

ADDRESS BY SIR ROY DENMAN
HEAD OF THE DELEGATION IN WASHINGTON
OF THE COMMISSION OF THE EUROPEAN COMMUNITIES
EXECUTIVE FORUM ON UNITARY TAXATION
VISTA INTERNATIONAL HOTEL
WASHINGTON, D.C. THURSDAY 23 FEBRUARY, 1984

UNITARY TAXATION

How can the subject of unitary taxation have sparked so much interest?

- Since 1981 the European Community has sent several formal diplomatic protests to the State Department on the subject.
- The British and Dutch governments have also separately sent a similar number of notes.
- The Supreme Court has heard cases related to unitary taxation on a number of occasions.
- Mrs. Thatcher and other visiting Heads of Government have raised the issue on official visits.
- Most recently, as we all know, the President set up a high level Working Group under the Chairmanship of Secretary of the Treasury, Donald Regan.

Why so much interest?

It could be argued that the amounts of money are relatively small. Some estimate the sum involved at not more than \$700 million - a lot of money for you and me, helpful to a hard pressed State but small in relation to a Federal budget deficit of the order of \$200 billion.

But the argument is dangerously misleading. The sum I have quoted is based on existing conditions i.e. on the existing distribution of multinational companies among the States and their worldwide income. But I shall attempt to show unitary taxation could have a profound effect on these factors.

Unitary tax is important because it has direct implications for three much more fundamental things.

1. The Rights of States
2. the International Trading System.
3. Implications for the Developing Countries.

1. The Rights of States

I do not have to tell an American audience - only a few hours from Gettysburg - about the importance of the Rights of the States.

Against this background I only want to say a few words on the merits of the case of whether individual States have or should have the right to levy this sort of tax or not. The European Community was disappointed with the Supreme Court's ruling in the Container case. And it was disappointed that the Administration did not see fit to file a brief as a friend of the court. In a case in 1982, Chicago Bridge and Iron Co. v. Caterpillar Tractor Co. and Illinois Department of Revenue, the Administration did file a brief objecting to a worldwide combined tax system because it "impairs federal uniformity in an area where such uniformity is essential", namely in negotiating bilateral tax treaties that are an integral part of its foreign policy. The court dismissed that case without deciding it.

In the more recent Container Co. case, the court would not take the Administration's previous brief into account, and decided that in the absence of federal legislation States do have a right to use this form of taxation. Should they have the right? Should legislation like the Conable-Mathias bill, which would specifically deny the right, be enacted? As outsiders we follow this question with intense interest, but without taking sides. It would be in line with our interests if the Administration favoured such legislation and pushed its enactment, and we hope that the States will also see the benefit of such legislation.

The whole question however should not be seen only in terms of States' rights in a domestic context, it has also to be seen within the context of the world trading system. Here I want to make a number of points:

- 1) State's rights or for that matter any other "domestic" issues have to be seen increasingly within an international context.
- 2) Unitary taxation is likely to decrease international investment and world trade for a number of reasons.
- 3) Despite the turnaround in the U.S. economy, the world economy is still too fragile to support anything that could hinder its progress.

Lets take these points in turn.

The International Context

One of the most fundamental changes that has been taking place over the last decade and a half is the internationalisation of the U.S. economy. From the Civil War until the 1970's, trade only accounted for some 3 to 4 percent of the U.S. economy. But over the '70s the situation has been changing rapidly. Trade now accounts for around 12 percent of the economy. This trend will continue in trade and other fields. It seems inevitable to me that with the rapid advance being made in communications, the interdependence of the world economy will increase.

This interdependence will bring benefits to us all but it will also imply a changing set of obligations. To return from the abstract to unitary taxation, it will imply that individual States within the United States cannot both participate in the benefits of interdependence and also set their own taxation policy solely with reference to States' rights vis-a-vis the Federal Government. States' rights and duties either separately or jointly as the United States vis-a-vis the world economy are also increasingly important.

We normally think of the ground-rules for the rights and obligations of international trade in terms of the GATT. Another important part however are the rules which attempt to ensure a fair treatment of taxable income. The flow of international investment could be drastically curtailed without the tax treaties which have been established. Tax treaties, like tariff treaties, are concluded between sovereign states, either bilaterally or even better in a multi-national context. It is unthinkable that we should regress and that each county in England, Länder in Germany and Departments in France should have to negotiate a separate tax treaty with each State in the United States. We should all be worse off.

International Taxation

It is an accepted principle of international taxation that an enterprise of a state which carries on business in another state through a permanent establishment or a subsidiary may only be taxed in that other State on profits of activities carried on in that other state.

The Organisation of Economic Cooperation and Development (OECD) Model Double Taxation Convention of 1977, to which the United States subscribed makes it quite clear that a permanent establishment of a foreign enterprise shall be attributed the profits it might be expected to make if it were a distinct and separate enterprise, and that it may only be taxed on those profits, and not on some method which combines worldwide revenues and then attributes some proportion of them to the particular subsidiary based on a given location. Only directly determined profits resulting from activity carried out in the state are the ultimate yardstick of the taxation rights of a state, according to the convention.

The OECD convention has been adopted by the Council of the OECD which means that this is the basis for the worldwide system of double tax convention including those to which the USA is a party. Since it is a model convention and despite the fact that it does not directly create written tax law, it nevertheless follows that its guidelines form an integral part of long established international taxation practice. It cannot be unilaterally ignored for internal political reasons by one party without serious consequences to the whole equilibrium of international tax principles as a basis for international trade and commerce.

Furthermore, the report of the OECD Committee on Fiscal Matters, on Transfer Pricing and Multinational Enterprises (1979), firmly endorses the arms-length principle, and rejects alternative principles as being unnecessarily arbitrary.

