equal to the central governments' total revenue plus grants, and is scaled by GDP.

[3] Data on oil rents are taken from Ross 2012.

[4] These regressions also include a batter of control variables. See Bodea, Ye & Kerner (2020) for more details.

ability (or willingness) to generate tax revenue from their natural resources. This could be especially damaging for governments with limited capacity to reach harder-to-tax parts of their economy.

This analysis is not meant to provide a holistic evaluation of the impact of BITs, but to draw attention to fiscal effects that have been heretofore overlooked. It is possible, for example, that limiting MNCs' access to ISDS through BITs would affect the flow of FDI into the oil sector, and the fiscal and developmental implications of that possibility is unknowable from these regressions. But whatever those consequences, any accounting of BITs' economic or developmental impact should consider the constraints they place on a government's ability to tax, and the special burden those constraints place on governments in oil producing countries. The relevant question for BITs is not only whether or not they attract FDI, but whether they attract enough of it to compensate for their fiscal impacts.

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CHAPTER 6

THE WTO AND TAX MOBILIZATION FOR DEVELOPING COUNTRIES

Sonia E. Rolland*

Developing countries need more fiscal revenue to build their infrastructure, achieve energy security and environmental sustainability, and provide social services necessary for human development. The United Nations' Sustainable Development Goals 17.1 and 17.4 also enshrine the need to improve tax mobilization. While trade liberalization has typically been assumed to be revenue-neutral, as Dutt & Gallagher point out (chapter 2), economic studies demonstrate that such is not, in fact, the case. The legal literature has not given much consideration to this issue, assuming instead that the tax effects of economic globalization were addressed by bilateral tax treaties meant to avoid double taxation. However, as a practical matter, double taxation treaties are not meant to address, redress or otherwise complement global trade commitments when it comes to fiscal impact or tax mobilization. Moreover, as a normative matter, trade liberalization commitments have a myriad more consequences on taxation than has been recognized so far, particularly for developing countries. Notably, the WTO pillars of non-discrimination as well as commitments under the General Agreement on Trade in Services keep many member states from taxing key economic activities, and imposing new taxes in services sectors. This essay assesses the range of impacts that the WTO and its associated agreements have on domestic tax policy and on countries' ability to reshape their tax policy as their socio-economic requirements evolve. It then draws out the implications for WTO reform as well as for domestic tax policy-making.

BOX 1: Impact of Trade and Investment Treaties for Domestic Tax Policy

Present Impact	Future Impact
• Decreased tax revenue due to trade liberalization • Limitation on the ability to tax some economic activities • Limitations on differential taxes for foreign and domestic operators	• Constraints on changes in tax policy • Constraints on changes in judicial interpretation • Constraints on changes in enforcement

Overall, the economic literature shows that trade liberalization has a positive fiscal impact for rich countries, a neutral impact for middle income countries and have a negative fiscal impact for poor countries (Dutt et al. 2019). While developed countries can offset tariff losses with increased revenue from income and profit taxation, or even from broad based consumption taxes, poor countries are typically unable to do so (Ebrill, Stotsky & Gropp 1999, Emram & Stiglitz 2005, Baunsgaard & Keen 2010). This can be a result of the informal nature of much of these countries' economies, poor governance, limited administrative, judicial and police infrastructure, lack of resources to create, administer and enforce a tax system, and a limited tax base, amongst others factors.

The rules laid out in the WTO agreements, in addition to lowering tax revenue, add constraints to developing countries' ability to reform and enhance their tax regime. These constraints on policy-making are much more complex and nuanced than the mere loss of tariff revenue. For developing countries aiming to mobilize their fiscal resources more effectively, a first step is to fully understand

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* Professor of Law, Northeastern University School of Law. This research was supported by the Global Development Policy Center at Boston University. The author is grateful to Kevin Gallagher, Rachel Thrasher and Devika Dutt for comments and suggestions throughout this research.

the impact of their current WTO commitments on tax policy. Second, they must be able to evaluate the fiscal impact of future negotiations and reform efforts at the WTO. Both aspects are essential for developing countries' ability to exercise their fiscal sovereignty in a dynamic environment, where their domestic socio-economic needs change over time and the international framework also evolves with ongoing negotiations.

In the next section this essay lays out the direct and indirect constraints on fiscal mobilization for developing countries under the WTO for goods and services trade. It then follows by pointing out the areas of policy flexibility and potential for reform.

Constraints on Fiscal Mobilization at the WTO

Trade law's most direct and clear impact on countries' tax resources is the decrease in duties levied on trade in goods (also called tariffs). Beyond tariffs, however, trade law also establishes standards of treatment for foreign goods and rules for regulating foreign service suppliers, which includes cross-border e-commerce. Although these rules often do not reference taxation, they nevertheless have a bearing on how countries can design their tax policy.

> *"Beyond tariffs, however, trade law also establishes standards of treatment for foreign goods and rules for regulating foreign service suppliers, which includes cross-border e-commerce."*

DECREASED REVENUE FROM CUSTOMS DUTIES ON GOODS

Through the WTO's General Agreement on Tariffs and Trade (GATT) countries typically agree to fix their import duty rates at a "bound" rate, though they are free to apply a lower rate if they wish (Article II). Mean applied weighted tariffs worldwide stand at 2.59 percent in 2017, down from 8.57 percent in 1995 (World Bank 2017, applied tariff). While high income countries have an average rate of 2 percent, low income countries have the highest rate, at 9 percent.[1] Countries could raise their tariffs up to the bound rates, and therefore increase their fiscal revenue from tariffs, assuming the volume and value of trade does not decrease in response to the higher rate.[2] However, bound rates are only slightly higher than applied rates on average, giving little room for low income countries to increase applied rates up to the maximum bound level.[3]

Overall, country commitments under the GATT have been very effective at bringing global average tariffs down. At the WTO, schedules of concessions, combined with the most favored nation (MFN) clause, ensure that trade partners get the most favorable treatment accorded to any other trade partner (including non-WTO) by that country, which puts further downward pressure on applicable tariff rates. Although decreased tariff rates may lead to an increase in imports such that the overall revenue would not be heavily impacted, trade volume has not, in fact, sufficiently increased in many developing countries to make up for the tariff loss. Furthermore, as developing economies become more diversified, a domestic product may be available instead of the imported product, leading to a decrease in tariffs revenues.

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[1] Brazil's rate is 8.6 percent, China stands at 3.8 percent, India at 5.8 percent (World Bank 2017, applied tariff).

[2] The Laffer curve predicts that at a certain point, increases in tariffs are inefficient because they cause a decrease in imports, resulting in a loss of overall revenue. How this theory applies in practice may depend on a number of factors. For instance, are the local customs authorities effective at administering the increased duties? Are there substitute domestic goods that will affect the tipping point at which increased duties no longer generate additional revenue? Other legal constraints may also come into play. For instance, could foreign investors affected by the increased tariffs claim that the change amounts to a breach of fair and equitable treatment under an applicable bilateral treaty (see further discussion in Section II.B below)?

[3] The weighted mean most-favored nation tariff for the world is 4.17 percent, it is 3.4 percent for high income countries and 10.8 percent for low income countries (World Bank 2017, MFN tariff).

An additional factor impacting tariff revenues is the emergence of a digital economy. It has resulted in substituted digital versions of traditional products and created vast opportunities for a range of digital transactions that are currently not subject to customs duties thanks to a WTO moratorium. Estimates run to nearly USD 5.2 billion of revenue foregone for developing countries (excluding Least Developing Countries), using the average MFN applied rates and a further USD 344 million for Least Developed Countries (LDCs) alone (Banga 2019).

TAX POLICY CONSTRAINTS

In addition to the direct constraints on fiscal revenue resulting from decreased tariffs, the WTO imposes a number of restrictions regarding countries' tax policy. These constraints generally take the form of non-discrimination rules for trade in goods and services, which fall into two categories:

- Most favored nation (MFN) obligations, requiring states to treat the products, services, and service providers of another country no less favorably than it treats the like products, services, and providers of the most favored trade partners, and
- National treatment obligations, requiring states to treat foreign products, services and providers no less favorably than the treatment accorded to like products, services, and providers.

The scope of both obligations reaches to domestic taxes and other charges (GATT Arts. I, III). In a recent case, for example, a dispute settlement panel ruled that tax advantages granted by Brazil only to Mexico and MERCOSUR members were inconsistent with the MFN clause (*Brazil-Taxation*).[4] National treatment involves a significantly higher volume of litigation, and are particularly germane to indirect taxes, such as consumption taxes, sales taxes, use taxes and value-added taxes.[5] Several WTO members have challenged each other's domestic consumption taxes favoring domestic alcoholic beverages over imported counterparts (e.g., *Korea-Alcohol*, *Philippines-Distilled Spirits*, *Japan-Alcohol*, *Chile-Alcohol*).[6] Generally, the complaining party won and the taxing country had to align the taxation of domestic and foreign alcohol. In the context of the General Agreement on Trade in Services (GATS) similar MFN commitments apply (GATS 1994, Art. II:1).[7]

Taxing foreign services activity presents additional challenges. First, extraterritorial taxation is often not possible for cross-border supply of services, which is the most common mode of supply (GATS Art. XXVIII(o)). Second, taxation attached to specific services transactions is only possible insofar as the consumption of those services is able to be tracked and assigned to a particular jurisdiction, which is particularly difficult for most cross-border supply.[8]

Overall, then, MFN and national treatment obligations in trade agreements leave countries free to set the level of direct and indirect taxes as they see fit, so long as the policy does not discriminate against

[4] In another program promoting the automotive sector, Indonesia's higher tariff and tax measures applied to imports of certain members were struck down (*Indonesia-Autos*).

[5] Direct taxes, such as income taxes, profit taxes and corporate taxes, are generally understood to be excluded from the scope of the national treatment commitments (Slemrod & Avi-Yonah 2002).

[6] Similar issues arose with respect to cigarettes (*Thailand-Cigarettes*, *Dominican Republic-Cigarettes*).

[7] Although GATS members may grandfather in some existing (pre-1995) inconsistent measures through notification and periodic review, late comers to the WTO, often developing countries, face increasingly stringent conditions of accession. Once a WTO member does decide to open a particular service sector to foreign competition, it must then comply with a number of requirements (specific commitments), including non-discrimination between the foreign service supplier and domestic service suppliers (national treatment) and market access obligations, which ensure that foreign service suppliers will not be encumbered in the volume, value of their transactions, number of service suppliers, licensing and other regulatory requirements, and the type of business entity they set up locally.

[8] Supply of services through Modes 3 (commercial presence) and 4 (presence of natural persons) do not face the same logistical challenges, but are not nearly as prevalent modes of supply.

some foreign operators vis-à-vis other foreign operators or vis-à vis their domestic competitors. Most cases tend to involve tax revenue foregone for protectionist purposes or for industrial policy purposes, which can conflict with subsidies rules as well as the non-discrimination obligations. These constraints not only affect countries' current tax policy, but also their ability to change their tax policy in the future to support particular sectors of their economy or population. With respect to the digital economy, the theoretical problems arising from tying a transaction, an operator or a consumer to a particular taxing jurisdiction are compounded with operational issues of tracking the activities and the operators. This is a particularly significant hurdle to fiscal mobilization with low-capacity developing countries.

Preserving Domestic Tax Autonomy: Carve-Outs, Exceptions and Future Negotiations

The WTO offers a number of avenues for states to assert and protect their taxation power. Most of these provisions are not directly aimed at tax policy but may be used for fiscal mobilization. Others are explicitly aimed at avoiding conflicts between WTO obligations on the one hand, and domestic and international tax rules on the other hand, but their scope and interpretation is uncertain.

One narrow but straightforward flexibility is non-reciprocity for LDCs which allows them to not extend reciprocity in WTO negotiations. Beyond that, both the GATT and the GATS allow a limited degree of renegotiation or modification of commitments (GATT Art. XXVIII:4; GATS Art. XXI). Such provisions make it possible, albeit costly, for a state to raise its tariffs or otherwise reduce its market access to foreign competition. In theory, the goal is to maintain an equivalent level of trade liberalization, such that if a party wishes to change its concessions in one sector, it must offset it in another sector. The net fiscal impact of such rearrangements may be correspondingly marginal.

