TAX INTEGRATION UNDER NAFTA: RESOLVING THE CONFLICT BETWEEN ECONOMIC AND SOVEREIGNTY INTERESTS

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I. INTRODUCTION

The recent debate over the North American Free Trade Agreement (NAFTA) [FN1] highlighted the tension between two conflicting but common desires of nation-states, namely the desire for greater economic efficiencies and the desire for sovereign control over governmental policymaking. [FN2] This tension, endemic to international trade discussions, is perhaps no more pronounced than with respect to proposals for international tax integration. [FN3] Nation-states considering such proposals find the prospect of ceding the power to shape tax policies--policies traditionally used to pursue domestic political, social, and economic goals--unnerving. However, governments are forced to balance the political costs of ceding control over national tax policymaking with their desire to secure heightened economic efficiency.

Consider Europe's experience. After decades of effort, the member states of the European Union accepted a diminution of their sovereignty [p. 40] over tax policy when they implemented value-added tax (VAT) harmonization in order to promote economic efficiency. [FN4] These same states, however, continue to resist measures which would lead to Union-wide harmonization of the rules governing business taxes. [FN5] Unlike the European Union, NAFTA is merely a trade pact; it contemplates only negligible political integration by its membership. Nevertheless, a good argument can be made that the movement toward freer regional trade and investment under NAFTA ought to be complemented by the gradual harmonization of North American tax regimes. Such gradual harmonization could enhance North American economic efficiency, while acknowledging and respecting the desire of NAFTA's members to maintain sovereign control over domestic tax policies.

This Article seeks to provide the reader with insight into the main economic and sovereignty interests surrounding taxation of cross-border flows in North America. Part II identifies the main economic concerns arising from the interaction of the United States, Canadian, and Mexican tax regimes. Part III reviews the factors that have promulgated tax integration initiatives in Europe, and discusses sovereignty concerns that the United States, Canada, and Mexico (collectively, the "NAFTA Member States") may have with respect to tax integration initiatives under NAFTA. Part IV reviews possible tax integration initiatives and considers the resulting constraints that might hamstring domestic tax policymaking. This Article concludes that a gradual heightening of tax policy coordination among the NAFTA Member States is desirable in light of the current economic and political environment in North America.

II. THE ECONOMIC STAKES

NAFTA is the world's largest regional economic bloc. Collectively, the NAFTA Member States produce thirty percent of the world's Gross Domestic Product (GDP), or U.S. $6.690 bbillion. [FN6] Under NAFTA, economic and institutional barriers to cross-border trade and investment will continue to decline, and mobile factors such as capital, goods and services will move progressively more freely across borders. [FN7] As this [p. 41] process goes forward, trade and investment flows among the Member States will become increasingly sensitive to "barriers" created by the Member States' disintegrated tax regimes. [FN8] As NAFTA matures, the Member States will increasingly need to weigh the economic benefits of tax integration against the costs associated with the loss of sovereignty associated with tax integration. [FN9] NAFTA is an agreement to cooperate in trade and investment matters by lowering international economic barriers. The pact has already limited each Member State's sovereign power in some areas. However, the question remaining to be answered is whether a further reduction in sovereignty through NAFTA-wide tax integration is desirable and, perhaps more importantly, feasible.

A. CAPITAL FLOWS

International investment flows are often divided into two categories: foreign portfolio investment, or nonentrepreneurial investment sensitive to interest rate fluctuations, and foreign direct investment, or entrepreneurial investment typically involving control of a foreign business entity and the placement of physical assets in a foreign business jurisdiction. There are a number of concerns surrounding the impact of tax differentials on both types of investment flows among the NAFTA Member States. For one, differing Member State tax regimes may distort investment patterns and reduce overall North American capital productivity. [FN10] The tax regimes of the Member States were, in part, designed to promote investment in selected activities deemed "worthy" of promotion by Member State legislatures. For example, tax policy is often configured to promote investments in research and development by increasing after-tax returns on these activities. Such policies can cause inefficiency by artificially inflating rates of return on otherwise unprofitable projects. As a result, investment decisions are sometimes undertaken for tax reasons, rather than for purely economic rationales. [FN11] Such distortion of the investment decision-making process can harm the economy of one NAFTA Member State by diverting resources to another Member State. In some cases, this diversion of resources reduces the capital productivity of NAFTA as a whole. Economists assert that reduced capital productivity may harm the ability of states participating in regional economic integration to compete with other countries or regional trade blocs. [FN12]

There does not appear to be a study measuring the cost of reduced capital productivity within NAFTA as a result of differing Member State tax regimes. Conducting such a study would be problematic because cross-border capital flows, and especially foreign direct investment, are influenced by many nontax factors. [FN13] For example, factors such as a state's general business climate or its overall political situation frequently influence an investor's decisionmaking calculus. In Europe, the Ruding Committee encountered great difficulty when it tried to measure the costs attributable to differing tax regimes within the European Community. The Committee stated that it had found no satisfactory way of quantifying the size of the distortions that may exist. . . . Nevertheless, the fact that empirical evidence gathered on behalf of the Committee indicates that taxation does have a strong influence on the location of investment and on financing decisions is prima facie evidence that the distortions to competition and resulting efficiency losses caused by taxation could be large. [FN14]

The empirical evidence referred to by the Committee consisted of studies, conducted by economists, that attempted to measure the extent to which differing marginal effective tax rates encourage or discourage international investment behavior. [FN15] Despite a number of limitations, [p. 43] cross-country comparative marginal effective tax rate studies can roughly assess whether a state's tax regime favors or discourages investment relative to those of other states. [FN16] Studies comparing the marginal effective tax rates of Canada and the United States, [FN17] and others comparing the rates of all three NAFTA Member States, [FN18] generally indicate that, overall, the tax burdens imposed on most new capital investments in North America are comparable. Although a certain amount of distortion results from the interaction of the differing Member State tax regimes, these studies indicate that, as a general rule, decisions to invest in a NAFTA Member State are not significantly influenced by taxes. Accordingly, policy proposals designed to prevent the misallocation of capital by creating NAFTA-wide uniform tax burdens on capital flows do not seem to be warranted.

B. TAX COMPETITION

Despite the existence of similar tax burdens on capital, there is a legitimate concern that, absent formal harmonization of the tax systems of the Member States, tax competition for cross-border investment flows [p. 44] could develop. This tax competition could have an adverse economic impact, as the NAFTA countries find themselves in a "race to the bottom." Such a "race" could result from deliberate actions by a Member State government for reasons of political expedience or simply from the inadvertent interaction of differing tax regimes. In either case, firms with cross-border operations could then take advantage of disharmony among the Member States' tax regimes by structuring their decisions and transactions to exploit the differences. This is especially true for large multinational corporations with operations throughout North America, whose willingness to exploit regulatory arbitrage opportunities is a primary cause of international tax competition. [FN19] A "race to the bottom" could also develop if Member States begin competing for foreign investment by reducing their overall capital income tax burdens. [FN20] Continued rate decreases might ultimately lead to a tax burden insufficient to fulfill the revenue of a Member State. [FN21] In part, the potential for tax competition led the Ruding Committee to recommend that certain aspects of corporate income taxes be harmonized throughout the European Community. [FN22]

In the North American context, analysis of tax competition is necessarily one-sided. Due to the economic size of the United States, relative to that of Canada or Mexico, its tax regime can be expected to have a disproportionate effect on capital movements in North America. [FN23] Further, since the United States currently accounts for roughly one-third of the total world capital market, [FN24] it is not significantly affected by the tax policies of its NAFTA partners. The United States does not [p. 45] necessarily use its tax system to compete with Canada and Mexico. Nevertheless, United States tax policy is becoming increasingly constrained by global concerns; the United States government must ensure that its tax system does not discourage cross-border capital investment by becoming relatively less attractive than the tax systems of competitor nations. [FN25]

The norm in North America is regulatory emulation. [FN26] In certain circumstances, Canadian and Mexican regulators change their tax policies to ensure that they do not impose burdens on mobile factors dissimilar to those imposed by the United States. Indeed, there is evidence that both Canada and Mexico have felt pressure to conform parts of their tax regimes with that of the United States. For example, Canada's effective tax rates on corporate capital income have been gradually reduced over the last twenty years. Now the Canadian tax system imposes a tax burden on capital activity similar to that imposed by the United States. [FN27] Further, Canadian tax reform in 1987 was influenced in part by the tax reform undertaken in the United States in 1986. [FN28] Mexican tax reform in the 1980s was initiated primarily to reflect the Mexican government's economic strategy at the time: encouraging stability and predictability in the Mexican economy. [FN29] Of course, one [p. 46] way for Mexico to accomplish such a goal is to implement a tax regime similar to that of its major trading partner, the United States. [FN30] Deliberate tax competition among the NAFTA Member States is not yet a contentious issue. The marginal effective tax rate studies noted previously suggest that inadvertent competition is not contributing to significant capital relocation. Nevertheless, a NAFTA Member State might be tempted to attract specific investments or some other particularly mobile factor of production through the use of tax incentives. [FN31] Further, a NAFTA Member State might initiate new tax measures for domestic purposes that would cause capital income tax burdens to diverge, thus creating adverse spillover effects on the economies of the other Member States. [FN32] Both of these potential problems could be avoided through NAFTA-wide tax harmonization.

C. TRADE FLOWS

International trade patterns can be distorted by discriminatory tax measures. [FN33] The tax regimes of the NAFTA Member States distort trade flows through the use of tax subsidies granted to a variety of businesses, including subsidies to companies that export goods and to selected domestic industries. [FN34] However, the magnitude of this distortion has not been calculated. [FN35] Apart from this type of trade distortion, the cross-border tax treatment of goods and services is currently not a major area of concern. [FN36] Economists generally believe that exchange rates offset the impact of taxes on goods and services, such as Canada's Goods and [p. 47] Services Tax [FN37] and Mexico's Value-Added Tax, [FN38] which are imposed on a destination basis (i.e., taxes are placed on imported goods while exports receive a tax rebate.)

However, both NAFTA and the tax treaties of the Member States contain antidiscrimination provisions which ensure that national and, at times, subnational taxes placed on goods and services do not discriminate against foreign goods and services. [FN39] Moreover, as a free trade area and not a European style customs union, NAFTA does not strive to create a truly free flow of goods across borders. Under NAFTA rules, many goods are stopped at the border by custom officials to ensure that they are properly marked as originating from a Member State. [FN40] Accordingly, there is not an impetus to remove border tax adjustments, since goods already have to stop at the border for origin purposes.

