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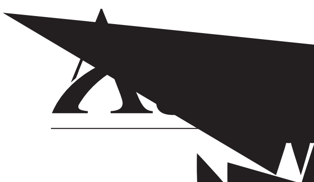

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Purism and Contextualism within International Tax Law Analysis: How Traditional Analysis Fails Developing Countries

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Abstract
There are two broad approaches to the study of international tax law. Purists adopt a traditional approach, emphasizing conceptually pure tax solutions based on efficiency interests. Contextualists combine economic analysis with political, historical, social, institutional and other perspectives. It is argued that the Purist approach is overly-reliant on international tax economics which, in turn, is challenged by significant theoretical, empirical, and behavioral uncertainty. The Purist analysis nevertheless can be effective in respect of situations in which there are relatively balanced capital flows between countries with developed economies. Developing countries, however, are generally capital importing nations and their interests tend to be downplayed under the Purist approach. In an increasingly integrated global economy, the Contextualist perspective is more effective at taking account of the interests and needs of devel

Part III discusses how the Contextualists' use of broader contextual analysis that emphasizes historical, political, institutional, social or other developments could provide a deeper understanding of potential refo

investment.[12] The Financial Committee provided the Group of Experts with a number of terms of reference to assist in the framing of their work, including "What are the economic consequences of double taxation from the point of view: (a) of the equitable distribution of burdens; [and] (b) of the interference with economic intercourse and with the free flow of capital?"[13]

In 1923, the Group of Experts presented their masterful report, which ultimately played an important role in laying the foundation for the subsequent debate surrounding the design of optimal international tax rules and bilateral agreements. In particular, the report played a great influence on the now-accepted differential cross-border tax treatment of different categories of income: income streams generated by land or commercial establishments ("corporeal wealth") should be taxed at their source while primary taxing jurisdiction for interest, dividends, and professional services ("intangible wealth") would be assigned to the residence jurisdiction.[14]

The Group of Experts acknowledged that governments historically emphasized that they have the primary right to tax income generated within their borders, which was considered to be the "*main* instinctive principle."[15][their emphasis] They noted that the residence or source country may both claim tax jurisdiction over different income streams under entitlement theories (such as the theory of economic allegiance developed by the Group of Experts where "a part of the total sum paid according to the ability of a person ought to reach the competing authorities according to his economic interest under each authority") and hence they accepted that any geographic divisions in the tax base will be somewhat arbitrary.[16] For this reason, they did not dwell extensively on the first part of the question posed by the Financial Committee concerning the 'equitable division' of tax revenues.

The economists emphasized the need to promote taxation on a residence-basis in part because of the desire to ensure that progressive individual income taxes could be applied to world-wide income streams on the basis of a taxpayer's ability to pay taxes. They considered a number of options to relieve international double taxation and ultimately recommended the 'method of exemption for income going abroad' whereby source countries would exempt all non-residents from taxation on income from sources within their borders.[17] The method of exemption was primarily justified on efficiency grounds in that it was considered to be the most straight-forward solution to prevent international double taxation.

The Group of Experts noted that where capital flows are fairly equal between countries, the solution would promote "rough justice" as both countries would enjoy the benefit of collecting similar revenue streams. They recognized that this solution may not appeal to capital importing countries because "it does violence to what are at

[12] Ibid at 3.
[13] Ibid.
[14] Ibid at 39. This classification system already existed in certain tax treaties of the era, but the Group of Experts provided an economic justification for the regime.
[15] Ibid at 40.
[16] Vogel discusses how the late 19th Century scholarship of Georg von Schanz similarly agreed that both source and residence state had legitimate tax claims over cross-border transactions on the grounds of services provided. In Schanz' view, the source state, however, typically provides more services and hence should be entitled to share in a greater amount of the income tax base. See Vogel, above n 3, 395.
[17] See Group of Experts, above n 1, 48, 51.

present their instinctive ideas as to their rights to origin [i.e., source] taxation."[18] Nevertheless, they thought that capital importing and developing countries might be amenable to this approach because: (a) it would encourage more investment in these countries; (b) mechanisms could be created to give them a residual right to tax certain streams of income at the source; (c) government fiscs could negotiate end-of-year transfers to make up for revenue losses; and (d) as developing nations became more industrialized the capital flows would become more balanced.[19]