In future WTO tariff negotiations, the modality by which tariff cuts are made also has an impact on tax revenue mobilization. Tariff cuts across the board based on mathematical formulae would result in less control over the fiscal impact of the cuts depending on the structure of imports, whereas line-by-line negotiations may preserve higher tariffs on key imports. Agreements like the Trade Facilitation Agreement, which allow WTO members to opt-in selectively to different types of obligations and benefit from funding mechanisms for implementation are also likely to preserve tax revenue by lowering the cost of implementation.

TEMPORARY INCREASES IN TARIFFS

Countries also have access to temporary tariff increases in certain contexts such as sudden surges in competing imports, suspecting unfair trade practices by foreign companies, or subsidies by foreign governments. In those cases, a country may impose temporary safeguards, anti-dumping or countervailing duties to manage the crisis or address the unfair practices (GATT Arts. VI, XIX; GATS Art. X; ADD (1994); SCM (1994); Agreement on Safeguards (1994)). These unilateral approaches can increase revenue as long as the import of targeted products does not decline to the extent that it offsets the potential additional revenues.

TAX CARVE-OUTS IN THE GATS

The GATS allows some additional flexibility through the ability to notify "non-conforming measures" regarding MFN and (where a sectoral commitment is made) national treatment obligations. Moreover, general exceptions in the GATS permit members to take measures in breach of their national treatment obligation as long as they are "aimed at ensuring the equitable or effective imposition … of direct taxes" with respect to services and suppliers of other Members (Art. XIV(d)). Measures inconsistent with the MFN standard due to other tax treaty commitments are likewise carved out, however members may not apply the measure in a way that constitutes arbitrary or unjustifiable discrimination or a disguised restriction on trade (Art. XIV; GATT Art. XX). The panels and the Appellate Body have interpreted this requirement to mean that states' measures must also be the least trade restrictive alternatives that will achieve the purpose allowed in the general exception (*China-Rare Earths*).

It is worth noting that all of this risks being further constrained in regional trade agreements, either because exemptions or flexibilities available at the WTO are not available in RTAs (WTO-) or because of more stringent non-discrimination obligations (WTO+).

Conclusion

There are certainly a number of constraints put on fiscal mobilization as a result of trade treaties and trade liberalization has, in practice, decreased fiscal revenues for all but the high-income and middle-income countries. Perhaps most critically, trade liberalization has fostered the expansion of economic activities, such as trade in services, but the tax policy for such activities, domestically or through tax treaties or investment treaties has not kept up. The result is a gap between the types and volumes of economic activities enabled through trade law, and the taxation of these other activities, which takes place outside the realm of trade law.

> *"Perhaps most critically, trade liberalization has fostered the expansion of economic activities, such as trade in services, but the tax policy for such activities, domestically or through tax treaties or investment treaties has not kept up."*

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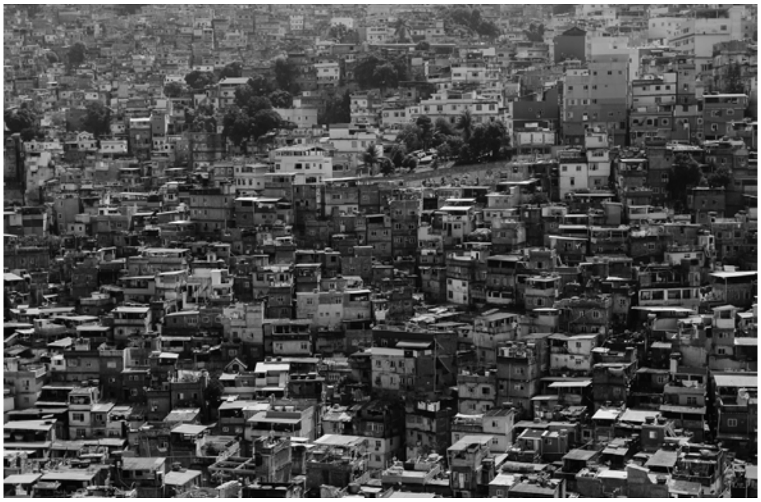
CHAPTER 7

WTO REFORM AND DOMESTIC REVENUE MOBILIZATION: THE CASE OF STZS

Reuven Avi-Yonah*



Many countries have relied on Special Tax Zones (STZs) to distribute tax preferences to companies that contribute to the diversification of the economy and local employment. Although the WTO agreements have no special reference to STZs, the existing legal framework restricts developing countries from exploiting their competitive advantages in the manufacturing of goods. By contrast, the current system incentivizes STZs in areas where, traditionally, developed countries have the comparative advantages, such as financial services, telecommunications, and banking.

One of the main instruments created by the WTO to achieve fairness in trade is the Subsidies and Countervailing Measures Agreement ("SCM Agreement"). This agreement provides substantive rules governing when, and under what circumstances, a member state may challenge a subsidy imposed by another member state. The agreement provides two avenues for objection: A state may unilaterally impose countervailing duties on subsidized imports, or file a formal complaint with the WTO Dispute Settlement Body with the possibility of imposing retaliatory sanctions if the complaint is upheld (Trebilcock 2011). One important caveat is that the SCM Agreement is limited in scope to the area of goods and does not includes rules on subsidies in the area of services.

Article 1 of the SCM Agreement defines a subsidy as a "financial contribution by a government conferring a benefit", which includes: the direct transfers of funds, goods, or services (other than infrastructure), and the non-collection or forgiveness of taxes otherwise due. Further, the SCM Agreement distinguishes two categories of subsidies: prohibited subsidies, and actionable subsidies. The prohibited subsidies, described in Article 3 of the SCM Agreement, are disallowed outright and WTO members are allowed to unilaterally impose countervailing measures against the country sponsoring them. This category includes:

1. Subsidies that are contingent, in law or in fact, upon export performance, and;

2. Subsidies that are contingent upon the use of domestic over imported goods.

On the other side of the spectrum, the actionable subsidies category includes any other subsidies that are not considered "prohibited" and that satisfy the following two additional requirements:

1. Specificity: An actionable subsidy is considered specific when the eligibility to receive the benefits is limited to certain enterprises, industries, or areas (article 2 of the SCM Agreement), and;

* Professor of tax law at University of Michigan.

2. Adverse effect: An actionable subsidy is considered adverse when it produces a serious prejudice to the interests of another member, an injury to its domestic industry, or a nullification or impairment of benefits accruing directly or indirectly to other members under the General Agreement on Tariffs and Trade (GATT) 1994 (article 5 of the SCM Agreement).

When an actionable subsidy is specific and produces an adverse effect, the affected countries are entitled to file a formal complaint with the WTO Dispute Settlement Body, and may impose retaliatory sanctions in the event that the complaint is upheld.

Special Tax Zones: A Taxonomy

Once demonstrated that the tax preferences granted by the STZs are subsidies under Art. 1 of the SCM Agreement, the next step consists of determining whether those subsidies are considered prohibited, actionable, or non-actionable. For these purposes, this paper distinguishes: "red light STZs," which are those that qualify as prohibited subsidies under article 3 of the SCM Agreement; "yellow light STZs," which are those that qualify as actionable subsidies under article 2 of the SCM Agreement; and finally, "green light STZs," which are those that are outside the purview of the WTO.

RED LIGHT STZS

"Red light STZs" are prohibited under article 3 of the SCM Agreement. This category includes STZs granting tax benefits that qualify as prohibited subsidies under the agreement. An STZ grants a prohibited subsidy when the tax benefits are contingent upon export performance or the use of domestic over imported goods. For further detail, Annex 1 of the agreement provides a list of prohibited export subsidies which includes (in paragraph "E") income tax reductions, remissions, deferral, or special exceptions, to the extent they are specifically related to exports. With regard to indirect taxes and custom duties, an exemption, remission, or deferral is considered a prohibited subsidy only if it is in excess of those levied with respect to the production and distribution of like products when sold for domestic consumption.

The language of Article 3 and the guidelines provided by Annex 1 of the agreement treats as a prohibited subsidy any ring-fencing scheme based on prohibiting the introduction of goods manufactured within the STZ into the domestic market of the sponsoring country. When an STZ qualifies as a red light STZ, any WTO member may request the establishment of a dispute settlement procedure in order to obtain a ruling recommending that the offending subsidies must be withdrawn without delay. The requesting member does not need to demonstrate that the subsidy is specific to a certain industry or sector, or that the subsidy is producing an adverse effect on the economy of other WTO member. Further, if the member found in violation does not comply with the recommendation, the complaining party may eventually receive authorization from the Dispute Settlement Body to take appropriate countermeasures (Farrell 2013).

> *"The entry into force of the SCM Agreement was a hard blow for many countries, especially developing countries with long-established manufacturing STZs."*

The entry into force of the SCM Agreement was a hard blow for many countries, especially developing countries with long-established manufacturing STZs treated as separate areas outside their borders or "national customs territory" and with tax benefits conditioned to export performance. In the years that followed the introduction of the agreement, indeed, several developing countries expressed concern that some of their internal tax and import duty exemption programs that would be covered by the prohibition were still of crucial importance for achieving their development objectives. Besides, developing countries argued that export subsidies are superior to tariffs to protect their infant industries, because the latter also negatively affect consumers in the domestic markets (Commission on Growth and Development 2008).

To sum up, since the SCM Agreement entered into force, the number of "red light STZs" around the globe has dropped, mainly after the end of the last transition period. As of today, only a reduced number of small trading developing countries maintain red light STZs.

YELLOW LIGHT STZS

"Yellow light STZs" qualify as actionable subsidies under the SCM Agreement. The "yellow light" category includes STZs granting benefits that are actionable subsidies, satisfy the specificity requirement of Article 2 of the agreement, and satisfy the adverse effect requirement of Article 6 of the agreement. If these three requirements are satisfied, the affected WTO member is entitled to file a formal complaint with the WTO Dispute Settlement Body, with the possibility for the imposition of retaliatory sanctions in the event that the complaint is upheld.

The tax benefits provided by an STZ would normally satisfy the "specificity" requirement, because ring-fencing, by definition, is based on restricting the tax benefits to a separate area, sector, group, or enterprise, in order to protect the domestic tax base. Based on this reasoning, an STZ that excludes the tax residents of the sponsoring country from the tax benefits would potentially qualify as an actionable and specific subsidy if the industry sector is included within the scope of the SCM Agreement. As explained before, the SCM agreement is limited in scope to trade in goods and excludes trade in services.

Upon establishing "specificity," the tax break must result in "adverse effects" to another WTO member. The SCM Agreement provides for three types of adverse effects: (i) injury to a domestic industry, (ii) nullification or impairment of benefits accruing directly or indirectly to other Members under GATT 1994, or (iii) serious prejudice to the interests of another Member.

Article 6 of the SCM Agreement provides complex rules to determine whether an actionable subsidy produces a "serious prejudice." A subsidy is generally deemed to produce a serious prejudice under these rules if:

1. The total value of the subsidization represents more than 5 percent of the value of the product, or more than the amount of net operating losses sustained by an industry (with the exception of one-time measures), or

2. The subsidy consists in a direct forgiveness of debt.

To sum up, the tax benefits granted by an STZ to a specific industry, sector or taxpayer are by definition treated as specific subsidies under the SCM agreement. Therefore, it would be necessary to test whether the adverse effect requirement of Article 6 of the SCM Agreement is satisfied. In this regard, for example, if the lower corporate income tax rate is found to subsidize the production costs by 5 percent or more, then the STZ would be deemed to cause "serious prejudice" and "adverse effects" to the interests of other Members. If that is the case, the STZ will be obliged to withdraw the subsidy or remove its adverse effects. But the sponsoring country could bring the regime into conformity with the subsidy rules by only increasing the low corporate income tax rate to the extent necessary, or lowering the mainstream rate to match the level offered within the STZ. Alternatively, the sponsoring country could remove the "specificity" of the STZ by opening up the tax benefit to all industry sectors, domestic and foreign. However, this in effect may negate the purpose of the STZ. In consequence, under the actionable subsidies criteria, the legality of STZs is still very risky (Farrell 2013).

GREEN LIGHT STZS

"Green light STZs" are outside the scope of the WTO Agreements. This category includes:

1. *Non-harmful STZs:* These are STZs with tax benefits that are actionable and specific subsidies but do not satisfy the adverse effect requirement. This category would include, for example, STZs in which the benefit does not exceed the 5 percent threshold described in article 6 of the SCM Agreement (see above).