D. ADDITIONAL PROBLEMS

Differences in the NAFTA Member States' tax regimes encourage tax arbitrage, a phenomenon in which multinational corporations attempt to gain tax benefits through the manipulation of intercompany transfer prices. For example, a company in one NAFTA Member State can try to increase the price of transfers on goods being shipped to a subsidiary in another Member State with a heavier tax burden, thereby shifting its accounting profits to the low-tax Member State. The company's profits in each Member State are thus allocated for tax reasons and do not reflect true economic profitability. The problem of taxing corporate activity that takes place in two or more Member States is exacerbated by NAFTA, which encourages firms to increase their operations in other NAFTA countries. Although corporate tax rates are generally similar among Member States, there appear to be areas in which the different tax regimes permit some amount of tax arbitrage. [FN41] As a result of the [p. 48] significant amount of intracompany transfers, [FN42] the issue will likely remain a sensitive one. [FN43] Double taxation problems may also arise when two Member States, each with its own rules for imposing tax liability, claim a right to tax the same earnings. [FN44] Currently, these issues are resolved by the "competent authorities" provisions of the bilateral tax treaties, which permit Member State tax authorities to negotiate a resolution to disagreements.

A final problem involves the fact that each Member State's rules contain provisions which favor domestic investors by discriminating against investment from foreign countries, including other NAFTA Member States. For example, Canada offers resident shareholders tax relief on dividend proceeds received from Canadian corporations but, in most circumstances, nonresident shareholders are not afforded the same level of tax relief. The effect of these Canadian provisions, while difficult to quantify, is to distort investment activity. [FN45]

E. ADVANTAGES OF MAINTAINING TAX DIFFERENCES

The economic benefits derived from tax differentials can sometimes outweigh the benefits of efficiency gains provided by tax integration. The current cross-border flow taxation system in North America may have its advantages. Competition for capital investment can be viewed as desirable insofar as it creates an incentive for governments to fashion an "optimal regulatory burden." [FN46] In other words, governments are disciplined by international tax competition because excessive regulation may compel investors to move their investments to a more favorable tax jurisdiction. International tax competition can thus be viewed as taming the "Leviathan tendencies of government"; [FN47] it helps impose on governments a degree of discipline that would not otherwise exist. [FN48]

[p. 49] Maintaining different tax regimes also promotes policy experimentation and innovation. As markets and economies evolve, tax uniformity could actually reduce the flexibility of governments to respond to these changes in an effective manner, possibly reducing future efficiency gains. [FN49] Furthermore, allowing governments to subsidize a particular investment activity through favorable tax policy is, arguably, sometimes necessary in order to support and promote business activities that are deemed crucial for national economic success. [FN50] In short, maintaining tax differences can serve important economic goals.

Despite these advantages, however, disharmony among the tax regimes of the NAFTA Member States is problematic. Ultimately, it harms the economic interests of the citizens of the Member States, since disharmony hinders the economic efficiency of the trade bloc. [FN51] The extent of the harm caused to these citizens has yet to be measured. Without information regarding the extent of this harm, it may seem premature to advocate measures that would comprehensively integrate the tax regimes of the Member States. Still, because tax policy is often a barrier to the flow of mobile economic factors, it seems likely that the economic harm caused by tax disharmony will become more serious as the economies of the NAFTA Member States become increasingly integrated. The NAFTA Member States are, however, understandably reluctant to consider tax integration initiatives so long as such initiatives ask them to cede sovereign control over their tax regimes.

III. THE SOVEREIGNTY INTEREST

The discussion above outlined the economic arguments for integrating tax policies under NAFTA. The simple fact is that the trade and investment environment in North America has changed under NAFTA, while the mechanisms for taxing cross-border activities remain largely the same. Seen in that light, the current tax treatment of cross-border flows is inconsistent with the trend toward the reduction of barriers to the mobility of goods, services, and capital as well as toward increased global commercial competition. [FN52]

Why has North American international tax policy not kept up with the trend toward trade and investment liberalization? [FN53] The answer lies in the unique place that tax measures occupy in a government's fiscal [p. 50] policy. Taxation is an important policy tool, one used to satisfy the distinct needs of the citizens of each NAFTA Member State (e.g., through wealth redistribution). Indeed, "fiscal sovereignty tends to be guarded jealously, so that it is extremely difficult to secure any significant degree of cooperation between states in fiscal matters. . . ." [FN54] The issue, then, boils down to one of state sovereignty.

A. LESSONS FROM EUROPE

The Treaty of Rome, which, among other things, called for the harmonization of all legal regimes impeding the free flow of goods, services, capital, and labor, was adopted by six European countries in 1957. [FN55] Since then much of Europe has moved, albeit unevenly, toward economic and political integration. [FN56] This movement resulted in the formation of a European common market and the implementation of VAT harmonization in 1993. [FN57] Other significant steps toward European tax integration include the adoption of three significant measures regarding company taxation [FN58] and the issuance of recommendations by a committee of tax experts to partly harmonize corporate income taxes. [FN59] The Treaty of Rome's call for harmonization was the foundation of VAT and corporate income tax harmonization. These provisions mandated tax harmonization in the case of indirect taxes and influenced the Ruding Committee to issue certain harmonization recommendations for direct taxes. [FN60] [p. 51] NAFTA's goals are, of course, more modest, focusing on "the progressive elimination of tariff and non-tariff barriers to trade in goods and the establishment of reciprocal national treatment obligations regarding trade in services and investment." [FN61] NAFTA does not contain provisions creating an obligation to harmonize Member State legal regimes, although it does call for the harmonization of certain health standards. [FN62]

1. Centralized Political Institutions

The drive toward European integration was influenced by non-economic factors such as social and political concerns. Indeed, the European integration movement was viewed by its creators "as a meta-value in itself above any mundane cost-benefit analysis." [FN63] Ultimately, the movement was born of a recognition that a mechanism was needed to combat nationalist tendencies that led to two world wars in the first half of this century. Accordingly, the Treaty of Rome created a number of interstate political links by establishing centralized decisionmaking institutions. [FN64] These institutions, including the European Commission, the European Court of Justice, and the European Parliament, now view their main function as encouraging and providing a forum for debate on further integration. These bodies thus help turn generalized visions and goals, such as the need for tax harmonization, into detailed plans. [FN65] NAFTA, on the other hand, grew out of economic concerns [FN66] and established few centralized decisionmaking institutions. [FN67] A free trade area, not a customs union, NAFTA requires much less institutional support because its objectives are less ambitious. [FN68] In fact, NAFTA's institutions exist as a setting for consultation and cooperation among the [p. 52] Member States. NAFTA institutions do not have the power to bind the Member States, with the exception of dispute resolution for antidumping duties (which occur when an exporter exports its products at a lower price than it charges in its own country or at a price below cost) and countervailing duties (which offer redress against government subsidies to exported products). [FN69] Indeed, contrasted with the situation inIn the European Union,, where decisions of the European Court of Justice are generally binding on the national courts of the European member states, [FN70] and the European Commission can propose legislation which, at times, binds the citizens of the European member states. [FN71] NAFTA, by contrast, has a comparatively weak institutional base from which to develop and implement tax integration initiatives.

2. A New Approach

The member states of the European Community had decades in which to learn to trust each other and develop working relationships which, in turn, led to the acceptance of further integration. The citizens of these countries felt the tangible benefits of economic union and were thus prepared to accept further integration in the form of the European Union. [FN72] North Americans, however, have had little time to digest NAFTA. American public opinion is divided as to the benefit of a pact that includes a Mexican economy struggling to recover from the collapse of its currency in 1994. [FN73] Canada and Mexico, wary of interference in their public policy decisions, continue to be uncertain of the implications of their pact with the United States. [FN74]

In addition to the passage of time, however, a new approach toward integration matters helped pave the way for the European common market in 1992. This new approach included adopting the principle of [p. 53] subsidiarity, based on the idea that the European Commission would impose centralized harmonization only in areas indispensable to the function of the internal market. [FN75] The approach focussed on steps that the European member states could not take by themselves, or that were unlikely to be generated by market forces. [FN76] Since the common market contemplated ensuring that goods move freely across borders, it was necessary to harmonize VATs so that border tax adjustments could be removed. [FN77] Subsidiarity led to the establishment of minimum standards or levels of regulation. This has led some European commentators to cease viewing the harmonization of regulations as a diametric alternative to regulatory competition. Rather, the two are now viewed as compatible and even complementary. [FN78] This view is demonstrated by the harmonization of indirect taxes in the European Union, which places a 15% floor on the VAT and permits competition between member state tax systems above this floor. [FN79]

3. Europe Today: Overcoming Sovereignty Hurdles
A number of sovereignty hurdles to tax integration in Europe remain. The Ruding Committee's corporate tax harmonization proposals received only tepid political support from the European Commission and the governments of the European member states. In fact, the Commission has not yet attempted to pursue most of the committee's harmonization recommendations. [FN80] Further, the political hurdles associated with VAT harmonization have apparently not yet been completely overcome. [FN81] [p. 54] Despite these setbacks, it is clear that the European Member States have moved away from traditional views of sovereignty. Today, their views are grounded in the economic, social, and political realities of a Europe marked by more than forty years of experience with regional integration. The evolution of this new economic, social, and political reality has permitted the European member states to make progress on tax integration initiatives. The specific factors, discussed previously, that have contributed to this progress include a legislative impetus to harmonize certain taxes, the creation of political links through centralized institutions, the passage of time and the development of the principle of subsidiarity. None of these factors are present in North America. This contrast highlights the crucial differences between the European Union (a supranational polity) and NAFTA (a mechanism to promote economic efficiencies).

This does not mean that tax integration initiatives under NAFTA are doomed to fail. It does, however, highlight the difficulties that the NAFTA Member States would encounter if they attempted to overcome the sovereignty hurdles associated with regional tax integration. The fact that, despite four decades of regional integration, tension between the desire to reap further economic efficiencies and to maintain tax sovereignty continues to play a dynamic role in Europe bodes ill for similar North American efforts. The next Subpart will examine whether the current political environment in the NAFTA Member States would support certain types of tax integration.

B. SOVEREIGNTY CONCERNS OF THE NAFTA MEMBER STATES

Law and society scholars tell us that legal rules both reflect and reinforce existing norms. [FN82] Any proposals for NAFTA-wide tax harmonization must therefore convince citizens of the Member States that more is to be gained than lost through their implementation. In other words, tax integration proposals must reflect the "double movement" of history, through which social forces promoting economic integration are countered by forces opposing the social disruption caused by such integration. [FN83] [p. 55] Sovereignty is a nebulous concept which escapes precise definition. [FN84] On an individual level, it can be something as intangible as a "gut feeling," or a notion of nationalism held dear to the heart. [FN85] Nevertheless, the following brief overview of the political situation in the NAFTA Member States demonstrates that their citizens continue to place a premium on the preservation of sovereignty, however defined.