In 1925, a group of technical experts reviewed the Group of Experts' report to determine how the League of Nations should proceed with respect to the development of international tax agreements.[20] These experts noted that the most common mechanism already employed by countries (including the first multilateral tax treaty—the Rome Convention—signed in 1921) was the 'method of classification and assignment of sources.'[21] Moreover, the technical experts asserted that certain types of source taxation such as that of interest might in fact be the most efficient and

B. Theoretical Uncertainty

i. Lack of Benchmarks

Unlike certain areas such as international trade, international tax economics struggles with the fact that there is little agreement on the appropriate benchmarks to gauge the efficacy of policy prescriptions. For example, under neoclassical trade theory a country that unilaterally reduces its tariffs will be better off as its importers will be able to access international services and products at a reduced price, which should enhance their own efficiencies.[25] In the long term, countries should unilaterally or collectively move toward free trade, which will enhance national and international efficiency, lead to a better allocation of cross-border resources and increase standards of living. For these reasons, the consensus view among economists supports a reduction of tariffs along with free trade. While there remain a number of challenges to assumptions underlying trade theory such as perfect information, perfect competition, and so on, the basic insight that reduced barriers to trade enhances welfare is generally accepted.

In contrast, there is less theoretical agreement on optimal international tax solutions.[26] Taxes imposed on cross-border transactions will almost always carry efficiency costs at the national and international level.[27] A country that offers tax rate and/or base incentives for international investments may improve its domestic welfare potentially at the expense of international efficiency concerns. For example, a country could offer a generous research and development tax credit to both domestic and foreign firms that conduct these activities within its borders. This move could lead to a misallocation of resources as multinational firms start-up or relocate their research and development departments because the after-tax cost of engaging in these activities has now been reduced (hence increasing the returns on engaging in these activities). From an international efficiency perspective, the misallocation of mobile factors of production is thought to be undesired because it reduces capital productivity, which is ultimately thought to lower world-wide standards of living (i.e., the misallocation may lead to an overall diminishment of global per capita income). Moreover, these sorts of misallocation of resources for tax reasons may be inhibiting the efficiency of regionally integrated free trade areas or customs unions and reduce their competitiveness vis à vis other competitor trade blocs or nations.

From a national interest perspective, however, it may make economic sense to promote these sorts of tax incentives for both domestic and foreign businesses: to the extent that the incentives actually work they arguably generate new economic

As long as national interest and interna

source.[34] Theoretical perspectives tend to support both sides of the capital import/capital export neutrality debate.[35]

The theoretical uncertainty surrounding guiding principles can be traced to the different national and international efficiency concerns noted previously. At the national level, institutional factors such as courts, tax authorities, and legislative bodies encourage consensus surrounding guiding principles that drive the formulation of tax laws. If necessary, the highest court in the land can pronounce on a particular issue that affects national and subnational tax concerns. Consider the ongoing dilemma surrounding the imposition of U.S. state and local sales and use taxes on out-

While these studies are considered to be the most sophisticated way of estimating the influence of taxes on investment decision-making, economists recognize a number of drawbacks that reduce their utility with respect to policy analysis. First, economists deploy different methodologies (typically based on the King and Fullerton method[43] or some variation) to calculate METRs, which can generate very different results.[44] Second, the studies involve the use of assumptions that can lead to greatly varying results. For example, most of the models incorporate an assumption of full loss offsetting for losses suffered by taxpayers over the course of the year. If this unrealistic assumption is varied to include the fact that most tax laws only permit partial loss offsetting with time limits for loss carry-forwards and carry-backwards then the METRs may change in a significant manner.[45]

In fact, each model necessarily incorporates a number of assumptions, each one potentially controversial, along with a corresponding chance to skew the results obtained. These assumptions include: whether to lump all economic activity into

distinct feeling that effective tax rates, like sausage, are best enjoyed in their final form, and that one can quickly lose one's appetite by looking too carefully at the details of preparation."[46] Economists are aware of the limitations involving METR studies although these limitations are rarely voiced within the actual study that a legal analyst may draw from. A more sophisticated critique, beyond the scope of this paper, might assert that METRs should be downplayed in favor of some other approach such as the use of cash-flow studies that simulate the amount of taxes (including income tax, capital tax, payroll tax and property tax) paid to tax authorities.[47] This approach, which generates average tax rates, is theoretically offensive to most economists because average rates include marginal and infra-marginal decisions of the firm.[48]