Trade and Investment

The adoption of unitary taxation, because it is arbitrary and because it is likely to involve double taxation will be harmful to the spread of international investment and hence to international trade. It therefore goes without saying that States adopting this method of taxation will not in the longer run benefit from increased revenues. The longer run may also be rather soon. Its highly significant that a group of visiting U.K. businessmen looking for locations for investments cancelled their planned visit to Florida shortly after that State introduced unitary taxation. A Japanese company which subsequently made a major investment in the U.S. rejected Oregon specifically because of unitary taxation.

The spread of unitary taxation within the United States is already worrying but the prospect of some less developed countries following the example of those States which use the method is terrifying. All the United States' major trading partners have vigorously urged the Working Group under the Chairmanship of Secretary of the Treasury, Donald Regan, to consider the international implications. I should like to quote from a note sent jointly to the Working Group by the Embassies of the Member States of the European Community, the European Commission and the Embassies of Australia, Canada, Japan and Switzerland. They say the following:

"Our countries constitute the United States' main trading partners, accounting for about half of US trade. We also account for approximately \$75 billion of direct investment in the United States (83% of the total) and US direct investment in our countries amounts to \$143 billion (65% of total US direct investment abroad). Our governments are all deeply concerned about the use of the worldwide unitary basis of taxation in some individual States of the United States of America and have submitted our views to the Working Group set up by the President and chaired by the Secretary of the Treasury, Donald T. Regan.

At this time, when the Task Force is nearing the completion of its work, we reiterate our concern that the Working Group itself and the US Administration in formulating proposals for action on its recommendations should give full weight to the combined views of the United States' main trading partners so that an internationally-agreed solution to this growing problem may be implemented quickly thereafter. The achievement of this objective would represent the removal of a serious obstacle to the further development of our trade and investment relationships".

The significance of the fact that this is a joint note should be stressed. There are very few topics in which you can get the agreement of such a group.

The Economic Background

We can never afford measures that are harmful to the world trading system, but the current state of the world economy and the accompanying growth of protectionism, makes such measures even more worrying.

Yes, certainly things are much better in the U.S. economy than they were, and we welcome that unreservedly. But when you look at the global economy, it is all too clear that we have a long way to go. First, although there has been some improvement, the international debt situation remains at best precarious. It cannot improve in any durable way if the exports of the major debtors do not increase and that will not happen without growth of world trade. Second in Europe, 1983 was not a year of rapid growth as it was here. In fact our growth rate was only just positive. We are very cautiously optimistic for 1984. We are hoping that we will prove to be wrong in the same way as so many were here last year, and that growth will in fact turn out to be much better than the current forecasts. There are however a number of factors which could make our situation different,

Third, very large currency misalignments persist. The prolonged rise of the dollar from 1980 onwards has caused a turnaround in the United States balance of payments situation. The current account has swung from a modest surplus to a massive deficit. The forecast for the trade deficit for 1984 is over \$100 billion. The counterpart of this is good for the rest of the world; it is for them (us) increased exports. But it also means increased protectionist pressures in the U.S.

Let me take protectionist pressures. The Council of Ministers of the European Community discussed earlier this week the state of EC-US relations in the context of the world trading system. Let me read you their conclusions.

The Council took note with disquiet of the rising tide of protectionist pressures in the United States.

Escape clause petitions have been filed on a range of important products including steel and footwear. Recently anti-dumping and countervailing duty investigations have been opened against imports of wine from the European Community. Shortly the US Administration will be deciding on a petition by the US machine tool industry to limit imports. These and other actions cover \$4.7 billion worth of European Community exports to the United States.

The Council recognised that on a number of issues the US Administration had taken a firm stand against protectionist pressures. They had opposed Domestic Content legislation, proposals

for a global 15 percent limitation of steel imports and the Wine Equity Bill.

Nevertheless the picture is still alarming. The Council's view is that the present difficulties in certain sectors of the US economy cannot be resolved by protectionist measures. This is even more striking given the relatively more favourable economic situation in the US than in Europe. Such measures could lead to a dangerous increase in trade restrictions and to a rapid erosion of the open multilateral trading system, which has had the support of the US and Europe for the past four decades and on which the basis of world prosperity has depended.

The Council therefore stresses the crucial importance it attaches to a strict adherence to the commitments entered into at Williamsburg and other meetings "to halt protectionism and as a recovery proceeds to reverse it by dismantling trade barriers". Here the Community has already given a lead and hopes it will be followed.

Developing Countries

Then let me say a word about the danger for the United States - as a major world trading power with investments ranging across the world - if unitary taxation became a world wide model. US companies plan to invest 12.4 billion dollars in developing countries in 1984. Would a major US company welcome it if its investment in a small developing country - useful to both partners in the way of increased business - were to be taxed on its world wide activities. There is a well known fable of the Sorcerers Apprentice. I recommend a careful re-reading.

Conclusions

- Unitary tax is already a significant irritant and has a large potential to create problems. It is contrary to agree international taxation procedures, it results in double taxation and it is administratively burdensome.
- We understand that it is a State's rights issue, but States should need to reflect on the consequences for them in the long term if they do not abide by the international rules.
- It has been a tough time for international trade and we are not yet out of the woods. In fact protectionist pressures are increasing. So everything possible should be done to ease the path forward, to ease tensions wherever possible. Refraining from practices like unitary taxation is a good example.

And finally the world wide implications for US business of a generally increasing recourse to unitary taxation should not be forgotten.

We hope that these considerations will be borne carefully in mind by the Working Group on World Wide Unitary Taxation now due to report at the end of March. We look forward to constructive and forward-looking recommendations.