Canada and Mexico share similar views of their respective relationships with the United States. Both fear that American culture will erode their cultural distinctiveness and undermine their national identities. [FN86] Until recently, both countries would have considered even the cultural costs of greater economic ties with the United States to be prohibitively high. [FN87] Recognizing that external trade ties with the United States are crucial to their economic success, [FN88] however, Mexico and Canada have sought to align their economies more closely with that of the United States. [FN89] Still, the Mexican and Canadian governments took care to [p. 56] assure their electorates that NAFTA would not place significant constraints on state functions or undermine national distinctiveness. [FN90]

The belief that NAFTA will benefit the average citizen is not widely shared in the United States, [FN91] where polls suggest that a majority of citizens do not support expanded free trade agreements. Many constituencies in the United States continue to be suspicious of supranational institutions, especially institutions with the power to directly affect American interests. [FN92] There is a certain "go it alone" sentiment in the United States, an outlook not fully shared by citizens of the other NAFTA Member States, who are more likely to believe that their standards of living are tied to export strategy. [FN93] In fact, it has been noted that the United States' traditionally isolationist values may make NAFTA an uneasy fit. [FN94]

Table 1, located in the Appendix to this Article, sets out comparative data measuring several economic and social indicators in the NAFTA Member States. It reveals many similarities between Canada and the United States in terms of per capita economic wealth, population growth rate, vital statistics, and government expenditures. Mexico, by contrast, is a much less wealthy country still recovering from the collapse of its currency in December 1994. Table 1 also illustrates some of the disparities in wealth [p. 57] and social conditions between Mexico and its two NAFTA partners. [FN95] Studies estimate that long term GDP gains attributable to NAFTA are less than 0.5% for Canada and the United States while estimates of the impact on Mexican GDP range from 0.1% to 11.4%. [FN96] However, the factors in Table 1 cannot gauge nationalism or patriotism. These phenomena, springing from the internal value systems of individuals, cannot be measured in concrete terms. Nevertheless, for a variety of historical and cultural reasons, the citizens of the NAFTA Member States take sovereignty issues very seriously and would be sensitive to measures eroding the ability of their governments to respond to their distinct desires. [FN97] Tax measures within each Member State currently reflect differing political, social, and economic agendas and raise different amounts of revenues. Tax integration efforts that would be perceived as reducing revenues, investment levels, or employment levels would be difficult for adversely affected citizens to accept.

In sum, despite decades of effort toward economic and political integration, the European member states continue to refuse to cede tax sovereignty in certain circumstances. While they have adopted some measures which limit their tax autonomy, they nevertheless continue to resist implementing other measures placing constraints on their taxation of business income. As in

Europe, economic integration in North America has produced intrusions into the sovereign powers of each NAFTA Member State. [FN98] The NAFTA agreement itself, however, only grudgingly restricts limited state powers. This reticence to limit state power reflects a strong desire in the Member States to preserve sovereignty. This commitment to maintaining sovereignty flies in the [p. 58] face of economic notions such as aggregate wealth maximization and greater wealth distribution through the development of comparative advantage. Unfortunately, there is little common ground between economic theory and nationalistic values. It is unlikely that the NAFTA Member States would implement tax integration recommendations that place significant constraints on their ability to use their tax systems as they see fit. The framers of NAFTA, through their democratic institutions, continue to place an emphasis on pursuing distinct tax policies, which affect the types and amounts of public goods and services provided by the government as well as the degree and pattern of income redistribution. The next section reviews potential tax integration initiatives under NAFTA, with a focus on the sovereignty costs that would be incurred were the Member States to enact each initiative.

IV. TAX INTEGRATION INITIATIVES UNDER NAFTA

This Article has discussed the ways in which international tax integration is hampered by tension between, on the one hand, a desire to reap economic benefits through integration, and, on the other hand, a desire to maintain sovereign control of tax policy. This Part identifies three possible approaches to tax integration among the NAFTA Member States and discusses whether they are possible in the present economic, social and political environment. [FN99] Under the first possible approach, the NAFTA Member States could decide to maintain the status quo, coordinating the taxation of cross-border activities through existing bilateral tax treaties. Under a second possible approach, the NAFTA Member States could undertake immediate comprehensive tax integration by harmonizing their tax systems or adopting another far-reaching mechanism, such as a NAFTA-wide formulary approach toward taxing the profits of business entities operating in two or more NAFTA countries. Finally, the NAFTA Member States could pursue a policy of gradualism, slowly harmonizing their tax regimes and coordinating their tax policies. In the current environment, gradualism is the most appropriate approach to resolving the tension that exists in each state's desire to obtain greater economic efficiencies while still preserving sovereign control of tax policy.

[p. 59]

A. MAINTAIN THE STATUS QUO

Under the first possible approach to tax integration, the NAFTA Member States could, despite the liberalized trade and investment environment created by NAFTA, elect to maintain their current mechanisms for dealing with cross-border flows. Obviously, maintaining the status quo would preserve a great deal of tax autonomy since the Member States' tax regimes would not undergo significant changes. Such a "do nothing" strategy, however, would not guarantee each Member State's tax sovereignty. As discussed previously, small players in the global capital markets, such as Canada and Mexico, must pay close attention to the tax policies of their major trade and investment partners in order to avoid capital outflows; [FN100] they must ensure that overall tax burdens on capital income do not stray too far from those imposed by the United

States. The United States, in turn, must ensure that its tax system does not make it inhospitable to investment in comparison to large competitor nations. In other words, external economic concerns already impact development of national tax policies and, to that extent, they reduce a sovereign's control over its domestic tax measures.

Under NAFTA, problems that are created through the interaction of Member State tax systems are primarily resolved through tax treaties. [FN101] However, existing tax treaties fail to remove many of the economic distortions caused by differing tax burdens; tax rules which create different after-tax rates of return will influence the cross-border flow of mobile economic factors. [FN102] Existing tax treaties also do nothing to prevent investors in one Member State from shifting resources to another Member State which taxes capital income more favorably. Potential inefficiencies in the allocation of capital resources are therefore not curtailed through the use of treaties.

The bilateral nature of existing tax treaties is problematic in the context of a multilateral trade regime such as NAFTA. [FN103] Their lack of [p. 60] uniformity can contribute to distortion and fragmentation of the North American market. [FN104] For example, different withholding tax rates are established by tax treaties between Member States. [FN105] These withholding tax rate differentials can serve to fragment the market since they discourage investment by nonresidents by, at times, raising the cost of doing business. [FN106] The Member States agreed to NAFTA in order to reap the economic benefits of free trade while ensuring that state sovereignty was preserved to the greatest extent possible. Accordingly, it makes sense for NAFTA to be complemented by further tax integration efforts that do not impose significant constraints on the tax policies of the Member States. It seems likely that differences in Member State tax regimes will increasingly influence resource allocation as barriers to the mobility of goods, services and capital are further reduced and as, over time, the economies of North America become more integrated. Over the long term, then, these differences will increase the cost of maintaining the status quo. [FN107]

B. COMPREHENSIVE TAX INTEGRATION

At the opposite end of the spectrum, comprehensive tax integration, the second possible approach to tax integration, would remove or greatly reduce many of the economic inefficiencies caused by the differences in NAFTA Member State tax regimes. Comprehensive integration initiatives would, however, be viewed as imposing an unacceptable constraint on tax policy, and would thus be unacceptable to the sovereignty-jealous citizens and governments of the NAFTA Member States.

1. Harmonization of Corporate Income Taxes

The comprehensive harmonization of corporate income taxes would be enacted by agreement among the NAFTA Member States to adopt common rules (such as similar business income tax bases or tax rates.) [FN108] In fact, it appears that, even without formal initiatives, the business tax regimes of Member States have converged somewhat during the past ten years. All three NAFTA Member States employ a modified version of the Haig-Simons definition of income, under which virtually all increases in wealth are taxable. [FN109] All three Member States generally do not tax unrealized capital appreciation, nor do they tax imputed income.

Since the mid-1980s, the Member States have undertaken similar tax reforms in an attempt to improve the efficiency and equity of their tax systems. Their tax bases have been expanded and tax rates reduced, while deductions and incentives have been curtailed. In 1986, the United States undertook significant tax reform measures, including a reduction of its corporate income tax rate from 46% to 34%, elimination of its investment tax credit, reduction in capital cost allowances and the introduction of an alternative minimum corporate tax. Canada undertook major tax reform in 1987. It reduced tax rates, eliminated a number of tax incentives, including the general investment tax credit for specified industries, and modified a number of deductions. In 1987, Mexico also began significant tax reform. In an effort to reduce tax avoidance, it widened its tax base and reduced personal, VAT, and corporate tax rates. Significantly, one major objective of Mexico's tax reform measures was to emulate "modern" tax regimes, such as that of the United States. [FN110]

Table 2, located in the Appendix to this Article, summarizes several of the notable differences in the corporate income tax regimes of the Member States. [FN111] This Table demonstrates that, despite the conceptual similarity of the Member States' tax regimes, there are many significant differences among them. These differences are perhaps due to differing political, social, and economic agendas. Most importantly, the Table shows that NAFTA-wide tax harmonization would require each Member State to significantly alter its domestic tax rules; harmonization would likely entail significant alteration of all three tax regimes. Each Mmember Sstate would resist harmonization if it felt that the tax reform would adversely affect revenues, investment, or employment levels.

Because capital is so mobile under NAFTA, and because corporations often have interests in two or more Member State jurisdictions, the disharmony of Member State corporate income tax rules is a pressing concern. [FN112] Studies reviewing the differences between the corporate tax [p. 62] regimes of Canada and the United States, [FN113] as well as those of Mexico and the United States, [FN114] generally indicate that these regimes are fairly similar. Still, a number of important differences among them continue to distort economic activity. For example, each Member State taxes dividend income differently. [FN115] According to one commentator, "Within NAFTA, from the perspective of U.S. and Canadian investors, it appears that lack of harmonized integration of corporate and shareholder taxation is the most significant obstacle to free movement of capital. . . ." [FN116]

The sovereignty costs associated with corporate income tax harmonization are very high. A trend toward subnational tax decentralization in Canada and the United States only raises these costs and is perhaps the greatest hurdle to income tax harmonization. [FN117] Subnational tax regimes are important sources of revenue in both countries; they raise an estimated 40% to 50% of overall tax revenue. [FN118] Subnational taxation is less important in Mexico, where it raises less than 20% of overall tax revenue. [FN119] Complicating matters further, each Member State relies on different combinations of subnational tax measures to raise revenue. Personal income taxes are important subnationally in Canada, [FN120] while personal income taxes, retail sales taxes, and property taxes are important in the United States. [FN121] Subnational taxation in Mexico involves payroll and property taxes. [FN122] [p. 63] In Canada, subnational corporate income tax systems are highly integrated with the federal tax regime. [FN123] Nevertheless, the Canadian provinces are increasingly developing independent tax policies, matching a general trend toward decentralization of political power nationwide. [FN124] Furthermore, the Canadian federal government has had difficulty harmonizing its goods and services tax with provincial sales taxes. Differing federal and provincial sales tax systems, as well as different capital tax burdens, distort and impede trade and capital flows within Canada and are a continuing area of national concern. [FN125] Similarly, in the United States the lack of uniformity between state and federal tax policy is thought to have a harmful effect on economic efficiency. [FN126] The states, however, continue to pursue independent tax policies, and there is no indication that greater cooperation between them and the federal government is forthcoming. [FN127] NAFTA-wide income tax harmonization, which would require a common definition of the tax base, will be hard to achieve so long as subnational tax regimes within Canada and the United States remain varied. [FN128]

Finally, efforts to encourage subnational corporate income tax harmonization are hampered by the federal structures of Canada and the United States. In certain instances, Canada's provinces and each state of the United States are constitutionally empowered to develop their own tax regimes. As a result, negotiators were careful not to constrain subnational jurisdictions when negotiating a recent protocol to the U.S.-Canada tax treaty. [FN129] In short, income tax harmonization efforts [p. 64] that attempted to alter subnational tax policy would be viewed as unacceptable by the subnational governments in both countries.