As touched on in the next section, METR studies are often used as the basis for policy prescriptions. Taking into consideration the problems noted above, METRs can be viewed as a rough measure of the potential influence of taxation on cross-border investment decisions. Yet the studies do not attempt to estimate the actual welfare losses associated with maintaining different national tax regimes. Such an attempt would be problematic in any event, in part because different empirical studies continue to question whether tax plays a significant influence on foreign direct investment flows.[49] Moreover, as touched on previously, empirical work has thus far failed to confirm theoretical perspectives regarding tax competition: "The study of tax

unanimous approval for direct tax issues (unlike cross-border consumption taxes where the Treaty of Rome permits a majority of EU member states to dictate policy). As a result, the Commission is unable to mandate a particular reform path in this area

the coordination among the different European Union tax systems in areas such as exit taxes and cross-border loss relief.[54]

There are a number of reasons that could explain the gap between prescriptions based on efficiency considerations and the actual policies implemented by government officials. For instance, the fact that policy analysis often ignores or downplays political concerns over a potential loss of tax sovereignty may be inhibiting sound policy analysis.[55] Moreover, there may be a disconnect between the tax reform discourse and recommendations offered by policy experts and the needs perceived by policymakers in other countries, particularly developing or transitional governments.[56]

E. Summary

Three sources of uncertainty—theoretical, empirical, and behavioural—reduce the utility of international tax economics with respect to international tax law policy analysis. Developing countries in particular may suffer from an over-emphasis on efficiency concerns largely because of their imbalance in capital flows with developed countries. Because the interests between developing and developed countries diverge with respect to international tax rules, they often find themselves on the short end of the stick. The next section claims that greater resort to other analytical tools is needed to complement the economic analysis to promote reform efforts that take more fully into account the interests of developing countries, which in turn will benefit the interests of developed countries.

III. CONTEXTUALISM AND INTERNATIONAL TAX

To overcome these problems, certain legal analysts deploy other analytical tools often in integration with economic analysis. These tools sometimes draw from different academic disciplines apart from economics or in integration with economic theories that take into account broader interests (e.g., institutional economics or political economy). These analysts can be characterized as Contextualists as their works emphasize the need to study international tax law reform within its political, social, historical, institutional or other context.[57]

Underlying this argument is the view that a fuller understanding of the political/historical/institutional or other factors that drive the adoption of international tax rules could promote insights into ways to promote the adoption of optimal tax laws and cooperative cross-border tax agreements. Interestingly, both the Contextualist and the Purist approaches are widely deployed in domestic tax law policy analysis while Contextualism is arguably downplayed by international tax law analysts. Yet, as discussed in Part II, international tax economics likely suffers from more sources of uncertainty when compared to domestic tax economics. If this view is accurate then the Contextualt approach is called for to an even greater extent in international tax law analysis when compared to its domestic counterpart.

As discussed, as long as countries share roughly balanced capital flows, the emphasis on efficiency concerns may not create undue problems. But, as many observers have noted, to the extent that these flows differ as occurs with developing and developed countries then more contentious issues appear.[58] The Indian government, for instance, has complained in the past that traditional international tax principles and practices, based to a large extent on the OECD model tax treaty, do not result in a fair sharing on

[57] A literature review of works that arguably fall within the Pragmatist school is outside the scope of this paper. A sample of a few works could include Reuven S. Avi-Yonah, 'The Rise and Fall of Arm's Length: a Study in the Evolution of U.S. International Taxation' (1995) 15 *Virginia Tax Review* 89; H. David Rosenbloom, 'Sovereignty and the Regulation of International Business in the Tax Area' (1994) 20 *Canada-United States Law Journal* 267; Robert A. Green, 'Antilegalistic Approaches to Resolving Disputes Between Governments: A Comparison of the International Tax and Trade Regimes' (1998) 23 *Yale International Law Journal* 79 (employing international relations theory to promote understanding of international tax cooperation mechanisms); Alex Easson, 'Harmful Tax Competition: An Evaluation of the OECD Initiative', (2004) 34 *Tax Notes International* 1037 (discussing some of the political problems associated with OECD reform efforts); Arthur J. Cockfield, 'Tax Integration under NAFTA: Resolving the Conflict between Economic and Sovereignty Interests' (1998) 34 *Stanford Journal of International Law* 39 (integrating internaaelations lie(a)-terature into international tax law anysis);e(a)-Diane M. Ring, *International Tax Relations: Theory and Implications* (Boston College Law School Legal Studies Research Paper 97, 2006)(noting that relatively little attention has been devoted to understanding how a variety of different forces, including political needs and multinational lobbying, shape international tax policy); Michael J.ichael M.e "Original Intent" of U.S. International Taxation', (1997) 46 *Duke Law Journal* 1021 (discussing the historical forces that shaped U.S. international tax policy); Walter Hellerstein, 'Jurisdiction to Tax Income and Consumption in the New Economy: A Theoretical and Comparative Perspective' (2003) 38 *Georgia Law Review* 1 (discussing the need to ensure that a government's enforcement jurisdiction is aligned with its powers to impose tax on transactions that have a relationship to economic actors within the state).