2. *Service-oriented STZs*: Subsidies promoting the provision or export of services are outside the scope of the SCM Agreement.

3. *STZs granting benefits protected by the agreement on Agriculture*.

4. *Art. 8 STZs (until 1999)*: While SCM Article 8 was in effect (through 31 December 1999), STZs intended to promote certain research activities, assistance to disadvantaged regions, or the adaptation of existing facilities to new environmental requirements, were not considered unfair or distortive by the WTO. Since this provision was eliminated, the tax policies underlying the subsidization are no longer relevant for the WTO legal analysis. The main factors to determine whether a subsidy is permitted under the WTO rules (e.g. specificity, adverse effect, etc.) are fact-specific and do not rely on tax policy considerations.

Conclusion

In the last two decades, the WTO has become the global leader in the regulation of STZs. The rules of the SCM agreement filled a regulatory vacuum that the OECD left when its members decided to withdraw the organization from any initiative intended to regulate tax incentives and countries' tax policies.

The shift of the global leadership from the OECD to the WTO could be seen as a positive change in terms of legitimacy, because the WTO is a truly global organization with 164 members representing 98 percent of world trade. In addition, this change could be seen as a legal progress because the WTO can create "hard international law" enforced by a quasi-judicial global institution. The main benefit of creating hard international law is the break-down of the "Westphalian dilemma" and all the collective action problems of the current international tax regime.

Overall, however, the current WTO legal framework governing STZs appears to be unfair and inconsistent with the underlying policy goals of the organization. This is because service STZs generally remain free from legal challenges (because there are no formal subsidy rules concerning services), whereas manufacturing STZs (with substantial activities) are significantly curtailed. The disparity of treatment between "goods-oriented STZs" and "service-oriented STZs" has produced a negative impact on developing countries, as they tend to rely more on manufacturing STZs to achieve economic growth. By contrast, developed countries tend to rely more on offshore banking, technology, and financial services STZs to attract investment, which are largely immune from WTO oversight.

> *"… the current WTO legal framework governing STZs appears to be unfair and inconsistent with the underlying policy goals of the organization."*

The current WTO system restricts developing countries from exploiting their competitive advantages in the manufacturing of goods. At the same time, the current system incentivizes developed countries to implement STZs in areas where they have comparative advantages, such as financial services, telecommunications, banking, etc. The WTO records of requests for consultations provide factual support to this conclusion: From a total of 115 cases based on the SCM Agreement, only 32 were initiated by developing countries (WTO 2017). In addition, most of the export-contingent STZs created in the developing world were significantly restricted during in the early 2000s by operation of the SCM agreement. The technical reason for this disparity is that the SCM Agreement did not include services within its scope, and the GATS has not included subsidy rules to fill that gap. As a result, international financial service zones, or international business centers that offer offshore banking are generally free from challenges under the current WTO law, although they could be challenged at the regional level (e.g. under the EU law). The fairness and distributional concerns raised by this disparity has not been sufficiently addressed by the WTO leadership, on the grounds that the main objectives of the WTO are limited to market access, freedom, and non-discrimination in trade.

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CHAPTER 8

POLICY SPACE FOR FISCAL REVENUE MOBILIZATION UNDER FTAS AND BITS

Manuel F Montes*

Outside of the WTO, free trade agreements (FTAs) and bilateral investment treaties (BITs) place additional downward pressure on fiscal revenue, while simultaneously decreasing the policy space to make changes to their tax policy. This is especially true for developing countries. Compared to developed countries, developing countries are more dependent on trade taxes for revenue than on other kinds of taxes. Agriculture, which tends to represent a bigger proportion of developing country GDPs, is difficult to tax. Collecting taxes on personal income is also more difficult in developing countries where formal employment is a much smaller proportion of total employment than in developed countries. In the United States, tariffs were the largest source of federal revenue from the 1790s to the eve of World War I, until it was surpassed by income taxes (South Centre 2012).

Trade taxes represented nearly one-fourth of tax revenues in low income countries in 2000-2006 (Cage and Gadenne 2018), even in the aftermath of two decades of trade liberalization. Cage and Gadenne (p. 27) suggest that:

> Trade liberalization … seems to have come at a larger fiscal cost in today's developing countries; this may be because they decreased taxes on trade before having developed tax administrations capable of taxing domestic transactions on a large scale."

Governments have to upgrade their capacity to collect revenues as development happens. Tax revenues lost from premature trade liberalization can severely limit not only resources governments need for developing spending and social development but also resources and policy space required toward expanding state capacity to collect other kinds of taxes. Moreover, these treaties put contingent liabilities on developing countries through obligations to compensate foreign investors within the Investor-State Dispute Settlement (ISDS) system.

The next section will examine the impact of accession to BITS and FTAs on tax revenues themselves. The second section will discuss the impact on fiscal policy space. The third section offers prospects and possible solutions.

* Senior Advisor, Society for International Development. I am solely responsible for all errors, opinions and analyses. Email: montesmf0@gmail.com.

The Impact on Fiscal Revenues Under FTAs and BITs

The immediate revenue impact of an FTA stems from the "goods" and "services" chapters, in which participating countries (usually called "Parties") make commitments to eliminate tariffs and promise not to raise these in the future. USMCA's parent, NAFTA, was the first trade agreement that "eliminated tariffs between high wage economies (US and Canada) and a low wage developing country (Mexico)" (Polaski, Capaldo, and Gallagher (2019); all subsequent FTAs between developed and developing countries have done the same.

THE REVENUE IMPACT OF FTAS

For developing countries, the impact on fiscal revenues of joining an FTA has been significant, requiring extensive reforms in a developing country's fiscal structure. The average tariff rates of developing countries in the WTO are bound over higher ranges. By acceding to an FTA, developing country Parties bind their tariff rates to zero on most goods and services from developed country Parties.

An Economic Partnership Agreement (EPA) between European countries and developing countries require that Parties eliminate tariffs from 80 per cent of tariff lines. A South Centre (2012) study of the (EPA) between African countries and European countries estimates that Sub-Saharan African countries stood to lose USD 3.4 trillion per year in revenues, with LDCs losing USD 1.3 trillion and non-LDCs losing USD 2.1 trillion in revenues.

> *"Baunsgaard and Keen (2005) in an IMF working paper find that low-income countries (which are those most dependent on trade tax revenues) have recovered, at best, no more than about 30 cents of each lost dollar through the introduction of VAT."*

Tariff revenues lost to FTAs can be made up for by reforming the fiscal revenue system. However, FTA accession must recognize the often onerous and politically fraught process of fiscal reform; signing an FTA is not just a matter of trade policy. The IMF has long championed the introduction of value-added taxes (VAT) to strengthen the tax systems in developing countries and as a good candidate to replace tariff revenues lost. Based on panel data from 111 countries in the period 1975 to 2000, Baunsgaard and Keen (2005) in an IMF[1] working paper find that low-income countries (which are those most dependent on trade tax revenues) have recovered, at best, no more than about 30 cents of each lost dollar through the introduction of VAT. For middle-income countries, recovery has been in the order of 45–60 cents for each dollar of lost trade tax revenue.

Cage and Gadenne (2018, p. 4) find that the typical trade liberalization reform in developing countries since 1970 during which trade tax revenues declined was not revenue-neutral but instead lead to a decrease in total revenues.

THE CONTINGENT LIABILITIES IMPACT OF INVESTOR PROTECTIONS

The impact of BITs on government revenues derives from the unbudgeted contingent liabilities to investors. Under the standard BITs, host country governments hold obligations to compensate foreign investors (Montes 2019, p. 83). FTAs with investment chapters and BITs in effect create unbudgeted contingent liabilities plus the costs of the litigation. When host governments lose cases under the arbitral procedures of BITs, monetary compensatory damages must be paid to aggrieved enterprises (Montes 2019). They must also bear the costs of often extended periods of litigation.

[1] No subsequent studies have overturned the results of this working paper.

In March 2010, Ecuador had lost an arbitral dispute in an oil-concession case, brought by Chevron for approximately USD 700 million. In another oil-related case in October 2012, Ecuador was ordered to pay to the U.S.-based Occidental Petroleum Corporation USD 1.7 billion plus interest for having canceled its operating contract in 2006. These two awards combined are the equivalent to approximately 3.3 percent of that nation's gross domestic product (GDP).

The claims on the public budget of the costs of mounting a defense in arbitral litigation can be an immense burden for developing countries. The Philippine government "spent USD 58 million to defend two cases against German airport operator Fraport—the equivalent of the salaries of 12,500 teachers for one year, vaccination for 3.8 million children against diseases such as TB, diphtheria, tetanus, and polio; or the building of two new airports" (CEO/TNI 2012, p. 15).

THE IMPACT ON FISCAL POLICY SPACE

Many FTAs and BITs take pains to carve out tax policy space for fiscal revenue mobilization The structure of actually existing FTAs and BITs have introduced the so-called "matryoshka structure" in which the general original tax policy carve out provision is whittled down through exceptions in subsequent paragraphs. This structure involves rules within rules (Uribe and Montes 2019, p. 2), in the manner of the Russian "matryoshka" nesting dolls.

It is useful to illustrate the structure from the text of the Trans-Pacific Partnership (TPP) (2016, Chapter 29, Article 29.4, paragraph 3). The TPP is one of the most recent mega-FTAs and reflects the most developed and elaborate structure of provisions applicable to the tax policy carve out. In Chapter 29 entitled "Exceptions and General Provisions" the 'overall' carve out is stated this way:

> 3. Nothing in this Agreement shall affect the rights and obligations of any Party under any tax convention. In the event of any inconsistency between this Agreement and any such tax convention, that convention shall prevail to the extent of the inconsistency.

The United States, the dominant developed country among the 12 signatory Parties to the TPP withdrew from the TPP but the other 11 countries completed the negotiations. Like most of the text of the TPP, this article was "imported" into the final text into the "CP(TPP)" Text (2016) ("Comprehensive and Progressive Agreement for the Trans-Pacific Partnership").

Inside FTAs and BITs, investor and supplier protections, particularly those emanating from National Treatment (NT) and Most Favoured Nation (MFN) obligations, limit the policy space supplied by the tax carve out. In many instances, the carve-out provisions can often be contradictory and vague, subjecting tax policy making to interpretations by arbitral panels. For example under the Energy Charter Treaty (2016) (an important treaty from 1998 widely applicable in investment in oil and natural gas projects) the tax carve outs are limited by additional vague prohibitions against discrimination, uncompensated expropriation, and measures that "arbitrarily restrict benefits accorded under the Investment provisions of this Treaty".

The *matryoshka* structure finds a codification in the CP(TPP). To illustrate, the paragraph after the previous paragraph 3 above says (TPP 2016, Chapter 29, Article 29.4, paragraph 4) starts with:

> 4. In the case of a tax convention between two or more Parties, if an issue arises as to whether any inconsistency exists between this Agreement and the tax convention, the issue shall be referred to the designated authorities of the Parties in question. The designated authorities of those Parties shall have six months from the date of referral of the issue to make a determination as to the existence and extent of any inconsistency.

This paragraph walks back the Paragraph 3 carve out by opening a process by which an 'inconsistency' between a tax treaty and the CP(TPP) can be litigated. The rest of the paragraph, not included here for brevity's sake, provides the possibility of a dispute settlement action as early as six months from the start of the complaint. Subsequently, the CP(TPP) codifies the manner in which the carve out for domestic tax policy is whittled down. Length restrictions obviate direct quotation from these paragraphs. The import of these texts indicate that (to give only two examples):

> in the case of taxes applicable to trade in goods are concerned, Paragraph 6(a) reinstates the protection of national treatment and the blanket prohibition against export taxes; in case of trade in services, Paragraph 6(b) reinstates national treatment in cross border trade in services (Chapter 10 of CP(TPP)) and in supplying financial services (Chapter 11 of CP(TPP)) in respect to taxes on income, capital gains, and other taxes on transactions mainly related to the valuation of mergers and acquisitions;

In Paragraph 6(b), the applicability of Paragraph 29.3's tax carve-out is further confined with the reinstatement of National Treatment and Most-Favored-Nation Treatment, as it applies to investor protection (Chapter 9 of CP(TPP);

At the end of Paragraph 6, there are exceptions to the exceptions including, for example, for a "non-conforming provision of an existing taxation measure." Another 'exception to the tax policy carve out' are set out in Paragraph 7 and apply to investment performance requirements from the Chapter 9 for investor protections. CP(TPP) has codified explicitly the *matryoshka* structure of the tax policy carve out of older BITs and FTAs – inviting importation into future FTAs, BITs, and possibly the WTO. Uribe and Montes (2019, p. 1) state that "the rise of arbitral disputes of tax-related measures is a reality." There are 42 ISDS tax-related measures against states by private investors. Twenty-eight are based on BITs with tax carve out clauses. There are provisions that allow for a delay in the lodging of a dispute by the addition of a joint tax consultation process, but which is time restricted (often six months), after which the aggrieved private party can file a dispute.