2. Formulary Taxation

Formulary taxation, a third proposal for comprehensive tax harmonization among the NAFTA Member States, would replace the current method of allocating corporate income through the use of international transfer pricing. [FN130] Under a formulary taxation regime, the income of corporations operating in more than one NAFTA Member State would be treated as a singe taxable entity, and their tax payments would be divided among the Member States by way of formulary apportionment. [FN131] In other words, revenue raised through taxation of such corporations would be divided among the appropriate Member States according to a set of apportionment rules established by a trilateral tax treaty. [FN132]

In many ways, the formulary apportionment process resembles the system already used to divide income realized in different Canadian provinces and territories as well as different states in the United States, where factors such as the ratio of property, payroll, and sales in the taxing jurisdiction are to be weighed against similar factors in another jurisdiction. To implement formulary apportionment, the NAFTA Member States would have to agree on a set of supranational tax rules determining how much revenue each state would collect from the operations of multinational corporations; the Member States would have to cede a portion of their fiscal sovereignty with respect to the taxation of multinational corporate profits. [FN133] Naturally, each Member State is likely to have a different perspective on what rules ought to govern formulary apportionment. Mexico and Canada, net importers of capital from the United States, would argue for rules that strengthened source apportionment, while the United States would argue for apportionment based [p. 65] primarily on residence. [FN134] Determining which factors should be included in the apportionment formula would also be problematic. Each Member State would seek to establish a formula serving its own interests, and there could be constant argument concerning interpretation of the factors even if agreement is reached. [FN135] Furthermore, for formulary apportionment to be workable, large portions of the Member States' tax regimes, such as corporate income tax bases, may need to be harmonized. [FN136] Laying a foundation for formulary taxation may not be possible under NAFTA, a free trade pact which does not contemplate extensive political integration. [FN137]

3. Comment on Comprehensive Tax Integration

The primacy of tax policy in the NAFTA Member States may mean that, at present, the pursuit of tax harmonization policies placing severe constraints on a Member State's sovereignty over its tax system is inappropriate. [FN138] Indeed, any significant transfer of tax sovereignty from the NAFTA Member States to a centralized tax regime will remain unlikely until the economic benefit of tax harmonization outweighs its costs in loss of sovereignty. Nevertheless, pacts like NAFTA lay the groundwork for subsequent efforts to reduce barriers to economic efficiency created by the differing tax regimes of the NAFTA Member States. Any attempt to harmonize the Member States' tax regimes, however, must strike a balance between the social forces in each state promoting economic integration and the forces opposed to the social disruption which could accompany harmonization. [FN139]

[p. 66]

C. GRADUALISM

1. Form a NAFTA-Wide Tax Working Group

Europe's experience shows that resolving the tension between economic efficiency and sovereignty inherent in international tax integration efforts is a slow process fraught with political danger. Nevertheless, the NAFTA Member States need to develop an enhanced understanding of how their tax regimes interact. The learning process could begin with the creation of a Permanent Tax Working Group comprised of tax experts from each Member State. [FN140] With the consent of the Member States, such a Working Group would operate under the auspices of the NAFTA Trade Commission. [FN141] Officials from the Member State governmental departments that traditionally negotiate tax treaties--the Mexican Treasury Department, the United States Treasury Department, and the Department of Finance in Canada--could comprise the Group's membership. [FN142] The Group's initial efforts would be directed at quantifying the economic costs of tax disharmony.

A Tax Working Group would present a forum for developing a fuller understanding of the impact of tax regime disharmony on trade and capital flows among the Member States. Ideally, the Working Group would be able to determine which tax policies significantly distort economic activity within NAFTA and, conversely, which policies are essential to each individual government's political agenda. A comprehensive understanding of these challenges would ease the process of integrating the tax regimes of new NAFTA Member States with those of the present membership.

2. Negotiate Tax Treaties Multilaterally

The absence of uniform tax treaties among the Member States leads to economic distortions [FN143] in the North American marketplace. [FN144] In [p. 67] light of these distortions, the NAFTA Member States should consider undertaking multilateral tax treaty negotiations. In the context of NAFTA, the traditional practice of bilateral treaty negotiation need not be etched in stone. [FN145] Reluctance to enter into multilateral negotiations traditionally stems, in part, from a state's desire to extend tax benefits to its trading partners on a reciprocal basis, without granting these benefits to all trade partners. In a free trade area, however, it makes sense to offer the same tax benefits to all members, for such uniformity reduces fragmentation in the marketplace. [FN146]

3. Develop an Arbitration Procedure for Transfer Pricing

The main difference between current transfer pricing mechanisms and the formulary taxation proposal discussed earlier is that the former treats each business entity within an affiliated group as a separate taxpayer, while the formulary approach treats the affiliated group as one enterprise. [FN147] Transfer pricing at the international level has been heavily criticized. [FN148] Nevertheless, the treatment of transfers at arm's length is, at least in theory, a straightforward and unifying principle which has been employed by the tax authorities of the Member States for some time. It seems likely, however, that the calculation of arm's length costs on an international basis will move to a type of hybrid between the current system of using comparables and the one in use by the United States and which haves been proposed by the OECD. [FN149] The adoption of the same transfer pricing rules among the Member States would assist the coordination of cross-border activities. Canada and Mexico should consider adopting rules similar to either those proposed by the OECD or, possibly, those currently in use in the United States (despite the fact that these rules are dreaded by Canadian tax practitioners). [FN150]

[p. 68] Currently, all of the Member States have procedures that allow for advance (transfer) pricing arrangements which permit a multinational and the relevant tax authority to agree on the methodology that will to be used to calculate the transfers. [FN151] It may make sense to administer the advance pricing rules for transfer pricing at a centralized level if the Member States adopt similar rules. Binding arbitration procedures for transfer pricing disputes would resolve any outstanding differences. [FN152] The arbitration procedure could be modeled after that which was recently adopted by the European member states. [FN153]

4. Comment Concerning Gradualism

A gradual approach to tax integration would permit the NAFTA Member States to begin enjoying the benefits of greater economic efficiency without rapidly sacrificing large swaths of sovereignty. An obvious drawback of such an incremental approach is that it can easily be labeled a series of half measures. Gradualism, however, is the only possible approach to tax integration among the NAFTA Member States that both acknowledges each Member State's desire to maximize its sovereignty over tax policy and presses forward toward integration.

V. CONCLUSION

The political, economic, and social tensions which inevitably accompany proposals for international economic integration are particularly acute in the context of tax policy. Governments considering proposals for international tax integration must weigh the economic benefits of greater tax harmonization with the political costs that such harmonization would impose by constraining domestic tax policy decisions. Sovereignty concerns are well placed, because modern tax regimes are important tools for ensuring the satisfaction of their citizens' social, economic, and institutional needs. Accordingly, a reduction in the ability to use tax measures to meet these needs is unpalatable to NAFTA governments, which view NAFTA as a mechanism for achieving trade [p. 69] and investment efficiencies, not creating sovereignty compromising political linkages. Tax proposals that impose significant constraints on the tax autonomy of the Member States are thus inappropriate at this time.

Still, the need for tax policy coordination will increase as the Member States' trade and capital markets become more integrated under NAFTA. This integration will result in the markets of the Member States becoming ever more closely interconnected and, as a result, capital flows among the Member States will become increasingly sensitive to differences in their tax regimes. The inevitable corollary is that real governmental sovereignty over certain aspects of taxation will erode, especially for Canada and Mexico. The adoption of more comprehensive measures, including some tax uniformity among the Member States, will thus become a more attractive alternative in the long term.

A strategy of "gradualism" should thus be adopted to slowly harmonize the NAFTA Member States' tax regimes. Gradualism embodies a compromise between sovereignty concerns and the desire to reap greater efficiencies; it would permit the NAFTA Member States to adapt their tax policies to the distinct needs of their citizens, while also ensuring that greater economic efficiency is possible through centralized policymaking. In sum, gradualism accommodates the so-called "double movement" of modern society, responding to market pressures for greater economic efficiency while ensuring that the socially disruptive effects of international economic integration are minimized.

VI. APPENDIX

Table 1: Member State Comparisons, 1993 [FNd1]

	Canada	United States	Mexico
Area (mil. sq. km)	9.9761	9.3726	1.9725
Population Growth Rate 1992-93 (%)	1.1	1.1	2.1
Population Density (person/sq. km)	2.9	27.5	46.2
Infant Mortality (deaths/1000 live births)	6.8	8.5	18
Life Expectancy at Birth (male)	74.9	72.3	68.6
Life Expectancy at Birth (female)	81.2	79.1	74.6
GDP (bil. US$)	546.3	6259.9	361.9
Agriculture	2.4	2.0	6.8
By Sector (%) Industry	28.1	27.0	28.7
Services	69.4	71.1	64.6
Per Capita GDP (US$)	19,001	24,302	3968
Average Annual Growth Rate 1983-93 (%)	2.6	2.8	2.0
Labor Force (mil. persons)	13.946	129.525	32.383
Unemployment Rate (%)	10.2	6.7	3.2
Female Participation Rate (%)	65.3	69.1	n/a
Expenditure on Health (% of GDP)	10.2	14.1	4.9
Expenditure on Public Education (% of GDP)	7.1	5.3	3.6
Adult Illiteracy Rate (%)	1	1	13
Worldwide Rank in Standard of Living, 1996	1	2	n/a

Sources: OECD Observer (1993); Statistics Canada, International Comparisons (1993); United Nations Human Development Index (1996).