[58] Importantly, there is evidence that capital flows from certain developing countries, especially international portfolio investments, to developed countries has increased in recent yeE. Prasa, R. Rajan and A. Subraminian (2006) tterns of International Capital Flows and their Implications for Economic Development' (IMF Research Paper, Sept. 2006); J.B. DeLong (2004) 'Should We Still Support Untrammelled International Cpital Mobility? Or are Capital Controls Less Evil than We Once Believed?' 1(1) *The Economist's Voice* 1.

the international income tax base.[59]

more fully taken into account, the countries may become more vested in ensuring the international tax regime remains stable and tenable in the long run. This view brings us full-circle to efficiency interests as global tax consistency and uniformity in terms of rules and practices is thought to promote international welfare by reducing the risk that tax will act as a barrier to international trade and investment.

Finally, it is important to note that heightened international law cooperative efforts with developing countries, including an extension of true free trade in agricultural and textile products, should be seen as a critical component in the war on international terrorism. Under one view, enhanced free trade, increased tax revenues and concomitant higher levels of per capita income for developing countries will reduce the risk that these countries will serve as a base to foment ideological hatred of individuals within developed countries.[63] Moreover, heightened information sharing with tax authorities from developing nations may inhibit terrorist financing schemes. In other words, increased tax cooperation and sharing of revenues with developing countries can be portrayed as a part of broader international law efforts to promote global security, including security for residents living in OECD member states.

As explored below, the Contextualist approach tends to (with many exceptions) call for policy prescriptions that seek incremental and politically-feasible solutions.[64]

B. Case Study: OECD E-commerce Reform Efforts

The Contextualist approach may help to promote a greater understanding of the legal and institutional framework and process that should govern international tax reform efforts. In fact, there are several central (and arguably under-explored) legal/institutional questions that this approach could assist in answering:

- should traditional international law mechanisms (e.g., binding international tax agreements) or non-traditional law mechanisms (e.g., soft law via model treaties) serve as the starting point for negotiating cross-border tax rules?
- what are the costs associated with changing international tax rules on an incremental or radical basis?
- on what basis should membership be granted to promote optimal international tax policy: regional (e.g., European Union or NAFTA), international (e.g., United Nations), broad common interests (such as shared-values concerning capitalism and democratic values within OECD countries), narrower common interests such as economic interests only (e.g., the G-8) or values only (e.g., Commonwealth countries)?

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[63] For discussion, see Aaron Schwabach and Arthur J. Cockfield, 'The Role of International Law and Institutions', in *Knowledge for Sustainable Development: An Insight into the Encyclopedia of Life Support Systems* (vol. 3, Oxford: UNESCO, 2002) 611 (discussing international law mechanisms in light of international terrorism developments along with the need for a stricter adherence to the values of liberalism within international law); Arthur J. Cockfield, 'Who Watches the Watchers? A Law and Technology Perspective on Government and Private Sector Surveillance' (2003) *Queen's Law Journal*. 364 (discussing privacy concerns with respect to cross-border information sharing practices to combat terrorism).

[64] Of course, the Contextualist approach, to the extent that it makes a fuller accounting of developing country interests, could also lead to more radical reform suggestions to address these interests. See, e.g., Reuven S. Avi-Yonah, 'Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State', 113 *Harvard Law Review* 1573 (2000)(proposing to re-introduce withholding taxes on portfolio interest and advocating cross-border income taxation on the basis of consumption) .