"There are 42 ISDS tax-related measures against states by private investors. Twenty-eight are based on BITs with tax carve out clauses."

As in other areas, there has been a lack of consistency among ISDS awards on tax measures. Some panels have seen the violation of the "legitimate expectations" on the part of private investors regarding a stable fiscal regime as a violation of fair and equitable treatment when applied to changes in tax laws (Eberhardt, Olivet & Steinfort 2018, Childs 2011).

The acceptability of challenges on tax measures has naturally created the suggestion on the part of international legal professionals to use the threat of dispute filing as a "preventive" measure against proposed tax measures (see Montes 2019, p. 107, footnote 4 for an example). In view of the unfortunate record of ISDS as an unbounded, arbitrary, and inconsistent process, a widespread popular effort to attenuate its power, if not to eliminate it, has emerged. The Comprehensive Economic and Trade Agreement between the European Union and Canada signed in 2016 (Montes 2019, p. 102), sought to improve the governance of ISDS processes (but not the substantive imbalances in obligations between investors and host countries).

Possible Reform Proposals: Protecting and Expand Policy Space for Taxation

The previous two sections have indicated that FTAs and BITs have a direct impact on reducing revenue resources and a severe impact on tax policy space. The survey of obligations in various FTAs and

BITs which constrict the policy space for taxation measures should be understood as a rolling program with a tendency to expand the developing country obligations which shrink policy space.

A list of proposals from national governments to protect their tax policy space must begin with introducing genuine carve outs for tax policies. The removal of the applicability of fair and equitable treatment to changes in tax policy will be necessary as is the separation of national treatment and most favored nation exceptions. To point to a quick example, can the introduction of global minimum tax rates on international companies be challenged under national treatment? There are a host of issues: thin capitalization rules, not to mention alternative transfer pricing audit approaches.

The prevalence of the *matryoshka* structure of tax carve-outs in BITS and FTAs must be overturned. However, the effort must be imbedded within the ongoing global reform effort over imbalances in the allocation of taxing rights – between "resident" and "source" countries – over enterprises that operation in multiple jurisdictions. Developing countries are principally "source" countries" – where profits are made because economic activities take place there.

There is thus an impending struggle between developed versus developing country taxing interests. The debates in the OECD's Inclusive Framework of the Base Erosion and Profit Shifting project on the taxation of the digital economy is only the prelude to a more comprehensive debate about whether the OECD's standards which protect its residence-based tax preference will need to be overturned.

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CHAPTER 9

NAVIGATING THE TAX-TRADE-INVESTMENT REGIME COMPLEX: IMPLICATIONS FOR WEALTH TAXES AND STRUCTURAL ECONOMIC TRANSFORMATION

Todd N. Tucker, PhD*

At a time when the climate crisis poses an existential threat to humanity and economic inequality does the same for democracy, there is a growing demand for big structural changes to fundamentally remake our political economies. Once debated and discussed in separate siloes, questions of tax, industrial policy, decarbonization, and revitalization of democratic practices increasingly and by necessity interconnect. Yet future efforts to begin addressing these matters in domestic law will face significant challenges at the international law level. Thousands of tax, trade, and investment treaties drafted in an earlier era impose obligations on governments to minimize the impact of regulation on transnational business interests. Trade and investment provisions which purport to "carve out" tax policy from their purview have become increasingly narrow, while double taxation treaties are similarly narrow and may come with ramifications for international dispute settlement. This essay will briefly discuss these constraints and what they mean for structuralist initiatives like wealth taxes.

The Challenge

We live in an era of international "regime complexes," where distinct legal systems negotiated by different actors regulate the same issue area and activity – with no hierarchy above them that can help resolve conflicting rules (Keohane and Victor 2011).

This complex layering is particularly evident in the tax arena. Since the 1920s, through networks of thousands of bilateral tax treaties, governments have negotiated rules that give substantial discretion to private corporations and individuals in choosing in which country to report income gains. This encourages countries to compete to charge the lowest taxes, leading to the growth of tax havens and some major U.S. corporations paying nothing at all to the US Treasury (Stiglitz, Tucker, and Zucman 2019). Taxation in a world of footloose multinational capital creates an obvious need for international cooperation – i.e. giving up some sovereignty in the name of improving state solvency. Yet tax officials have agreed to stricter constraints in the field of double taxation than double non-taxation, thereby prioritizing the elimination of the chance that host country governments might dare to locally tax income also taxed elsewhere, over cracking down on income that is taxed nowhere.[1]

"Taxation in a world of footloose multinational capital creates an obvious need for international cooperation – i.e. giving up some sovereignty in the name of improving state solvency."

This leads to a substantial enforcement gap that could in theory be filled by other international economic agreements, although this has not worked out in practice. At the World Trade Organization (WTO), it is tax havens like Panama that have shown the most ingenuity in claiming that tax justice measures represent trade discrimination against them (Pettigrew, de las Casas, and Valenzuela 2015). And under investment treaties, foreign investors have brought a range of complaints against

* The author is a political scientist and director of governance studies at the Roosevelt Institute.

[1] In particular, states have agreed to increasingly automatic, mandatory, binding arbitration in the field of double taxation. See (Hearson and Tucker 2019).

corporate income taxes, personal taxes, and numerous tax subsidy schemes (Kim 2019). When European Union (EU) officials seek to keep intra-European tax disputes out of investment arbitrations, tribunals have been largely unwilling to help out.[2]

If trade and investment tribunals have been unwilling to help tax justice, they have also until now not gone far out of their way to hurt. The aforementioned Panama case ultimately went against the tax haven, while investors complaining about tax and regulatory schemes have largely had to truncate their complaints to just the regulatory part. The reason: most trade and investment treaties contain a carve-out exempting some or all tax matters. For instance, Article 32.3 of the recently negotiated US-Mexico-Canada Agreement (USMCA) reads in part: "Except as provided in this Article, this Agreement does not apply to a taxation measure."

> *"… the incentive that U.S. wealth taxes will give to the rich to expatriate themselves overseas has been a major criticism of the idea and why proponents place special emphasis on the importance that such behavior be penalized."*

But these carve-outs are not total, creating some space for conflicting obligations for states. The USMCA goes on to state that tax measures "*other* than a taxation measure on income, on capital gains, on the taxable capital of corporations, or taxes on estates, inheritances, gifts, and generation-skipping transfers" *are* required to comply with national treatment and most-favored nation requirements (emphasis added). A tax on the stocks of wealth – assessed annually on living taxpayers – is not on the list, and so would presumptively have to comply with USMCA rules. Given that wealth inequality is so extreme in 2020, the hunt for the largest stores of taxable wealth will inevitably come down to complicated Internal Revenue Service judgments about how to value the illiquid assets of a very few households. It is absolutely certain that the wealthy will feel some aspect of this process is rushed or unfair. Particularly for those families with substantial assets overseas, determining which national jurisdiction gets taxing rights over which assets will be a contested topic. Indeed, the incentive that U.S. wealth taxes will give to the rich to expatriate themselves overseas has been a major criticism of the idea and why proponents place special emphasis on the importance that such behavior be penalized (Zucman and Saez 2019). Numerous of North America's richest families and individuals divide their time or business across national borders,[3] so this is not a speculative matter.

Indeed, the carve-out is not as airtight as it might seem. According to the arbitral jurisprudence, to qualify, tax measures must be compulsory payments, imposed by the state on a defined class of people, to generate revenues for public purposes. To comply with international law, they cannot be confiscatory, expropriatory, or discriminatory, so taxing a company out of existence is unacceptable (Martinez 2019). Moreover, national authorities must (consistently across agencies and branches of government) consider the main purpose of the measure to be traditional taxation. In one case, where a solar levy was designed in a way to reduce subsidies to certain lines of business (while avoiding court challenge) rather than strictly to raise revenue, a tribunal declined to find that the carve-out applied (Bohmer 2019b). In another case, where the carve out was found to apply, a tribunal found nonetheless that it was acceptable to consider tax issues when determining how high to set damages (Bohmer 2019a).

This malleability of exceptions does not end there, with perverse implications for states attempting to regulate in ways that are compatible with their international obligations. WTO panels have been willing to find against respondent states for restricting commerce at all (on the threshold question

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[2] Indeed, in some cases, the fact that arbitrations were taking place in tax havens like Switzerland or Luxembourg meant that those countries' general bucking of other European countries' anti-tax haven postures had to be given weight when deciding tribunal jurisdictional questions (Charlotin 2019).

[3] See (Estevez 2017), (Otis 2019).

of whether trade rules had been violated), but then required superhuman levels of technocratic acumen and policy precision (on whether public interest defenses forgave the underlying violation). This was the upshot in the aforementioned Panama case, where Argentina was simultaneously faulted for interfering with financial services flows to Panama but then also for regulatory lenience for Panama when the country made some (but not total) progress towards addressing Argentina's needs.[4] Similarly, investment tribunals rule that states that make policy changes frequently and abruptly are acting arbitrarily, yet that same abrupt action can make it harder for investors to credibly claim they had a legitimate expectation that states would behave consistently (Bohmer 2019c). (Both of these lines of argument appear frequently in arbitrations involving the so-called "fair and equitable treatment" standard.)

This type of whipsawed second-guessing of policy action by adjudicators would be challenging enough in a national court system governed by precedent, centralized appeals, the possibility of removing judges for bad behavior, and a shared national culture. In international legal systems with few or none of these features, it invites sovereigntist backlash.

What This Means for Structuralist Policies

Funding the state is not the only motivation for using taxes. Indeed, new structuralist policies envision using taxation powers to reduce the power of those at the top of the income distribution, to boost social solidarity with working people, and to phase out undesirable industries like fossil fuels (Wong 2020). Thus, a side benefit of a structuralist policy like (say) a wealth tax is that it will generate revenue, but that is far from its only or major objective. A deeper and ultimately more important rationale is that it will reduce the stranglehold that the uber-rich have on technological innovation and policymaking (Boushey 2019).

Yet it is precisely such multi-faceted policies that will have difficulty surviving international legal scrutiny. In 2019, a WTO panel ruled against the green energy policies of eight U.S. states, finding that schemes that subsidized energy firms for using local goods and services were *per se* violations of WTO rules (Dumont, Ridings, and Mendoza 2019). The very logic of green jobs schemes, however, is to give local communities a political and economic stake in decarbonization. Such structuralist policy by necessity involves the simultaneous fulfillment of multiple objectives, but international lawyers struggle to defer to or even comprehend such matters of contemporary statecraft.

> *"... a WTO panel ruled against the green energy policies of eight U.S. states, finding that schemes that subsidized energy firms for using local goods and services were per se violations of WTO rules."*

None of this regime complex is set in stone. The U.S. and EU have agreed in recent years to begin fundamentally transforming their investment treaty template. The campaigns for digital taxes and anti-tax base erosion have created urgency around fiscal matters. And the appellate body – the crown jewel of the WTO – has collapsed. These challenges create an opportunity to repurpose these instruments for helping enforce structuralist policies like wealth taxes and a Green New Deal. A remade system should replicate some of the features of its predecessor – namely, leaning into amorphous terms like "fair and equitable treatment," but allowing this to be applicable to treatment of workers and the environment (not just investors). This frees up treaty negotiators from having to anticipate every eventuality, and instead tasks later-in-time actors with context-specific information (adjudicators, litigants, lawyers) with shaping the rules of the road for a new economy.

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[4] The WTO's appellate body eventually found against Panama, though without discussing many of the lower panel's novel interpretations, leaving it to future jurisprudence to uphold or reject many of the specifics.