Table 2: Differences in Tax Provisions, 1995

	Canada	United States	Mexico
I. Pertaining to the Tax Unit			
A. Personal Deemed Liable	Resident and deemed resident	Citizens and resident persons	Resident
Rate Structure	Individual income	Family income	Individual income
Dependents	Tax credits	Tax exemptions	No tax credit or exemption
Child Care Expenses	Deductible to limit	Declining tax credit	No deduction
Capital Gains on Bequests	Realized at death	Stepped up at death	Exempt from tax
B. Corporate Liability	Incorporated in Canada	Incorporated in United States	Incorporated in Mexico or principal place of management
Consolidation	No	Affiliated domestic corporations and foreign branches	With government permission
Indexation for Inflation	No	No	Yes
II. Pertaining to the Tax Base (Receipts)			
A. Personal			
Non-Cash Employer Compensation	Taxable, except pension contribution	Taxable, except pension contribution and certain fringe benefits	Taxable, except certain fringe benefits
Private Pension Benefits	Taxable with credit	Taxable	Taxable
Interest	Taxable	Taxable, except qualified state and local bonds	Taxable at reduced rate
Capital Gains	Taxed at regular rate with exemption for	Taxed at reduced rate with limited exemption for	Taxed at reduced rate, with exemption

	personal residence	personal residence	for gains derived from sale of certain Mexican shares
Gifts	Exempt	Taxable to donor over US$600,000	Exempt for certain family members
B. Corporate Foreign Income	Exemption for active business income of foreign affiliate	Taxable when repatriated from foreign affiliate	Taxable when repatriated from foreign affiliate
Intercorporate Dividends	Fully deductible	Full deduction for 'affiliated' corporations with declining	Exempt
Capital Gains	Taxable	Fully taxed	Fully taxed
III. Pertaining to the Tax Base (Deductions and Credits)			
A. Personal Mortgage Interest	No	Deduction with limit	No
State and Local Taxes	No	Deductions for state and local income and real property taxes	No, in most cases
Medical Expenses	Credit in excess of 3% net income or $1615	Deduction in excess of 7.5% of AGI and exclusion for employer-provided benefits	Fully deductible
Charitable Donations	Credit	Deduction	Deduction
Private Pension Plan	Deduction to limit	Deduction through employer-provided plan (401k) or individual retirement account if AGI is below set amount	Exemption for contributions (cuentas especiales para el ahorro)
Dividends	Credit if from domestic corporation	No credit for deduction	Not taxed in hands of shareholders

Alternative Minimum Tax	Yes	Yes	No
B. Corporate State and Local Taxes	Property taxes deductible	Income and property taxes deductible	Deductible
Depreciation	44 classes of property, declining balance deductions for most classes	6 classes of property with declining balance or straight line; 2 classes of real property deductions with straight line depreciation	14 classes of property with straight line or allowable depreciation
Intangible Assets	Deduction of up to 7% of 'cumulative eligible capital'	155--year amortization for certain purchased intangibles	No deduction for goodwill
Inventory Cost	FIFO or average cost	LIFO or FIFO purchased during tax year is deductible	All inventory
Loss Carryover	Backwards 3 years, forward 7 years	Backward 3 years, forward 15 years	No carryback, forward 5 years (or 10 years)
Minimum Tax	Yes (AMT only with certain provinces)	Yes (AMT)	Yes (1.8% asset tax)
IV. Pertaining to Tax Rates Graduation			
A. Personal	3 brackets (from 17% to 29%) Surtax 3% and 5% (for federal tax payable in excess of $12,500)	4 brackets (from 15% to 36%) Surtax for income over $250,000 resulting in rate of 39.6%	8 brackets (from 3% to 35%) None
Provincial/State Income Taxes	Ranging from 44% to 69% as a percentage of basic federal tax	0 to 13.5%	None
B. Corporate Tax Rate,	38% (less 10%	35%	34%

Most Firms	federal tax abatement)		
Provincial/State Income Taxes	To 17%	To 12%	None
V. Other Taxes			
National Value-Added Tax	7% GST on most goods and services	None	10% VAT on most goods and services
Mandatory Pension Plan	No	No	Resident corporation must set aside 10% of gross profits for employee profit sharing (labor legislation)

FNSources: 1996 Can. Master Tax Guide (CCH); Robin Boadway & Neil Bruce, Pressures for the Harmonization of Income Taxation between Canada and the United States, in Canada-U.S. Tax Comparisons 25 (John B. Shoven & John Whalley eds., 1992); Oscar Fierro, Mexico, in International Tax Handbook 653 (1994); H&R Block,1996 Income Tax Guide (1996); Miguel A. Va ldes, A Summary of Mexico's Tax Provisions, ABA Section of International Law and Practice Fall Meeting, Mexico City (Nov. 1994); Telephone interview with Luis Manuel Perez de Acha, Mexican tax attorney, in Mexico City (Mar. 15, 1996).

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[FN1]. North American Free Trade Agreement, Dec. 8--17, 1992, U.S.-Mex.- Can., 32 I.L.M. 605 (1993) [hereinafter NAFTA].

[FN2]. A "double movement" propels modern society. On the one hand, as market forces expand they increasingly constrain governmental policymaking, while on the other hand, people react to the socially disruptive effects of these market forces by demanding protectionist measures. See Karl Polanyi, The Great Transformation: The Political and Economic Origins of Our Time 138 (1957).

[FN3]. I use the term "tax integration" to mean the development of tax policy mechanisms that reflect the growing economic integration among countries participating in free trade agreements.

[FN4]. Beginning in 1967, the member states of the European Community instituted a common VAT system. The tax rates of the European VATs were harmonized on December 31, 1992; a minimum VAT rate of 15% is required, with reduced VAT rates of at least 5% for certain goods and services. For a description of recent European Union efforts with respect to VAT harmonization, see Sijbren Cnossen, Coordination of Sales Taxes in Federal Countries and Common Markets, 9 Conn. J. Int'l L. 741 (1994).

[FN5]. See Commission of the European Communities, Report of the Committee of Independent Experts on Company Taxation, Tax Notes Int'l, Sept. 2, 1992, at 366--15, available in LEXIS, Taxana Library, TNI File [hereinafter Ruding Committee].

[FN6]. See Industry Canada, Economic Integration in North America: Trends in Foreign Direct Investment and the Top 1,000 Firms 9 (1994) [hereinafter Industry Canada]. Data taken was for 1991.

[FN7]. For example, NAFTA will eliminate tariffs on virtually all goods traded among the Member States. See Jon R. Johnson, The North American Free Trade Agreement: A Comprehensive Guide 26 (1994). In addition, NAFTA contains a number of provisions to facilitate investment among the Member States, including national treatment, or nondiscrimination against investors and investments from other Member States, and most favored nation treatment. For a description of these provisions, see Gary C. Hufbauer & Jeffrey J. Schott, NAFTA: An Assessment 80 (1993); see also NAFTA and Investment (Seymour J. Rubin & Dean C. Alexander eds., 1995).

[FN8]. See generally Organization for Economic Cooperation and Development, Taxing Profits in a Global Economy: Domestic and International Issues 12 (1991) [hereinafter OECD].

[FN9]. See, e.g., Lawrence H. Summers, Taxation in a Small World, in Tax Policy in the Twenty-First Century 64, 75 (Herbert Stein ed., 1988) ("The only judgment confirmed by historical trends is that as long as the world remains at peace, economic integration will continue. As the example of the American states and the European Common Market demonstrate, increased economic integration can promote growth and prosperity... [yet] must inevitably limit national sovereignty.").

[FN10]. For a description of the effect of tax distortion, see Ruding Committee, supra note 5, ch..4.

[FN11]. See id. Foreign portfolio investment, which is extremely mobile, is sensitive to tax changes which alter after-tax rates of return. Economists continue to debate, however, the extent to which capital movement is influenced by taxation. A number of economic studies have focused on the impact of U.S. tax reform in 1986 on capital flows to and from the United States in an attempt to separate the impact of taxation on capital movement from that of nontax factors. See, e.g., Alan J. Auerbach & Kevin Hassett, Taxation and Foreign Direct Investment in the United States: a Reconsideration of the Evidence, in Studies in International Taxation 119, 137 (Alberto Giovannini et al. eds., 1993) (disputing the attribution of increased foreign direct investment in the United States after the mid-1980s to the 1986 tax reform); Joosung Jun, U.S. Tax Policy and Direct Investment Abroad, in Taxation in the Global Economy 55, 71 (Assaf Razin & Joel Slemrod eds., 1990) (concluding that U.S. tax policy may not significantly affect foreign direct investment financed by retained earnings abroad, but that it does have an influence on outward foreign direct investment financed by transfers from a domestic parent corporation); Joel Slemrod, The Impact of the Tax Reform Act of 1986 on Foreign Direct Investment to and from the United States, in Do Taxes Matter? 169, 192 (Joel Slemrod ed., 1990) (indicating that several aspects of foreign direct investment flows are consistent with the effect of the 1986 tax reform on tax incentives).

[FN12]. See Ruding Committee, supra note 5, ch. 10.

[FN13]. For example, the World Competitiveness Report, published by the World Economic Forum, lists eight principal factors for assessing the investment climate of a country: (1) overall economic strength; (2) barriers to international trade and investment flows; (3) government policies; (4) quality of financial services; (5) infrastructure; (6) management skills; (7) scientific and technological capacity; and (8) human resources. See Investment Canada Research and Policy Staff, International Investment and Competitiveness 49 (1992) (excerpting the World Competitiveness Report) [hereinafter Investment Canada].

[FN14]. See Ruding Committee, supra note 5, ch. 10. The Ruding Committee found that a general lowering of corporate income tax rates by the member states of the European Community was consistent with, but not necessarily proof of, international tax competition.

[FN15]. See, e.g., Robin Boadway, The Theory and Measurement of Effective Tax Rates, in The Impact of Taxation on Business Activity 60 (Jack M. Mintz & Douglas D. Purvis eds., 1985). Marginal effective tax rates encompass income tax rates and depreciation schedules as well as nontax factors such as inflation and interest rates in order to establish the tax burden that an investor considers when making an investment decision. The rates are termed "marginal" because they are calculated on marginal investments, or projects that are expected to earn a rate of return just sufficient to persuade an investor that a project is worth undertaking.

[FN16]. Most limitations result from attempts to oversimplify the tax regimes under study in order to keep the studies manageable, as well as to ease the comparative process. For example, these studies typically aggregate businesses in broad categories such as "manufacturing," "construction," or "retail trade." Households are sometimes aggregated by average personal tax rate or highest marginal tax rates, or assumptions are made concerning tax free investments. Similarly, broad arrays of capital goods are shoehorned into vague categories such as "industrial buildings," "machines," and "inventories." For a description of these limitations, see OECD, supra note 8, at 92. See also Lawrence J. Kotlikoff, Comment, in The Impact of Taxation on Business Activity 102 (Jack M. Mintz & Douglas D. Purvis eds., 1985) ("One comes away from this recipe book with the 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 at the details of preparation.").

[FN17]. See Kenneth J. McKenzie & Jack M. Mintz, Tax Effects on the Cost of Capital, in Canada-U.S. Tax Comparisons 189, 209 tbl. 5.2 (John B. Shoven & John Whalley eds., 1992) (showing a convergence in the cross-industry marginal effective tax rates of Canada and the United States and stating that in 1990 Canada's industry-aggregate marginal effective tax rate was 28.9%, while in the United States it was 20.4%, with most industry-specific results revealing closer rates); see also John B. Shoven & Michael Topper, The Cost of Capital in Canada, the United States, and Japan, in Canada-U.S Tax Comparisons 217, 232- 34 (John B. Shoven & John Whalley eds., 1992) (employing a different approach than most marginal effective tax rate studies, which do not incorporate risk analysis to conclude that the cost of capital in Canada and the United States is very similar and arguing that investment location decisions are driven by factors other than tax considerations).