(c) it was the first time that the OECD analyzed policy options in an extensive way through the publication of multiple discussion drafts of

Moreover, this process appears to have gathered support with respect to subsequent reform efforts. For example, in June 2007 Working Party No. 9 on Consumption Taxes met in Paris to discuss the drafting of VAT/GST Guidelines with respect to customer location and place of performance for supplies of services and intangibles. Building on the guiding principles set out in the Ottawa Taxation Framework Conditions put in place at the OECD Ministerial Conference on Global E-commerce in 1998, the government delegates had previously accepted certain general principles such as the place of supply should be the jurisdiction where consumption takes place. To overcome remaining hurdles, the Working Party agreed at the June meeting to create a new TAG and Task Team developed along similar lines to the ones in the OECD earlier e-commerce reform process.[72] The Task Team was then charged with the drafting of the specific sections of the VAT/GST Guidelines.

The OECD approach of encouraging discussion, study, and non-binding reform efforts resembles the phenomenon of ‘soft law’ or ‘soft institutions.’ Soft institutions are said to be more informal processes employed to achieve consensus by providing a forum for actors to negotiate non-binding rules and principles, instead of binding conventions.[73] The OECD approach is also consistent with emerging views in international relations theory that “government networks” (e.g., relatively informal arrangements among government officials in the same agencies) may be best at addressing global challenges.[74] Informally coordinated and networked action by governments, it is thought, may lead to a new form of international law- and policy-making that addresses these challenges without imposing undue restrictions on national sovereignty.

Similarly, the use of non-binding institutions promotes the interests of the OECD members by reducing tax obstacles to international trade and investment (thus encouraging national economic growth) while protecting tax sovereignty to the greatest extent possible. The OECD process more closely resembles customary international law, which is perhaps best understood as a set of normative expectations developed through observation of the actions of states. As is the case in other areas of customary international law, peer pressure

a society's or group of societies effectiveness in creating institutions that are productive, stable, fair, and broadly accepted and flexible enough to be changed or replaced in response to political and economic feedback.[75] The OECD's e-commerce reform process along with subsequent developments generally appears to have deployed institutions that meet the requirements for adaptive efficiency.

iii. What Are Transition Costs Associated with Different Reform Alternatives?

The OECD's apparent success with e-commerce can also be attributed to the loyalty to its reform process that has been underway since 1960. Moreover, the OECD member states have accepted the OECD model treaty as the basis for negotiating their own bilateral tax treaties since its formation in 1963. The OECD model was based on models developed by its predecessor entity, the Organization for European Economic Cooperation, which in turn were based on the League of Nations model treaties dating back to the post-World War I era (see the discussion in Part I). Moreover, the OECD is active in non-tax areas such as cross-border privacy and consumer protection, which has encouraged decades of cooperative government actions.

Loyalty to the OECD process is arguably deserved. It has been noted, for instance, that the vast majority of the over 1,500 tax treaties throughout the world exhibit significant uniform5(wa)-3.5p-ith e5.4(the Orocvisons)st toutin tue OECD me7.8(od-2.52(d-7.7(e)1.7(

perspectives and adopting them to new fact patterns: "The life of the law has not been logic: it has been experience… In order to know what [the law] is, we must know what is has been, and what it tends to become."[78] If the OECD model treaty was jettisoned in favor of some other approach it might undermine the common law principle of *stare decisis* as old decisions would now be less helpful as precedents for present or future cases. It would make it harder for tax lawyers to provide certainty with respect to their legal advice concerning cross-border transactions.

In short, radical change would encourage potentially significant costs that, at least in the short term, could result in adverse outcomes such as a reduction in international trade and investment. Instead, loyalty to the OECD reform process may signal readiness on the part of the OECD member states (and potentially non-OECD member states) to continue to work towards cooperative tax solutions, including in (arguably modest) areas such as enhanced information sharing as well as uniform transfer pricing documentation requirements and advanced pricing agreement procedures.

iv. Who Should Participate in Reform Efforts?

The OECD is constituted by thirty member countries, which generally possess similar

member states to vote on policy changes or to enlarge OECD membership to any significant degree. Under the Contextualist approach, a feasible and incremental solution could involve extending permanent membership to the OECD's Committee on Fiscal Affairs (CFA) to developing countries who wish to participate in the deliberation of potential reform efforts through a simplified and expanded outreach program.[84] This initial step might go a long way toward encouraging further buy-in by developing countries as it would give them a fo

sources of uncertainty—theoretical, empirical and behavioral—that may limit the utility of the Purist perspective. In contrast to the Purist approach, Contextualists