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CHAPTER 10

REVENUE MOBILIZATION UNDER A DIVERSE GLOBAL ECONOMIC GOVERNANCE REGIME: IMPLICATIONS OF NEW DIGITAL TRADE RULES IN FREE TRADE AGREEMENTS

Jane Kelsey*

The rapid expansion of digital technologies has deepened the fiscal and revenue challenges that multinational and transnational corporations pose to states, especially in the global South. At a time when governments face growing pressure to invest in digital infrastructure and support communities, workers and businesses that are negatively affected by digital disruption, they are finding digital products, services and entities extremely difficult to tax, especially when they involve cross-border transactions.

These challenges will be exacerbated by a new template of rules on the governance and operation of digital companies and services that has been developed in the new generation mega-regional free trade agreements (FTAs), starting with The Trans-Pacific Partnership (TPP), and is being vigorously promoted in the un-mandated plurilateral negotiations on e-commerce within the World Trade Organization (WTO).[1] Existing rules on trade in services have taken on new significance as well. It is concerning that few governments understand the tax implications of these developments, let alone how to regulate them, yet they are being asked to sign away the capacity to do so in the name of electronic commerce or digital trade.

Customs Duties for Electronic Transmissions

The most obvious example is the loss of tariff revenue from the temporary moratorium on customs duties for electronic transmissions adopted by WTO members in 1998 and rolled over every two years since then. There are concerted moves to make the moratorium permanent. 'Electronic transmissions' is undefined, with some members restricting the moratorium to the transmission itself, while others apply it expansively to all digital products, such as e-books and movies or 3D-printed designs.[2] Dr. Banga addresses the impacts on the global South in a separate chapter. Those direct impacts are aggravated by the loss of revenue as cross-border transactions displace local services that benefit the economy through employment, payment of business taxes and secondary economic benefits.

The main advocates for a permanent moratorium have sought to normalise the ban and build a critical mass supporting their position through the electronic commerce or digital trade chapters in FTAs, starting with the TPP.[3] The current WTO plurilateral talks on e-commerce are also informed by the e-commerce annex for the Trade in Services Agreement (TiSA) that was negotiated on the margins

* Jane Kelsey is a Professor of Law at the University of Auckland, New Zealand.

[1] Although the US withdrew from the finalized TPP in 2016, the remaining eleven countries re-invented it as the Comprehensive and Progressive Agreement for Trans-Pacific Partnership with the digital rules intact, meaning digital corporations would benefit without the US paying any price.

[2] This is discussed in Work Programme on Electronic Commerce (WTO E-Commerce Moratorium, Communication from India and South Africa 2019).

[3] E.g., TPP Article 14.3.

of the WTO from 2013 to 2016 but never concluded. TiSA proposed a permanent ban, without defining electronic transmissions. It introduced further uncertainty by saying the prohibition was without prejudice to whether such transmissions are a good or a service, a distinction that is also important for tax purposes (TiSA, art. 10, fn 7, Annex on Electronic Commerce). There was some discussion in TiSA on how to address other forms of tax for e-transmissions; notably, a government could still impose an internal tax, such as a consumption tax, provided it was consistent with the rest of the agreement, for example, that it does not impose a higher rate on cross-border transactions (TiSA, arts. 10.2, 14, Annex on Electronic Commerce). All these provisions could resurface in the WTO.

In practice, market power may prove a bigger obstacle to tax than these rules. The major electronic marketplaces threatened to geo-block Australian users from buying goods from overseas if the federal government proceeded with plans to impose a goods and services tax on low-value transactions that were conducted through their digital platforms and made them collect it ('Amazon, Alibaba' 2017). The Australian government went ahead despite the threats, reporting in May 2019 that revenue had exceeded expectations ('Australia's Amazon' 2019). Developing countries may be more easily chilled.

The WTO's Trade In Services Agreement

The General Agreement on Trade in Services (GATS) and individual WTO members' services schedules have not changed since 1995, but their fiscal implications have. The national treatment/non-discrimination rule effectively stops governments from imposing more onerous tax rules on foreign entities (insidetrade 2019), while the market access obligation prevents them requiring a commercial presence to take a specific legal form that makes them easier to tax.

"The national treatment/non-discrimination rule effectively stops governments from imposing more onerous tax rules on foreign entities , while the market access obligation prevents them requiring a commercial presence to take a specific legal form that makes them easier to tax."

Governments' schedules apply those rules to selected services, including taxation services, financial services, telecommunications and computer and related services, as well as retail, advertising, education, transportation, professional, health and education services. Because the obligations apply to 'measures affecting the supply' of services, the national treatment and market access restrictions can apply to taxation measures for those services that a government commits.

Governments can further differentiate between four modes for delivering the sectoral services they commit, including mode 1 (cross-border supply) and mode 2 (consumption of digitized services). Digitization has resulted in constraints on regulating cross-border services in ways that were not anticipated in 1995. This is especially significant for computer and related services, where commitments in mode 1 cover data transfers and those in mode 2 cover data storage offshore.

Trade in services commitments in specific sectors also trigger rules restricting payments and transfers and capital movements. Governments give away the right to restrict international transfers and payments for current transactions or impose restrictions on capital transactions, except for balance of payments reasons (GATS 1994 art. XI). Nor can they restrict movements of capital where they have a sectoral commitment in mode 1 (cross-border supply) and capital flows are an 'essential part' of that service (GATS 1994 art. XVI, fn 8).

New Constraints in FTAs

Contemporary FTAs have deepened these constraints in several ways. First, many FTAs now use a 'negative list' approach to commitments, promising not to adopt measures (including taxation measures) 'affecting' the supply of a service, contrary to core rules, for the indefinite future. To retain the right to use such measures a government must (be allowed to) list them in annexes that either impose a standstill at current levels of regulation or preserve future policy space but only for specific measures or activities that are listed. That requires a crystal ball – how many governments, for example, will have preserved the policy space to regulate and tax cryptocurrencies?

> *"... many recent FTAs have added new core rules at the behest of the Big Tech companies."*

Second, many recent FTAs have added new core rules at the behest of the Big Tech companies. Regulators usually want foreign corporations to have a local presence to ensure clarity of the applicable law, and avoid practical problems of service of documents, jurisdiction and enforcement.[4] The tech companies want to run their global operations from a single or small number of nodes for reasons of profit, logistics, tax, regulatory arbitrage and legal liability. A new rule prevents the government from requiring a cross-border supplier of a service to have a local presence inside the country (CPTPP art. 10.6). Parties can take a reservation against this rule in their annex, but must do so in relation to specific matters, including for taxation measures; few have had the foresight to do so.

Third, even where a tech transnational has a local presence, that entity may have minimal legal functions, powers and capitalisation. For example, the standard 'Uber model' has a separate legal entity that supplies only support services inside the country and receives none of the revenue, and hence has no tax liability relating to the Uber transactions or the corporation's earnings and profits (O'Keefe & Jones 2015).[5] The market access rule of the GATS prevents a government from requiring that foreign services companies establish themselves through a particular form of legal entity that would make it easier to hold them liable or at least to serve documents (GATS 1994 art. XVI(e)). Again, a government can explicitly reserve the right to deviate from that rule in its negative list schedule, including for taxation purposes. But no countries appear to have done so in their recent FTAs.

Investment chapters of contemporary FTAs contain additional constraints on moves to restrict profit shifting to tax havens through bogus royalties. The WTO Agreement on Trade-Related Investment Measures (TRIMS) prevents governments from imposing specific kinds of performance requirements on foreign investments and applies only to goods. Recent FTAs apply that rule to goods and services and prevent a government from requiring an investor to adopt a given rate or amount of royalty under a license contract, if that would constitute direct interference with the license contract by a non-judicial government agency (CPTPP art. 9.10(i)(i)).

Investment chapters also require governments to permit all transfers relating to a covered investment freely and without delay, including royalties, management fees and technical assistance (GATS 1994 art. XI). Governments can prevent or delay transfers in specified circumstances, such as for financial reporting that is necessary to assist financial regulators, for penal offences or for compliance with court orders. That might provide limited flexibility for tax purposes, but only where action was taken through the 'equitable, non-discriminatory and good faith application of its laws' (CPTPP art. 9.9.4).

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[4] In 2018 the South Korean government announced plans to impose new taxes on global tech companies like Google and Apple, which are notorious tax avoiders and benefit from the tax law that says only companies with a fixed place of business in the country have to pay tax (Lovejoy 2018).

[5] A similar structure enabled Facebook France to shift legal responsibility under French law for breach of advertising regulations to the parent companies in the US and Ireland. The decision of Tribunal de Grande Instance de Paris was delivered on 20 February 2014 (Andrieu 2014).

OECD 'Unified Approach' BEPS Proposal

Digital transnationals are notorious for profit shifting to low-tax jurisdictions, depleting corporate tax revenue in the country where the business activity took place. In October 2019 the OECD issued a consultation document for G20 consideration that would increase a government's right to levy taxes on corporate income earned from sales in the country (OECD 2019). This is intended to forestall the trend for individual countries to impose digital taxes. The proposal would allow countries to claim a proportion of the global profits of the big tech companies based on the sales of the global group in that country, even if the company has no local presence and irrespective of where the profits are formally held. Where there was a local presence, a formula would be developed to generate a fixed rate of return for local activity in the country. Tax justice analysts have criticised the proposals as 'weak and overly complex' and failing to address the problematic 'arms-length principle' that applies to transfer pricing. The main beneficiaries would be high-income countries with few benefits for the global South (Partington 2019).

Depending on the design, this initiative could partially alleviate the problem of local presence. However, other digital trade rules could make it unworkable. The proposal assumes that tax authorities have access to the relevant data.

However, governments are just beginning to explore regulatory options to ensure data is accessible and subject to local requirements and restrictions.[6] The Big Tech companies have lobbied hard and successfully for digital trade rules that guarantee the unfettered right to collect data related to their business and store, transfer, process, use, sell and exploit it in their place of choice anywhere in the world. While they argue it is inefficient to duplicate facilities and personnel, they are equally concerned to maximise their regulatory arbitrage; the bulk of servers are in the US, which does not regulate the Internet and has weak consumer and privacy laws. This works for tax authorities in the US who can access the data. It also highlights jurisdictional tensions within the EU. The Tax Justice network observes how the growth of data havens alongside tax havens, such as Luxembourg and Ireland (Turner 2017), compounds the corporate capture of regulatory authorities by Big Tech and encourages competition between such havens to attract their business (Shaxson 2019).

> *"The Big Tech companies have lobbied hard and successfully for digital trade rules that guarantee the unfettered right to collect data related to their business and store, transfer, process, use, sell and exploit it in their place of choice anywhere in the world."*

If binding rules on data transfer become more widespread, other countries will be unable to require that tax-relevant data is held locally or even specify which offshore destinations are acceptable. That rule is subject to 'legitimate public policy objectives', which would presumably include tax purposes. However, any restriction needs to be least burdensome to achieve the tax objective; that includes voluntary arrangements with corporations to make data available, which are problematic to monitor and enforce. The tax measure must also not constitute arbitrary or unjustifiable discrimination.

In addition, tax authorities may need to access source codes and algorithms. For example, in certain circumstances United States' law authorizes the copying of source code of software used for accounting, tax planning, tax returns and compliance for the purpose of analysis, and, with a court order, remove it from the place of business for review by external experts (26 U.S. Code § 7612). Yet e-commerce texts in recent trade agreements say a party cannot require disclosure of source code (EU-Japan EPA, art. 8.73). The US-Mexico-Canada Agreement (USMCA) explicitly extends that to algorithms.

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[6] Such measures are described by the US as trade barriers. See for example USTR 2018.

Governments have expanded the exceptions to this provision as they recognize the potential problems it poses for regulatory oversight and enforcement. The FTA between Japan and the EU included an exception to remedy a violation of competition law, but did not refer to tax law. The USMCA went further, and allows a regulatory body or judiciary authority to require preservation and disclosure of a source code or algorithm for a 'specific investigation, inspection, examination enforcement action or judicial proceeding'. That would apply to tax, but would not authorize routine requirements for disclosure. It is also subject to 'safeguards against unauthorized disclosure', which could prevent analysis by outside experts.