[FN18]. See Duanjie Chen & Kenneth J. McKenzie, The Impact of Taxation on Capital Markets: An International Comparison of Effective Tax Rates on Capital 15 tbl. 2 (1997) (indicating that for investments in manufacturing capital, the marginal effective tax rates for Canada and the United States are comparable, although Mexico imposes a lesser burden); see also Mahmood Iqbal, A Tax Comparison of Large Manufacturing Industries in Canada, the United States and Mexico 12 (1994) (using a cash flow approach, which provides average tax rate results, to conclude that overall corporate tax burdens for manufacturing activities are similar among the NAFTA Member States); Jack M. Mintz & Thomas Tsiopoulos, Latin American Taxation of Foreign Direct Investment in a Global Economy (1996) (finding that marginal effective corporate tax rates for manufacturing investments in the NAFTA Member States are comparable, with Canada imposing the highest burden and Mexico the lowest, while, for services, Mexico imposes the highest tax burden of any Member State).

[FN19]. See generally International Regulatory Competition and Coordination 38-41 (William Bratton et al. eds., 1996) [hereinafter Bratton et al.] (describing competition for mobile factors such as capital).

[FN20]. Tax competition may also generate certain economic benefits. See infra notes 46-50 and accompanying text.

[FN21]. Early work in this field was conducted by Professor Charles Tiebout, who created a model of the market for local public goods. The Tiebout model suggested that regulatory bodies would be disciplined by the public, who would "vote with their feet" if they did not approve of government policies by moving to a jurisdiction with a more favorable regulatory approach. In other words, there would be competition for voters (and taxpayers) between jurisdictions, each of which would try to achieve the optimally efficient size. The jurisdiction that best reflected the public preference (i.e., the correct mix of tax and the provision of public goods) would attract the most voters and hence the most tax review. See Charles M. Tiebout, A Pure Theory of Local Expenditure, 64 J. Pol. Econ. 416 (1956). The literature that has developed around this public choice theory concentrates on whether or not competition between tax regimes results in the suboptimal provision of goods. Others have criticized the extension of public choice theory to the international sphere. See, e.g., Peggy B. Musgrave & Richard A. Musgrave, Fiscal Coordination and Competition in an International Setting, in Influence of Tax Differentials on International Competitiveness 59, 63 (1990).

[FN22]. The convergence of interest and inflation rates in Europe was a principal cause of this harmonization. The Ruding Committee was concerned with thwarting the development of future tax incentives designed to attract international investment. See Ruding Committee, supra note 5, ch. 10.

[FN23]. The United States accounts for 88% of North America's GDP, while Canada accounts for 9% and Mexico 3%. See Industry Canada, supra note 6, at 9.

[FN24]. See Robert E. Hall, The International Consequences of the Leading Consumption Tax Proposals 18 (CEPR Publication No. 447, 1995).

[FN25]. According to one commentator:
Until recently, international taxation has been an arcane subspecies among American tax lawyers, and international considerations have rarely influenced the thrust of tax reform.... Such a provincial approach to tax policy may have been appropriate in an earlier era, but the increasing economic integration of the world requires a more global approach to tax policy. The emphasis in recent American tax reform debates on competitiveness is only a precursor to a time in which international considerations will play a pervasive role in shaping tax policies.
Lawrence H. Summers, Taxation in a Small World, in Tax Policy in the Twenty-First Century 64, 64 (1988). Likewise:
In the past, the United States has sometimes acted unilaterally in setting tax regulations and given little thought as to how the world would follow along. But now I think we recognize that an incompatible American tax policy may harm not only our own businesses in the international arena but also may allow other countries to take unfair advantage of our tax system.
James A. Baker III, The Momentum of Tax Reform, in Tax Policy in the Twenty-First Century 1, 6 (1988); but see Robert J. Patrick, Jr., Comments on U.S. Tax Structures and Competitiveness, 41 Nat'l Tax J. 343, 343 (1988) ("[T]here is virtually nothing in the legislative history of the 1986 Tax Act that indicates that concerns about international trade and investment

had anything to do with the legislation.").

[FN26]. I use the term "regulatory emulation" to mean "the process whereby regulators change their policies as a result of observing the regulatory policies pursued by other countries." Stephen Woolcock, The Single European Market: Centralization or Competition Among National Rules 15 (1994).

[FN27]. See McKenzie & Mintz, supra note 17, at 207 (noting that the convergence may not have been deliberate).

[FN28]. See John Whalley, Foreign Responses to U.S. Tax Reform, in Do Taxes Matter? 286, 294, 307 (Joel Slemrod ed., 1990). Whalley explains that although discussion of Canadian corporate income tax reform actually began prior to the American initiatives, the final version of the Canadian reform reflected concerns regarding Canada's ability to maintain an attractive tax climate for capital and the fear that, with lower U.S. corporate income tax rates, increased debt financing in Canada by multinationals would erode Canadian tax revenue.

[FN29]. For comments concerning the NAFTA Member States' tax reforms in the 1980s, see infra text accompanying note 108.

[FN30]. See, e.g., Luis Manuel Perez de Acha, Mexico Amends Tax Legislation to Reflect Increased Global Trade, NAFTA, 44 Tax Notes Int'l 1 (1994).

[FN31]. Canada and the United States abandoned a number of tax incentives in the 1980s. See infra note 107 and accompanying text.

[FN32]. See, e.g., Arthur J. Cockfield, The Impact of U.S. Consumption Tax Reform on Canada, 4 NAFTA L. Rev. (forthcoming Winter 1998)(discussing how implementation of a consumption tax by the United States could significantly reduce the tax burden it imposes on marginal investments, thus forcing Canada to adjust its tax policy in order to remain competitive). For a description of the impact of consumption-based tax proposals on U.S. marginal effective tax rates on investments, see Alan J. Auerbach, Tax Reform, Capital Allocation, Efficiency and Growth 23 (CEPR Publication No. 444, 1995) (concluding that all such proposals would lower the investment tax wedge facing new investments, resulting in a rise in the after-tax return on marginal investments).

[FN33]. See, e.g., Joel Slemrod, Free Trade Taxation and Protectionist Taxation, 2 Int'l Tax & Pub. Fin. 471, 471 (1995) ("[A]lthough international trade theory has been applied principally to policy instruments such as tariffs, quotas, and dumping, tax policy can have at least as large an effect on the flow of goods across countries, the location of productive activity, and the gains from trade as these trade policy instruments.").

[FN34]. NAFTA does not prohibit this type of tax subsidization. For a discussion of tax subsidies under NAFTA, see Paul R. McDaniel, Formulary Taxation in the North American Free Trade Zone, 49 Tax L. Rev. 691, 715-719 (1994).

[FN35]. See id. at 718.

[FN36]. To be sure, tax competition can influence purchasing patterns before exchange rates adjust to tax changes. See, e.g., Michael J. McIntyre, Commentary, The Design of Tax Rules for the North American Free Trade Alliance, 49 Tax L. Rev. 769, 783 (1994) (describing how millions of Canadians flooded across the U.S. border to purchase goods after the Canadian government introduced the federal Goods and Services Tax in 1991).

[FN37]. Excise Tax Act, R.S.C. (1985) (Can.).

[FN38]. For an explanation of how exchange rates adjust to offset price effects of corporate income taxes and rebated indirect taxes, see Jane G. Gravelle, International Tax Competition: Does It Make a Difference for Tax Policy?, 39 Nat'l Tax J. 375 (1986). However, it has been noted that nonuniform indirect taxes (i.e., different tax rates on different commodities) will distort the pattern of production and trade. These "[d]istortions will arise under either the destination or origin-based system if there are nonuniform taxes, but only under origin-based taxes will the locational pattern of production be disturbed." See Joel Slemrod, Tax Cacophony and the Benefits of Free Trade, in 1 Fair Trade and Harmonization: Prerequisites for Free Trade? 283, 283 (Jagdish Bhagwati & Robert E. Hudec eds., 1996).

[FN39]. Nevertheless, discriminatory treatment against goods and services from other NAFTA parties continues to a certain extent under NAFTA. For a review of significant GATT panels dealing with this alleged discriminatory treatment by Canada and the United States, see Trade Related Aspects of International Taxation, A New WTO Code of Conduct?, 30 J. World Trade L. 161, 188-93 (1996).

[FN40]. See NAFTA, supra note 1, annex 311 (explaining how goods must be marked to identify their country of origin).

[FN41]. See Malcolm Gammie, The Taxation of Inward Direct Investment in North America Following the Free Trade Agreement, 49 Tax L. Rev. 615, 650 (1994).

[FN42]. For example, almost 70% of trade in manufactured products between Canada and the United States consists of non-arm's length intrafirm trade. See Alan M. Rugman, Multinationals and Canada-United States Free Trade 3 (1990). The amount of U.S.-Canada related party transactions reached US$166 billion in 1993. See Robert Turner, Study on Transfer Pricing (Technical Committee on Business Taxation Working Paper No. 2 966--10, 1996).

[FN43]. For example, the adoption of new international transfer pricing rules by the IRS has caused some concern among tax practitioners in Canada, where tax authorities issued a statement indicating that they would not necessarily agree to abide by U.S. decisions under the new rules. See Robert Brown & Michael Alexander, Sovereignty in the Modern Age, 20 Can.-U.S. L.J. 273, 281 (1994).

[FN44]. See Robin Boadway & Neil Bruce, Pressures for the Harmonization of Income Tax Between Canada and the United States, in Canada-U.S. Tax Comparisons 26 (John B. Shoven &

John Whalley eds., 1992).

[FN45]. But see Ruding Committee, supra note 5, ch. 3 (indicating that the country of shareholder residence should give the tax credit).

[FN46]. See Charles E. McLure, Tax Competition: Is What's Good for the Private Goose also Good for the Public Gander?, 39 Nat'l Tax J. 341-48 (1986).

[FN47]. Jeanne-Mey Sun & Jacques Pelkmann, Regulatory Competition in the Single Market, 33 J. Common Market Stud. 67, 83 (1995).

[FN48]. But see Musgrave & Musgrave, supra note 21, at 63-70 (arguing that market forces alone cannot secure an efficient and equitable allocation of economic resources in the international arena).

[FN49]. For a discussion of the costs and benefits of competition among rules, see Woolcock, supra note 26, at 16-21.

[FN50]. See supra notes 34-35 and accompanying text.

[FN51]. For a discussion on the transposition of arguments for free trade into the international tax policy arena, see Slemrod, supra note 33, at 472-80.