Exceptions

Where governments breach these rules on trade in services or digital trade, and their schedules and the limited exceptions do not save them, they have to fall back on the taxation exception. The exception is a defence, with the burden of proof falling on the government that invokes it. The exceptions for taxation in the WTO's goods and services agreements are very narrow and were adopted unchanged in many early FTAs. The wording and scope of taxation exceptions vary across subsequent agreements. The same exception generally applies to multiple chapters, which for digital commerce includes goods, services and financial services, investment and e-commerce. Recent mega-regional agreements are especially complex, with a maze of carve-outs, carve-backs, and exceptions for different chapters, specific rules and kinds of tax (e.g., CPTPP art. 29.4). The result has been likened to a Russian matryoshka doll and provides tax authorities with neither clarity nor certainty as they approach the challenges posed by a rapidly transforming digital domain.

The most important protection at this stage is for countries, especially in the global South, to keep their policy and regulatory space open to assess and respond to these challenges by rejecting any more widespread adoption and extension of these electronic/digital trade rules.

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CHAPTER 11

NEW PLURILATERAL PROPOSALS: A COMMENTARY ON PROPOSED TAX-RELATED RULES AT THE WTO

Vahini Naidu*

Context

For most developing country Member States in the WTO, there is development policy space to pursue digital industrialization strategies to catch-up and build capacities in the digital economy. Currently, most Member States have the capability to introduce measures to regulate the transfer and flow of data and information across borders, requiring technology transfer or access to source and software codes, and requiring servers holding national data to be located in the country, amongst others. This is about to change with new global rules and standards on digital trade currently being developed amongst a group of Members in the WTO under the Joint Statement Initiative on E-commerce (JSI). The proposed rules are about setting the parameters for governance in the digital economy, and trade agreements are a preferred route to establish such rules given their legally binding character. In the view of many, the effect of the proposed rules would be to 'lock in' advantages of leading digital firms by reducing or eliminating any restriction on their ability to operate globally while also restricting the space for governments to regulate the digital economy in the public interest.

> *"In the view of many, the effect of the proposed rules would be to 'lock in' advantages of leading digital firms by reducing or eliminating any restriction on their ability to operate globally while also restricting the space for governments to regulate the digital economy in the public interest."*

Commentary on Proposed Tax-Related Rules

The global policy discourse on taxation of the digital economy is part of the WTO work stream through the multilateral framework established under the 1998 Global Declaration on Electronic Commerce and the recently launched JSI. The most prominent tax-related measure established under the multilateral framework in 1998 is the temporary moratorium where WTO Members declared that they would 'continue their current practice of not imposing customs duties on e-transmissions'. This moratorium comes up for renewal every two years and has been repeatedly extended under the Work Programme on E-commerce, most recently at MC11 in December 2017 for two years, and a six-month extension was agreed until MC12 in June 2020 (now postponed until June 2021 due to the COVID-19 crisis).

South Africa, together with several other African Group Members in the WTO are increasingly critical of the moratorium, which, in 2019, has proven to have far more significant revenue, policy and economic implications than many understood when they adopted it in 1998. As more and more products are traded electronically, the moratorium reduces government revenue from customs duties. South Africa is a net importer of electronic transmissions (ET), and revenue losses resulting from the moratorium amount to approximately USD 36 million per annum using bound tariff rates and USD 25 million per annum using applied tariff duties (Banga 2019). In addition, the moratorium circumvents tariff protection to domestic industries on those traded products and over time, the impact will

* Vahini Naidu is from the Department of Trade and Industry for South Africa.

increase. A key question will be whether WTO Members agree to extend or end the moratorium when the decision is taken at MC12.

If Members do not agree to extend the moratorium, a policy window is open for several WTO Members to consider implementing digital industrial policies on rapidly growing trade in ET, and introducing measures to protect certain types of domestic manufacturing and services. While it is unlikely that Members will immediately introduce measures in the absence of the moratorium, it does provide policy options for domestic revenue mobilization in Africa. For example creating innovative financing mechanisms to grow the fiscus and finance digital industrialization, reducing aid dependency and creating more reliable, fiscal revenue. Central to this narrative is the importance for developing countries, especially African countries to build digital capabilities to participate more effectively in digital trade and enhance manufacturing and industrialization processes. The potential for these countries to deepen and expand revenue mobilization can provide enormous benefits for society and the economy at large.

> *"… some Members are proposing a permanent moratorium on customs duties on ET, foreclosing policy space to collect tariff revenue, and for net importers of ET, to manage the disruptions associated with increased ET and the commensurate decline in trade in physical goods."*

Banga (2019) estimates that tariff revenue loss as a result of the moratorium on customs duties on physical imports of digitizable products for developing countries is 30 times more than that for developed countries. In the JSI, some Members are proposing a permanent moratorium on customs duties on ET, foreclosing policy space to collect tariff revenue, and for net importers of ET, to manage the disruptions associated with increased ET and the commensurate decline in trade in physical goods.

There are growing concerns that digitalization will exacerbate problems of tax base erosion and profit shifting. Digital firms are structured to minimize their tax bills and, in the EU for example, the effective tax rate for digital companies - such as social media companies, collaborative platforms and online content providers - is around half that of traditional companies (European Commission 2018). Jurisdictions around the world are beginning to take action to address these matters, individually and collectively.

One such proposed tax-related measure in the JSI is to prohibit requirements for corporations to establish a local presence. The growing evidence of new business models requiring less to no physical presence, benefitting from scale without mass, crowding out local competitors and challenging the traditional tax principle of Permanent Establishment - has amplified the necessity for reforming international taxation rules for the digital economy. However, digital corporations are resistant to these reforms and are seeking to gain the right to operate in markets around the world while preventing governments from being able to require them to have a local presence (James 2019).

This proposed rule raises some profound challenges. It would be extremely onerous for developing countries to exercise jurisdiction over the assessment, compliance and enforcement of tax liability if foreign entities have no local presence. These highly digitalized businesses are generating massive global profits at a time when many tax authorities are grappling with significant declines in tax base revenues.

The ongoing discussions in the OECD seek to address the tax liability of foreign entities on the profits they generate whether or not they have a physical presence. There is much uncertainty around whether these reforms will be agreed by the 2020 deadline. This has given rise to a diverse set of unilateral tax-related measures, including from Kenya, Nigeria and Turkey. This signifies the skepticism by developing countries about whether multilateral governance can produce a fair outcome.

Other tax-related measures proposed in the JSI include: introducing a *de minimis* for tariff-free treatment of small packages purchased online; joining the Information Technology Agreement and the expansion agreement in the WTO which is committed to completely eliminating tariffs on IT products covered under the Agreement; prohibiting requirements for technology transfer; prohibiting the disclosure of source code even for security purposes; prohibiting data/server localization requirements.

Data for Development

With the traditional notions of tax rendered obsolete in the digital era, the most fundamental question arises: where is value created? The heavy reliance on intangibles, data and network effects by digital firms is relevant in this context. In the new economy, digital data and digital intelligence are the key resources. Whoever owns, controls and manages digital capital and data will direct global value chains. Digital platforms generate consumer surplus at the expense of producers involved in a given supply or distribution chain. As these technologies generate surplus from efficiency gains, a key question would be whether surplus is re-invested back into productive investments in the national economy or 'lost'. Countries at all levels of development risk becoming mere providers of raw data to those digital platforms while having to pay for the digital intelligence produced by the platform owners. Breaking this vicious circle will require new approaches that lead to more balanced results and a fairer distribution of the gains from data and digital intelligence. Unlike software, data is essentially localized and the more local and specific the data, the greater its value. Platforms collect most digital data, including personal data. Similar to their role regarding natural resources, governments can act as trustees of such general data as a social and national resource (Singh 2019).

> *"In the new economy, digital data and digital intelligence are the key resources. Whoever owns, controls and manages digital capital and data will direct global value chains."*

Policy Recommendations

The majority of Members in the African Group have argued that for many reasons it is premature to consider negotiations on e-commerce in the WTO. Firms with digital capabilities (internet platforms, digital content, e-commerce) are at the center of the new economy and are able to create and dominate digital markets. The rules proposed in the JSI are carefully crafted to protect the interests of first movers and standard setters in a digital environment that is characterized by significant market concentration. For African countries, retaining policy space is crucial. The African Development Bank (2018) claims that domestic revenue mobilization improved substantially in recent decades, but tax-to-GDP ratios are still below the 25 percent threshold required to finance development. They recommend the urgent need for better revenue regimes including progressive elimination of the vast array of exemptions and leakages that pepper tax systems - to capture the gains from growth and rapid structural change that some countries are experiencing. African governments need to understand taxation in the digital economy in the context of domestic revenue mobilization. Digital technologies have resulted in massive flows of data and finance crossing borders resulting in illicit financial flows, tax avoidance, profit shifting and base erosion.

- African countries need to establish innovative sources of revenue. For example, if the WTO moratorium on customs duties on ET ended, the gains from this new stream of revenue could be used to finance digital industrialization such as building infrastructure to support the development of an African cloud, regional and continental data centers, local and regional servers; data-sharing agreements among African Regional Economic Communities to build regional digital economies, which will help build regional digital infrastructure.

- International tax rules need to be urgently reformed to address new business models in the digital economy. Deeper understanding and cooperation is required for designing rules that recognize the causal link between the role and value of data ('user participation') and digital firms generating profits from it; advancing the policy objective of allocating more taxing rights to market jurisdictions; and setting thresholds for digital presence. It is vital for Africa to be at the table when new tax rules and standards are developed. These rules should not be overly complex to administer, but comprehensive enough to address artificial profit shifting and stem illicit financial flows especially in Africa.
- African governments should consider an interventionist approach to actively support domestic revenue mobilization in the digital economy. While tax reforms are negotiated, interim measures should begin to look at a predetermined sales threshold that takes into account the value created by digital users in highly digitalized businesses and distribution-based approaches for profit allocation (African Tax Administration Forum 2019).
- National governments should consider introducing indirect taxes or consumption taxes on imports transmitted electronically. Australia has introduced a Goods and Services Tax on digital products and other services including streaming, downloading of movies, music, apps, games, e-books, etc. Some 50 WTO Member States are levying consumption taxes on imports transmitted electronically, including South Africa. This has increased our domestic revenue stream and levelled the playing field so that foreign firms also pay such taxes. UNCTAD (2019) estimates the potential additional tax revenue, taking into account the median annual revenue per individual using the Internet to range between USD 11 billion - USD 18 billion for developing countries (USD 0.9 billion - USD 2.4 billion for Sub-Saharan Africa).
- Given the complexities and growing evidence of the challenges of aid 'flowing' from North-South cooperation, enhanced fiscal revenue mobilization in the digital economy may be more efficiently served through South-South cooperation. UNCTAD (2019) has identified South-South cooperation as a major means for facilitating structural transformation through proactive policies in the areas of trade, investment, finance and the digital economy.

Concluding Remarks

African countries are under intense pressure in the WTO to negotiate multilateral rules on e-commerce and digital trade. In the absence of an integrated and coherent digital industrial policy response to digital transformation, African countries will struggle to catch-up and compete as GVCs digitalize. It would be detrimental for African countries to agree to give up their development policy space without having put in place national benchmarks such as data regulation and ownership policies, localization policies, cloud computing restrictions, tariffs on digital products, technology transfer requirements, amongst others. The African Regional Economic Communities and the African Continental Free Trade Area negotiations presents a viable opportunity for AU Member States to develop common positions and approaches to the digital economy, and strengthen market and industrial integration, including taxation and revenue mobilization.

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CHAPTER 12

SOVEREIGN DEBT RESTRUCTURING UNDER INTERNATIONAL INVESTMENT AGREEMENT GOVERNANCE: POLICY FLEXIBILITY FOR FISCAL STABILITY[1]

Rachel D. Thrasher*

One of the possible outcomes of fiscal instability is insolvency. As Dutt & Gallagher (chapter 2) point out, there is evidence that an increasing number of trade treaties, and the interconnectedness of those treaties, is correlated to increased debt burdens, especially for countries with the lowest income. Indeed, it seems we are entering a new era and reaching new levels of debt overhang, as the current COVID-19 crisis guarantees that most countries will need to take on record-breaking debt to finance public health and the rebuilding of the economy. Even now, Greece is still reeling from their debt crisis in 2012, while Brazil's debt-to-GDP ratio is almost 80 percent and Venezuela is breaking records at almost 200 percent. Argentina has also faced another default on sovereign debt, threatening an echo of its crisis 18 years ago. Many FTAs and BITs accentuate these problems by extending oversight to the process of sovereign debt restructuring (SDR). This essay explores the extent to which debt crises can be linked to underlying fiscal instability and the emerging role of international investment agreements (IIAs) in governing this process.

Sovereign Debt Overhang and Restructuring

As some researchers have shown, there seems to be a negative correlation between trade liberalization and government revenue (Dutt & Gallagher 2020). That is, to some extent, states miss out on traditional revenue sources when they lower tariffs. At the same time, other policy constraints imposed by the WTO, free trade agreements (FTAs) and bilateral investment treaties (BITs) all restrict the ability of certain countries to recoup those losses of tariff revenue through other forms of taxation (Rolland 2020, Montes 2020). One underexplored connection is the relationship between trade liberalization and government debt, or more specifically public debt crises. As one member of this workshop has demonstrated, countries with greater measures of trade openness (using her measure of hub connectedness), tend to be correlated with greater debt-to-GDP ratios (Dutt & Gallagher 2020).

Governments taking on debt is not necessarily a bad thing. In fact, developing countries have historically done so to make up for a savings gap (a gap between the level of aggregate savings and the savings required to provide funds for business investment). However there are risks inherent in the process. If government borrowing does not result in economic growth, either because of something internal to the economy (like low absorptive capacity to turn loans into successful income) or external

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[1] Drawn from Thrasher, R.D. & Gallagher, K.P. "Mission Creep: The emerging role of international investment agreements in sovereign debt restructuring." 6(2) *Journal of Globalization and Development*, pp. 257-285.

* Research Fellow, Global Development Policy Center, Boston University.

(like contagion from other crises), countries can find themselves facing a debt crisis and defaulting on their public debt (Minksy 1986, Herman et al. 2010). To add insult to injury, the same countries struggling to recoup losses in tariff revenue are the ones facing these savings-investment gaps, thus exacerbating the problem of debt overhang.

In the wake of a debt crisis, some countries have experienced a bailout (by the IMF or others). Bailouts come with some obvious problems, in particular the concern about moral hazard – where foreign investors may not take proper care to make wise investments because they know they will be bailed out (Eichengreen 2003; Stiglitz & Guzman 2015). The alternative approach is called Sovereign Debt Restructuring (SDR), which involves the private sector (private sector involvement or PSI), negotiating with bondholders to change the terms of the debt. This can include reducing the face value of the debt, lowering interest rates, and lengthening maturities, among other mechanisms. The resultant losses are "haircuts".

SDR faces its own set of challenges and complexities, especially in a modern world where sovereign debt is held by a myriad of individual investors with collective action problems (*what is best for one is worse for the group*), and the duration of those complex debt workouts can contribute to the burden on debtor countries (Eichengreen, 2003; Gelpern 2013). Resultant long workouts can further accentuate debt overhang. There is also no consistent governance regime to make sure that SDR workouts follow harmonized rules for the welfare of the investors and the state.

International Investment Agreements and SDR governance

The gateway by which IIAs extend their jurisdiction over SDR workouts is by adopting broad definitions of investment so as to include sovereign bonds as a protected investment. The archetype of this kind of definition can be found in the newly negotiated United States-Mexico-Canada Agreement which defines investment as "every asset an investor owns or controls", which "has the characteristics of an investment", including "bonds, debentures, other debt instruments and loans" (USMCA art. 14.1)

Once treaty parties agree to cover sovereign debt as an investment under the treaty, a number of key provisions act to protect the value of that investment.[2] At each juncture of the SDR process, different rules and standards of protection might apply. At the point of issuing sovereign bonds, governments, often inadvertently invite bondholders to be protected investors under relevant IIAs. Many times, these treaties include a right of establishment, which demands that countries extend to prospective foreign bondholders the same rights given to prospective domestic bondholders to become established as investors and thus protected under the treaty.

Once a country is facing a debt crisis and is unable to make interest payments on its bonds, the government may run afoul of the rules requiring free transfers. These provisions commonly state that current and capital account flows must flow "freely and without delay". Approximately half of all FTAs notified to the WTO have provisions of this sort, and a much larger percentage of BITs. Failure of make interest payments could also be considered an "indirect expropriation" if the value of a bondholder's investment is decreased considerably as a result and the government is not able to offer compensation.

[2] For an extended look at each of these provisions in turn, see Thrasher & Gallagher 2015.

Table 1. International Investment Agreement Governance of Sovereign Debt Restructuring

Sovereign Debt Restructuring	IIA jurisdiction overlap
• Issuing sovereign bonds	• Broad definition of "investment" – bond holders become protected investors; right of establishment
• Failure to pay interest payments	• Free transfers rules, indirect expropriation
• Negotiations with creditors	• National treatment, fair and equitable treatment, free transfers rules
• Restructuring proposing reduced face value, lower interest rates, longer maturities	• National treatment, fair and equitable treatment, indirect expropriation, free transfers rules

Once a government begins negotiations with creditors in order to restructure their debt and make changes to the bond contracts, a host of other provisions come into play. National Treatment provisions (ubiquitous in both the WTO and IIAs), for example, require any negotiations for restructuring to offer foreign investors the same terms and conditions as domestic investors. This may, in fact, put additional burdens on domestic investors at a time when they need to revive the domestic financial system. Another important provision found in FTAs and BITs is the fair and equitable treatment (FET) clause. In recent cases, investment treaties have been interpreted to adopt a broad scope to include protection of the "legitimate expectations" of investors. When negotiations have taken the form of take-it-or-leave-it debt swaps or involved large decreases in the face value of the debt, investors who do not like the terms have brought suit on the basis of their "legitimate expectations" being unmet. Furthermore, during negotiations, a slow-down or delay of bond payments could also violate the terms of the free transfers provision.

After the restructuring has been accomplished, holdout investors have relied on some of these same provisions to bring investor-state disputes. The SDR workout is subject to the national treatment clause in that it must treat foreign investors equal to domestic investors, in the terms of the haircut. Moreover, "de facto" discrimination is also prohibited so that even facially neutral workouts may violate national treatment rules. Holdouts may also claim violations of FET and indirect expropriation, if the restructuring results in unmet "legitimate expectations" or a substantial decrease in the value of their investment. Both these terms have been litigated extensively in tribunals interpreting NAFTA, so that many newer treaties have introduced new text clarifying the scope of these commitments, described in more detail below.

Exceptions and Safeguards for Sovereign Debt Restructuring

There are generally two kinds of safeguards in place for SDR. The first are exceptions to the general rules of investment protection for macroeconomic and financial crises. Most IIAs include safeguards for balance of payments crises, and serious difficulties for the operation of monetary or exchange rate policy. Some FTAs, especially if they contain commitments in the financial services sector, include exceptions for prudential measures to protect the "integrity and stability of the financial system."

While it is commonly understood that these exceptions and safeguards would not apply to SDR (Waibel 2011, Viterbo 2012), lawyers are often coming up with novel legal arguments and the connection between debt crises and the stability of financial system could lend support to this idea. In that case, the presence of a crisis could offer flexibility to countries in their restructuring if they are faced with an investor-state claim.

A third approach, found in newer treaties, is to include a special annex limiting the use of Investor-State Dispute Settlement (ISDS) for investor claims about restructuring. In particular, under the CPTPP, investor-state disputes are not allowed for "negotiated" restructuring, defined as a restructuring plan that involves at least seventy-five percent bondholder participation (except for national treatment and most–favored-nation treatment claims). It also requires that investors wait nine months before bringing claims as a sort of "cooling-off" period, which allows for de facto flexibility for countries involved in short-term crises.

Table 2. Existing Safeguards in International Investment Agreements

Sovereign Debt Restructuring	IIA jurisdiction overlap
• Failure to pay interest payments	• Balance of payments exceptions for macroeconomic difficulties, prudential measures exceptions, 9-month cooling off period
• Negotiations with creditors	• "Negotiated restructuring" carve out from investor-state disputes
• Restructuring proposing reduced face value, lower interest rates, longer maturities	• Balance of payments and prudential measures exceptions, "negotiated restructuring" carve out, 9-month cooling off period

These flexibilities are a step in the right direction but more change is needed.

Each of these provisions is enforced by the ISDS mechanism, which allow private investors to sue states to protect their own interests in a foreign arbitral tribunal, regardless of whether there are legitimate state goals in generating welfare benefits for the nation as a whole. This has already occurred in two instances – Argentina and Greece. In both cases, the investors sued for violations of national treatment, expropriation, and the fair and equitable treatment standard (with opposite outcomes). In *Abaclat v. Argentina*, the tribunal found the definition of investment in the Italy-Argentina Bilateral Investment Treaty, though vague, to include sovereign debt. It states that "investment includes, without limitation," "obligations, private or public titles or any other right to performances or services having economic value." Once the *Abaclat* tribunal found that it had jurisdiction based on the broad definition of investment, Argentina's policies were subsequently found to violate the FET and expropriation standards. Since that case, Argentina (under President Mauricio Macri) agreed to pay the holdouts who had refused the terms of the restructuring, in an attempt to end the ostracization of Argentina from international capital markets. In the years since the first debt crisis, Argentina has had three different presidents with varying approaches to sovereign debt. Unsurprisingly, Argentina recently defaulted once more on its sovereign bonds. President Fernández, elected in the fall of 2019, chose former President Christina Kirchner as his Vice President which may signal a move away from Macri's approach of appeasing the markets.

Not all treaties are so broad, however. An investment tribunal in *Postova banka v. Greece*, examined the Greece-Slovakia Bilateral Investment Treaty, showing that, although investment was defined generally as "every kind of asset", only "debentures of a company and any other form of participation in a company" (private bonds) were covered under the agreement. Notably, the tribunal in the Greek case distinguished the text of the two treaties when coming to the decision to dismiss the case on jurisdictional grounds.

New trends in IIA governance

Given the general trend toward broader and deeper coverage in investment agreements, some trade and investment agreements, have begun to increase the buffer between investment commitments and sovereign debt. The EU-Vietnam Investment Protection Agreement, one of the first BITs where the EU is a party, for example, includes the usual carve outs and exceptions for macroeconomic difficulties (4.11) and prudential measures (4.5), while at the same time excluding bonds of any sort in its list of transfers covered by the transfers provision (Article 2.8), and omitting sovereign bonds in its list of investments (Article 1.1). The treaty also does not demand the right of establishment for foreign investors. That means that foreign investors who are already established within the host country must be treated as domestic investors (national treatment), but up until that point, they are free to discriminate. The FET standard is likewise narrow, limiting breaches to measures that exhibit "manifest arbitrariness" or "targeted discrimination" (Art. 2.5.2). Finally, the EU-Vietnam BIT has adopted an annex specifically limiting claims for sovereign debt restructuring, with an exception for "negotiated restructuring" and a 9-month cooling-off period for all claims.

The USMCA, despite the fact that US agreements are typically much more investor-friendly, indicates a possible shift in approach (at least a temporary one). In particular, it offers an example of explicitly circumscribing the FET provision such that "the mere fact that a Party takes or fails to take an action that may be inconsistent with an investor's expectations does not constitute a breach of this Article, even if there is loss or damage to the covered investment as a result" (Art. 14.6.4). The treaty also adopts a more limited approach to ISDS in general. Investor claims may only be brought on the basis of national treatment or most-favored-nation treatment (but not with respect to the establishment of an investment), and for expropriation (but not indirect expropriation) (Annex 14.D.3). This could have an impact on future SDR claims, since fair and equitable treatment and indirect expropriation claims are both excluded. The USMCA also has a Public Debt appendix limiting ISDS for SDR where "the restructuring is effected as provided for under the debt instrument's terms, including the debt instrument's governing law". This could have in mind clauses in newer bonds called "collective action clauses" which would lay out minimum required percentages of participation needed for a restructuring, easing the burden on countries attempting to negotiate with diverse and myriad investors.

On-going negotiations of the Regional and Comprehensive Economic Partnership (RCEP) show some promise as countries that have historically lagged in development are setting the negotiating agenda. India, for example, submitted some interesting negotiating drafts, in particular excluding sovereign debt explicitly in its definition of investment. Given that India has stood alone in refusing to sign the final agreement, however, it is not likely that the agreement will take a form with Indian preferences.