[FN52]. It has been noted that globalization encompasses contradictory trends. On the one hand, the unaccountable forces of globalization are partially beyond the control of state regulation while, on the other hand, the state often pulls in the opposite direction by using a variety of government interventions to create a competitive edge. See James H. Mittelman, The Dynamics of Globalization, in Globalization Critical Reflections 16 (James H. Mittelman ed., 1996).

[FN53]. For a general review of sovereignty issues under globalization, see Saskia Sassen, Losing Control? Sovereignty in an Age of Globalization (1996).

[FN54]. Alex Easson, Taxing International Income (1997) (unpublished manuscript on file with the Stanford Journal of International Law). I use the term "sovereignty" to mean "the basic internal legal status of a state that is not subject, within its territorial jurisdiction, to the governmental, executive, legislative or territorial jurisdiction of a foreign state or to foreign law other than public international law." Helmut Steinberger, Sovereignty, in 10 Encyclopedia of Public International Law 408 (1981).

[FN55]. See Treaty Establishing the European Economic Community, Mar. 25, 1957, 298 U.N.T.S. 11 [hereinafter Treaty of Rome].

[FN56]. For a discussion of this movement, see generally Joseph H.H. Weiler, The Transformation of Europe, 100 Yale L.J. 2403 (1991).

[FN57]. For a description of recent VAT harmonization efforts, see International Bureau of Fiscal Documentation, Supplementary Service to European Taxation § 8 (1997) [hereinafter Supplementary Service].

[FN58]. The three measures adopted by the European Council are: (1) the Parent-Subsidiary Directive, which deals with the tax treatment of cross-border dividend payments between parent and subsidiary corporations; (2) the Merger Directive, aimed at the deferral of capital gains taxation related to the restructuring of companies; and (3) the Convention on the Elimination of Double Taxation, which deals with the adjustment of profits of associated enterprises. For a description of these measures, see id. § 1.1.

[FN59]. The committee, chaired by Onno Ruding, was appointed to prepare guidelines for the European Commission regarding company taxation. See Ruding Committee, supra note 5. Elaborate analysis of European integration has been conducted elsewhere. See, e.g., Integration Through Law (Mauro Capplelleti et al. eds., 1986).

[FN60]. Article 220 of the Treaty refers implicitly to direct taxation by indicating that the European Member States should enter into negotiations to abolish double taxation within the European Union. See Jan E. Brinkmann & Andreas O. Riecker, European Company Taxation: The Ruding Committee Reports Give Harmonization Efforts a New Impetus, 27 Int'l Law 1061, 1063 (1993). The Ruding Committee noted additional provisions in the Treaty of Rome which implicitly call for the harmonization of taxes, including the removal of all restrictions on the movement of capital (Article 67), the freedom of establishment of firms (Article 52) and the conditions of competition (Article 101). See Ruding Committee, supra note 5, ch. 1.

[FN61]. Frederick M. Abbott, Integration Without Institutions: The NAFTA Mutation of the EC Model and the Future of the GATT Regime, 40 Am. J. Comp. L. 917, 936 (1992).

[FN62]. For example, each Member State should adopt sanitary and phytosanitary measures that match stipulated guidelines. See NAFTA, supra note 1, art. 713(1).

[FN63]. Abbott, supra note 61, at 917.

[FN64]. See id. at 917.

[FN65]. For example, the European Commission has indicated that it favors a number of business tax proposals issued by the Ruding Committee and is creating draft legislation to deal with these proposals. See Supplementary Service, supra note 57, at 9 § A.

[FN66]. Canada's entrance to NAFTA has been characterized as "defensive," since by deciding to participate it avoided the costs associated with being excluded from the agreement. See Ronald J. Wonnacott, Canada's Role in NAFTA: To What Degree Has It Been Defensive?, in Mexico and the North American Free Trade Agreement: Who Will Benefit? 163 (Victor Bulmer-Thomas et al. eds., 1994). The Mexican impetus for initiating the negotiation of NAFTA was primarily motivated by economic reasons. The United States, in turn, desired to gain greater efficiencies, but also had noneconomic goals, like limiting illegal immigration from Mexico and improving Mexican environmental standards. See Frederick M. Abbott, Law and Policy of Regional Integration: The NAFTA and Western Hemispheric Integration in the World Trade Organization System 15-19 (1995).

[FN67]. The negotiators of NAFTA took great care to avoid granting to any centralized body the power to make decisions that would directly bind the Member States. See Abbott, supra note 61, at 936.

[FN68]. But see Leo Panitch, Rethinking the Role of the State, in Globalization: Critical Reflections 96 (James H. Mittelman ed., 1996) (NAFTA "will function as an economic constitution, setting the basic rules governing the private property rights that all governments must respect and the types of economic policies that all governments must eschew.").

[FN69]. See Johnson, supra note 7, at 487, 521-25.

[FN70]. In fact, the European Court of Justice has in recent years struck down domestic tax provisions based mainly on the right of establishment and the principle of freedom of movement of workers. See Gammie, supra note 41, at 639-40. The European Court of Justice can even ensure that each European member state follows certain community-wide standards for human rights, a development that would be shocking to most North Americans. See, e.g., Joseph H.H. Weiler, The Jurisprudence of Human Rights in the European Union: Integration and Disintegration, Values and Processes (1997) (unpublished manuscript, on file with the Stanford Journal of International Law).

[FN71]. The Commission consists of individuals appointed by the governments of the member states and proposes legislation to the European Council. The European Council then consults with the European Parliament to decide whether or not to issue a directive or a regulation. A directive instructs the governments of the member states to enact domestic laws while a regulation is a supranational legislative measure that binds the citizens of the member states directly.

[FN72]. Loyalty to the concept of a united Europe, as well as to the centralized institutions, may have developed as the European member states learned to effectively cooperate through decades of enhanced political voice. See Weiler, supra note 56, at 2465-66.

[FN73]. See George J. Church, Where He Rings True: Free Trade Isn't Always Fair, Time, Mar. 4, 1996, at 28 (citing a Time/CNN poll indicating 51% of respondents believed effects of free trade were "mostly bad" for workers); see also Jackie Calmes, Satisfaction with Today Hides a Fear of Tomorrow, Wall St. J., Mar. 8, 1996, at R2 (citing a Wall Street Journal/NBC News Poll in which 59% of respondents opined that free trade agreements cost jobs in the United States).

[FN74]. See infra notes 86-90 and accompanying text.

[FN75]. See Bratton et al., supra note 19, at 31-38.

[FN76]. See Maarten J. Ellis, Direct Taxation in the European Community: An Irresistible Force Meets an Immovable Object?, 28 Wake Forest L. Rev. 51, 56 (1993).

[FN77]. See generally Craig A. Hart, The European Community's Value-Added Tax System: Analysis of the New Transitional Regime and Prospects for Further Harmonization, 12 Int'l Tax & Bus. Law. 1, 5-8 (1994). See also Gianni Forlani, Fiscal Harmonization in the European Union, in International Tax Planning 173 (Dennis Campbell ed., 1995) (explaining that the removal of border checks created a fear that differences in indirect taxation would lead to a risk of fraud, distortion of competition, and income transfers).

[FN78]. See Sun & Pelkmann, supra note 47, at 88.

[FN79]. See Woolcock, supra note 26, at 39.

[FN80]. The Commission indicated that a number of proposals went beyond the scope of the subsidiarity principle, and that more discussion was required on the tax rates, tax bases, and tax structures to be applied to corporations before further harmonization. See John Goldsworth, European Community: EC Commission Reviews Ruding Committee Report, Suggests Member State Consultations, 5 Tax Notes Int'l 177, 178 (1992). It is understandable that the European member states would be reluctant to give up control over their business income tax systems in light of the restrictions that have been placed on their indirect tax policies as well as the potential loss of currency control with the European Monetary Union looming on the (distant) horizon.

[FN81]. Most European member states tax their commodities on a destination basis (i.e., goods and services are taxed on the basis of location of consumption or destination). The European Commission has proposed moving toward taxing commodities on the origin principle (i.e., goods and services are taxed on the basis of their place of production or origin). The European member states have thus far resisted switching systems since they worry that an origin-based VAT creates advantages for firms based in a country with lower VAT rates (e.g., a firm subject to a VAT rate of 15% would sell its product both domestically and throughout the community at this rate, while another firm subject to a higher VAT rate would sell the same product at the higher rate). See Hart, supra note 77, at 7-8. In July 1996, the European Commission released a document entitled A Common System of VAT: A Programme for the Single Market, which creates a gradual phasing in of a system of taxation based on the origin principle. The new system is not likely to enter into force before the year 2000. See Supplementary Service, supra note 57, at 2, 9. The Commission recently revisited the need for greater uniformity in corporate business tax systems of the European member states in a report released in 1996. See EC Update, 36 European Taxation 12 (1996), at EC-45.

[FN82]. See A. Javier Trevino, The Sociology of Law: Classical and Contemporary Perspectives 439--49 (1996) (discussing the manner in which legal modifications follow social modifications and the ways that legal changes can instigate social changes).

[FN83]. See Polanyi, supra note 2, at 88-89 (describing the social forces which encouraged the laissez-faire market society in England from the 1790s onward and the social forces that opposed the commodification of land and labor; ultimately the interaction of these two forces led to the creation of new forms of the state). Some theorists argue that globalization will inevitably cause a convergence of values among countries and erode the usefulness of the nation-state. See, e.g., Malcolm Waters, Globalization 12 (1995) (suggesting that each society will converge on a "single set of axial principles for its social organization," including values oriented toward individualization, universalism, secularity, and rationalism).

[FN84]. Legal theorists tend to conceive of sovereignty as the ability of a nation-state to pursue its preferences in an autonomous manner. See supra note 54.

[FN85]. For a discussion of the historical development of the modern conception of sovereignty, see Marc Williams, Rethinking Sovereignty, in Globalization: Theory and Practice 109 (E. Kofman & G. Youngs eds., 1996) (explaining that although emphasis is frequently placed on the political aspects of sovereignty, it must also be viewed as both a norm and a practice or institution).

[FN86]. See, e.g., Andrew F. Cooper, Questions of Sovereignty: Canada and the Widening International Agenda, 50 Behind the Headlines 10 (1993) ("The move to continental free trade was part of a much wider process towards globalism. Opponents of these deals not only dispute their economic benefits but contend that even if some benefits did emerge from this market-oriented approach, they would come at a very high social/cultural price.").