Policy Proposals for Sovereign Debt in IIAs

In light of these realities, our policy proposals are threefold. First, definitions matter. As demonstrated by the differing outcomes between the Greek and Argentine cases, the wording of the definition of "covered investment" matters greatly in the preliminary determination of jurisdiction. If there's no jurisdiction, then there's no case. In new trade and investment agreements and in renegotiating old ones, countries should consider excluding sovereign debt explicitly from coverage under the treaty and leaving sovereign debt restructuring to other international fora (like EU-Vietnam). Second, we need to improve sovereign debt safeguards. One simple, albeit controversial, way to improve the annexes would be to not maintain the national treatment requirement for negotiated restructurings. Since national treatment is one of the pillars undergirding these agreements, permitting discrimination in the case of SDR would have to be carefully limited. However, if legitimate domestic financial interests are taken into account, these annexes would go a long way (together with other measures) to protect SDR. Finally, state-to-state dispute resolution should be the default mechanism for SDR. Investor-State disputes are a well-established practice for modern IIAs. However, given the sensitive nature and complicated political realities of SDR, this context calls for a more collaborative process.

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Many current European BITs contain both a state-state process and an investor-state process. A proposed annex could simply preserve restructuring for state-state dispute resolution. This alternative approach could be modeled on a financial services safeguard present in the CPTPP, which states that in the case of an investor-state conflict over financial services, the authorities of the respondent state and the Party of the claimant investor must meet together to make a determination of whether an exception applies in that context (Art. 11.22). The determination of the authorities "shall be binding on the tribunal" making the decision between the investor and the state. That same provision could be read into a Public Debt annex, such that the authorities of each Party would have the chance to collaborate and determine whether a prudential reason exists for the restructuring.

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AUTHOR BIOGRAPHIES

Reuven Avi-Yonah, the Irwin I. Cohn Professor of Law and director of the International Tax LLM Program at the University of Michigan Law School, specializes in corporate and international taxation. He has served as a consultant to the U.S. Department of the Treasury and the Organisation for Economic Co-operation and Development (OECD) on tax competition, and is a member of the steering group for the OECD's International Network for Tax Research. He also is a member of the American Law Institute, a fellow of the American Bar Foundation and the American College of Tax Counsel, and an international research fellow at Oxford University's Centre for Business Taxation. In 2019, he was awarded the IFA Italy Prize for the article, "Complete Distributive Rules and the Single Tax Principle: A Review of Recent Italian Case Law," which he co-authored with Gianluca Mazzoni for the *Bulletin for International Taxation*. In addition to prior teaching appointments at Harvard University (law) and Boston College (history), he practiced law with Milbank, Tweed, Hadley & McCloy in New York; with Wachtell, Lipton, Rosen & Katz in New York; and with Ropes & Gray in Boston. After receiving his BA, *summa cum laude*, from Hebrew University, he earned three additional degrees from Harvard University: an AM in history, a PhD in history, and a JD, *magna cum laude*, from Harvard Law School. He has published more than 250 books and articles, including *Advanced Introduction to International Tax Law* (Elgar, 2019), *Global Perspectives on Income Taxation Law* (Oxford University Press, 2011), and *International Tax as International Law* (Cambridge University Press, 2007).

Rashmi Banga is a Senior Economic Affairs Officer of the Unit on Economic Cooperation and Integration among Developing Countries (ECIDC), Division of Globalization and Development Strategies (GDS), UNCTAD. She is former Adviser and Head of Trade Competitiveness in the Commonwealth Secretariat, which provided policy support to more than 30 countries. She has worked as a Senior Economist and OiC in DFID-funded UNCTAD's project which provided support to the Minsitry of Commerce, India in its trade negotiations. She was a Professor of Economics in Jawaharlal Nehru University, India and has taught for ninteen years. She received her doctorate from the Delhi School of Economics, specializing in development economics, international economics and econometrics. She has published extensively in refereed journals on digital issues, international trade and FDI issues. Her current area of research includes South-South Cooperation, digital issues, assessement of free trade agreements and global and regional value chains. She has been awarded the International Economic Development Research Award by Export-Import Bank of India and has been a recipient of two Gold Medals for her research on globalization and development from the Global Development Network, World Bank.

Devika Dutt is a pre-doctoral fellow at the GDP Center. She is a Ph.D. candidate in the Department of Economics of the University of Massachusetts in Amherst, writing a dissertation about the political economy of the costs of foreign exchange intervention, with a focus on developing economies. She has previous work that highlights the role of government-owned banks in fostering financial stability and mobilizing capital for financing development. Devika has previously worked at the Political Economy Research Institute and the Center for Public Policy and Administration at the University of Massachusetts Amherst. She is also an organizer of the Young Scholars' Initiative of the Institute for New Economic Thinking in the Financial Stability Working Group and has organized several conferences and workshops in this capacity.

Kevin P. Gallagher is a professor of global development policy at Boston University's Frederick S. Pardee School of Global Studies, where he directs the Global Development Policy Center. Kevin P. Gallagher is the author or co-author of six books: *The China Triangle: Latin America's China Boom and the Fate of the Washington Consensus, Ruling Capital: Emerging Markets and the Reregulation of Cross-Border Finance; The Clash of Globalizations: Essays on Trade and Development Policy*; *The Dragon in the Room: China and the Future of Latin American Industrialization* (with Roberto Porzecanski); *The Enclave Economy: Foreign Investment and Sustainable Development in Mexico's Silicon Valley* (with Lyuba Zarsky); and *Free Trade and the Environment: Mexico, NAFTA, and Beyond*. Gallagher serves on the United Nations' Committee for Development Policy and co-chairs the T20 Task Force on An International Financial Architecture for Stability and Development at the G20. He previously served on the investment sub-committee of the Advisory Committee on International Economic Policy at the US Department of State and on the National Advisory Committee at the Environmental Protection Agency. Gallagher has been a visiting or adjunct professor at the Paul Nitze School of Advanced International Studies at Johns Hopkins University, the Fletcher School of Law and Diplomacy at Tufts University; El Colegio de Mexico in Mexico; Tsinghua University in China, and the Center for State and Society in Argentina

Jane Kelsey is one of New Zealand's best-known critical commentators on issues of globalization and neoliberalism. She has taught at the University of Auckland since 1979, specializing in socio-legal studies, law and policy and international economic regulation. Jane is active internationally as a researcher, analyst, adviser and media commentator on globalization, especially the Trans-Pacific Partnership Agreement, trade in services, and investment agreements. She is an active member of a number of international coalitions of academics, trade unionists, NGOs and social movements working for social justice. She has written prolifically on the economic development of New Zealand, including her best-selling book on the neoliberal restructuring of New Zealand, 'The New Zealand Experiment. A World Model for Structural Adjustment?' and 'The FIRE Economy'. Other books include 'Serving Whose Interests? The Political Economy of Trade in Services Agreements' (Routledge Cavendish 2008), and the edited 'No Ordinary Deal. Unmasking the Trans-Pacific Partnership Free Trade Agreement' (ed) (Bridget Williams Books 2010), as well as many published articles.

Andrew Kerner is a researcher in the political science department at Michigan State University. His research considers the politics of international finance, and includes a particular focus on the financial consequences of international investment agreements. His articles appear or are forthcoming in International Organization, British Journal of Political Science, International Studies Quarterly, Political Science Research and Methods, Business and Politics, Economics and Politics, Comparative Political Studies, ICSID Review-Foreign Investment Law Journal and the Review of International Organizations. In addition to work on investment treaties, he is currently working on multi-part project on politics of gender representation in public sector economic leadership. He earned his Phd in Political Science from Emory University.

Manuel F. Montes, Senior Advisor of the Society for International Development, was previously Permanent Observer to the UN and Senior Advisor on Finance and Development at the South Centre, Chief of Development Strategies, and Chief of Policy Analysis and Development in the UN's Financing for Development Office, United Nations Department of Economic and Social Affairs (UNDESA); UNDP Regional Programme Coordinator, Asia Pacific Trade and Investment Initiative based at the Regional Centre in Colombo, Sri Lanka; Programme Officer for International Economic Policy at the Ford Foundation in New York, 1999-2005; Senior Fellow and Coordinator for economics studies at the East-West Centre in Honolulu, 1989-1999; and Associate Professor of Economics at the University of The Philippines, 1981-1989. In the UN, he also served as the Secretary of the UN Committee of Experts for Cooperation in International Tax Matters. He was a founding member of the Independent Commission to Reform International Corporate Taxation (ICRICT).

Vahini Naidu is a Deputy Director in the International Trade and Economic Development Division at the South African Department of Trade and Industry. She has amassed several years of experience since 2009 in international trade negotiations, specializing in Trade in Services, focusing on multilateral and regional trade negotiations. Currently she is covering digital trade issues. From March 2015 to August 2019, she served as a Foreign Economic Representative at the South African Permanent Mission to the WTO in Geneva, Switzerland. She was responsible for WTO negotiations on Services, E-commerce, and Trade and Environment. During her tenure, she served as the Focal Point on Services and E-commerce for the African Group and as the Coordinator of the African Group in the WTO in 2018. She has a Bachelor of Laws Degree from the University of KwaZulu-Natal and a Master of Commerce Degree from the Graduate School of Business of the University of Cape Town. Her postgraduate studies specialized in trade policy and trade law. Her Masters research analysed services rules of origin in Economic Integration Agreements for the SADC Services Negotiations.

Sonia Rolland is a Professor of Law at Northeastern University School of Law. She is the author of *Emerging Powers in the International Economic Order* (with D. Trubek, Cambridge University Press, 2019) and *Development at the WTO* (Oxford University Press, 2012). Prof. Rolland regularly acts as an expert for international and non-governmental organizations including the United Nations, the International Centre for Trade and Sustainable Development, and the India Institute of Foreign Trade. She has held appointments at Columbia University, Georgetown University and the University of Michigan.

Rick Rowden recently completed his PhD in Economic Studies and Planning from Jawaharlal Nehru University (JNU) in New Delhi, where he focused on India-Africa economic relations from a development economics perspective, and he will begin teaching as an Adjunct Professorial Lecturer in the School of International Service (SIS) at American University in Washington DC in 2020. Presently, he is a Senior Economist at Global Financial Integrity (GFI), a Washington DC-based research NGO that focuses on illicit financial flows out of developing economies. Previously, he worked for several international development NGOs, including ActionAid, the United Nations Conference on Trade and Development (UNCTAD) in Geneva, and lectured in Global Studies at California State University, Monterey Bay (CSUMB) and Political Science at Golden Gate University in San Francisco.

Rachel Thrasher received a JD and a master's degree in international relations, both from Boston University. She works on policy issues related to trade and investment agreements, trade law and development, economic relations between developing countries, and multilateral environmental agreements. She is the co-editor, with the Dean of the Pardee School of Global Studies Adil Najam, of a book titled The Future of South-South Economic Relations. She has taught courses on Trade and Development, International Trade Regulation, and International Law at Boston University and Northeastern University. Her research covers areas of trade and investment agreements and their impact on development policy as part of the Global Economic Governance Initiative at the GDP Center at Boston University.

Marilou Uy is Director of the Intergovernmental Group of Twenty-Four on International Monetary Affairs and Development (G-24). Prior to that, she was the Senior Adviser to the Managing Director at the World Bank. While at the World Bank, she also served as Sector Director for the Africa Financial and Private Sector Development Department from 2007 to 2011 and Director of the Financial Sector Operations and Policy Department in the Financial Sector Vice-Presidency as well as Chair of the Financial Sector Board from 2002 to 2007. Since joining the World Bank in 1985 as part of the Young Professionals Program, she has worked on financial sector and private sector development in Latin America, Middle East, South Asia, and Africa, and globally. She was also part of the Development Economics Group's research team that prepared "The East Asian Miracle" in 1991, in which she focused on financial sector issues, together with Joseph Stiglitz. Ms. Uy pursued her graduate studies in economics and finance at the University of California, Los Angeles.

BOSTON UNIVERSITY Global Development Policy Center

Boston University
53 Bay State Road
Boston, MA 02215

gdp@bu.edu
www.twitter.com/gdpc_bu
www.bu.edu/gdp