[FN87]. A 1988 Canadian federal election concerning free trade with the United States created an acrimonious national debate over the sovereignty implications of greater ties with the United States. The federal government at the time ensured the people of Canada that "cultural industries" would be protected under the new deal. See, e.g., Donald S. Macdonald, The Canadian Cultural Industries Exemption under Canada-U.S. Trade Law, 20 Can.-U.S. L.J. 253, 260 (1994). The Mexican debate concerning the loss of sovereignty was perhaps less vocal:
Criticism to [sic] NAFTA has been mute, timid or deliberately silenced by the government. There are nevertheless a number of areas where concerns have been repeatedly expressed. The most important is the issue of sovereignty. Concerns range from the denunciation that Mexico is surrendering its oil resources to US interests, that the country is giving up its regulatory powers necessary to design development, industrial and agricultural policies, to the outright conviction that Mexico is, by virtue of NAFTA, falling under the political and strategic influence of Washington.
Adolfo Anguilar Zinser, Is There an Alternative? The Political Restraints of NAFTA, in Mexico and the North American Free Trade Agreement: Who Will Benefit? 119, 123 (Victor-Bulmer-Thomas et al. eds., 1994).

[FN88]. Canada is the United States' largest trade partner, with approximately US$100 billion in exports to Canada and US$111 billion in imports from Canada in 1993. Mexico is the third largest trade partner of the United States (behind Canada and Japan) with approximately US$41 billion in exports to Mexico and US$39 billion in imports from Mexico. The European Union, in aggregate, was the third largest exporter to the United States (after Canada and Japan) and the second largest importer (after Canada). See Abbott, supra note 66, at 121 n.7.

[FN89]. See Editorial Board, Mexico and Canada: An Evolving Partnership, Globe and Mail, June 10, 1996, at A12:

Like Canadians, Mexicans resist getting too near their giant neighbour, fearing its cultural and economic heft. And like Canadians--or most Canadians anyway--they have come to realize that cowering behind protectionist walls is not the answer. Both Mexico and Canada know that living next door to the world's largest market is a blessing and a curse. Both are trying to square their need for access to that market with their desire to maintain their own traditions and institutions--and, so far, succeeding quite nicely.

Id.

[FN90]. A white paper on foreign policy issued by the Canadian federal government on February 7, 1995, called Canada in the World, warns that Canada must participate fully in economic globalization, while ensuring that government policies are tailored strictly to the national interest. See Andrew Cohen, Canada in the World: The Return of the National Interest, 52 Behind the Headlines 3 (1995) ("At root, though, Canada in the World marks a retreat for this country. It is a dilution--even a denial--of those principles which have driven Canada's foreign policy for a half-century.").

[FN91]. It has been argued that the global economy (which provides a huge supply of low-skilled foreign workers) is the principal cause of income inequality in the United States, since it reduces the wages of low-skilled workers. See, e.g., L.C. Thurow, The Future of Capitalism (1996). But see Paul Krugman, Pop Internationalism (1996) (arguing that technology, not global competition, is the principal cause of American income inequality).

[FN92]. See, e.g., NAFTA Panels Challenged by Coalition, Fin. Times, Jan. 17, 1997, at 6 (reporting that the American Coalition for Competitive Trade filed a complaint with the U.S. Court of Appeals on January 16, 1997, claiming that the supranational panels created under NAFTA are usurping the authority of the U.S. judiciary).

[FN93]. Similarly, U.S. tax reform debates continue to pay little attention to international issues. To be sure, the recent "flat tax" debate in the United States involved a discussion of the impact that a flat tax would have on the country's ability to attract and maintain foreign capital investment. The vast majority of the debate, however, revolved around domestic issues. For example, the Kemp Commission's report included only two pages that were exclusively devoted to international issues relating to the movement toward a broad consumption-based tax. See The National Commission on Economic Growth and Tax Reform, Unleashing America's Potential, A Pro-Growth, Pro-Family Tax System for the 21st Century, 70 Tax Notes 413 (1996).

[FN94]. As one commentator observed:

In the immediate future, America will remain preoccupied by... its own democratic logic at home. In the long run, its growing association with Mexico and Canada will require of it a tolerance of diversity in political style and national culture functioning outside the moral dynamic and purpose of its own national life.

Marc Pachter, American Identity: A Political Compact, in Identities in North America: The Search for Community 39 (Robert L. Earle & John D. Wirth eds., 1995).

[FN95]. Despite the apparent similarities between Canada and the United States, Canadians like to think of themselves as having needs distinct from those of Americans. For example, they tend to believe in a system of government that preserves a generous social safety net through measures such as universal health care and a variety of other benefits. Still, Canada and the United States are similar in most macroeconomic aspects. For example, both countries are mature industrial economies that provide a relatively high level of wealth to most citizens. The nature of the Mexican economy differs from that of the Canadian and United States economies, since it generally produces low value added and low skill-intensive components for export. The table shows that Canada and the United States have similar global standard of living rankings (ranking first and second in the world, respectively) while Mexico has less wealth and less government institutional support for social needs. Political differences also exist among the Member States. Canada and the United States have a strong historical commitment to a multiparty system of democratic government while Mexico has been ruled for the past 70 years by one party. Further, the legal systems of Canada and the United States are based on common law principles, whereas Mexico has adopted the civil law system. See Johnson, supra note 7, at 2-4.

[FN96]. See Ralph H. Felson & Michael W. Gordon, International Business Transactions 411 (1995).

[FN97]. See Joyce Hoebing et al., NAFTA and Sovereignty: Trade-offs for Canada, Mexico and the United States (1996) (describing the sovereignty concerns expressed by each Member sState prior to the implementation of NAFTA).

[FN98]. This convergence is not expected to lead to the type of union seen in Europe:
Given the distinct histories and trajectories of three very large federal states, and their disparities in economic power, the model of a federated, European-style community with a capital "C" is unlikely to apply to North America. Yet as we sort out the distorting perspectives of history and unexamined stereotypes, it is plausible to envision a loosely structured and largely informal community with a small "c."
Identities in North America: The Search for Community 197 (Robert L. Earle & John D. Wirth eds., 1995).

[FN99]. International tax policy principles generally assist the development of cross-border tax measures. Although the content of these principles is debated, there is consensus that they should generally promote economic efficiency and international equity. See generally Hugh J. Ault, Corporate Integration, Tax Treaties and the Division of the International Tax Base: Principles and Practices, 27 Tax L. Rev. 565 (1992); Easson, supra note 54; R.A. Green, The Future of Source-Based Taxation of the Income of Multinational Enterprises, 79 Cornell L. Rev. 18 (1993); Klaus Vogel, Worldwide vs. Source Taxation of Income: A Review and Reevaluation of Arguments, in Influence of Tax Differentials on International Competitiveness (1990). Despite this consensus, however, international tax policy has properly been characterized as "rudderless." See Stephen Utz, Tax Harmonization in Europe and America, 9 Conn. J. Int'l L. 767, 769 (1994).

[FN100]. See supra text accompanying notes 27-30.

[FN101]. The five principal goals of modern tax treaties are: (1) the elimination of double taxation; (2) the elimination of discrimination through national treatment; (3) the prevention of tax evasion; (4) the removal of administrative obstacles to international business and investment; and (5) the equitable allocation of tax revenues between the contracting parties. See Vern Krishna, Canadian International Taxation 100--6 (1995). NAFTA generally leaves taxation up to the tax treaties; it establishes that "[n]othing in [NAFTA] shall affect the rights and obligations of any [of the Member States] under any tax convention" and that the tax treaty provision will prevail in the event of any inconsistency between a NAFTA provision and a tax treaty provision. NAFTA, supra note 1, art. 2103(2), 32 I.L.M. at 700. See also Income Tax Convention, Sept. 18, 1992, U.S.-Mex., Tax Treaties (CCH) P 5,903 [hereinafter U.S.-Mexico Treaty]; Income Tax Convention, Apr. 8, 1991, Can.-Mex., Tax Treaties (CCH) P 34,687 [hereinafter Canada-Mexico Treaty]; Income Tax Convention, Sept. 26, 1980, U.S.-Can., Tax Treaties (CCH) P 1903.03 [[[hereinafter U.S.-Canada Treaty].

[FN102]. See supra text accompanying notes 15-16.

[FN103]. One commentator observed:
[I]ncome tax treaties are bilateral documents attempting to survive in a thrivingly multilateral world. Apart from the fact that treaty-shopping rules do not work very well in this environment, the treaty negotiators and interpreters must try to cope with the bewildering complexities arising from the burgeoning growth of partnerships, joint ventures, "alliances," "cooperation agreements," and other arrangements that are "pass-through" entities for U.S. tax purposes, foreign tax purposes in one or more countries or both.
David R. Tillinghast, Tax Treaty Issues, 50 U. Miami L. Rev. 455-56 (1996).

[FN104]. For a discussion on the ability of the existing bilateral tax treaties to distort trade and investment under NAFTA, see Brian J. Arnold & Neil H. Harris, NAFTA and the Taxation of Corporate Investment: A View from Within NAFTA, 49 Tax L. Rev. 529, 577-79 (1994).

[FN105]. See id. at 580.

[FN106]. The existing Member State tax treaties do, however, contain provisions ameliorating this effect. For example, the U.S.-Mexico Treaty contains a provision establishing that, if the United States agrees to a dividend withholding rate of less than 5% in a treaty with another nation, then that rate will apply in the United States-Mexico context as well. See supra note 101.

[FN107]. Additionally, the increased mobility of capital may put pressure on governments to find a less mobile tax base such as labor. Increased cooperation will likely be necessary to relieve this pressure, which may in turn encourage increased regressivity in the Member Sstate tax systems.

[FN108]. I use the term "tax harmonization" to mean the deliberate convergence of the tax systems of the Member Sstates through formal negotiations. It does not include the inadvertent convergence of tax systems that may take place due to tax competition or one government following the policies of another. Although this second form of noncooperative behavior may lead tax systems to become more "harmonious" in the sense that they become more similar, this

Article is concerned with the question of whether or not the governments of the Member Sstates should come to some formal agreement concerning the uniformity of their tax systems.

[FN109]. See William A. Klein & Joseph Bankman, Federal Income Taxation 76 (10th ed. 1994).

[FN110]. For a comparative description of tax reform in the mid-1980s among the Member States, see John Whalley, Foreign Response to U.S. Tax Reform, in Do Taxes Matter? 286 (Joel Slemrod ed., 1990).

[FN111]. A detailed description of the tax systems of the Member States and the differences between these systems is beyond the scope of this Article. For a description of the different Member States' tax regimes, see Arnold & Harris, supra note 104, at 532-38.

[FN112]. The differences among the tax rules of the Member States is more obvious at the personal income tax level since workers generally cannot relocate to lower personal income tax jurisdictions, permitting the countries to maintain divergent personal income tax policies.

[FN113]. See Boadway & Bruce, supra note 44, at 69 (reviewing the corporate income tax systems of Canada and the United States and indicating that the systems have converged partly as a result of the need to maintain attractiveness to mobile capital).

[FN114]. See Roger H. Gordon & Eduardo Ley, Implications of Existing Tax Policy for Crossborder Activity Between the United States and Mexico After NAFTA, 47 Nat'l Tax J. 435, 443 (1994) (concluding that Mexican and American tax laws are now similar and, although NAFTA would likely increase cross-border activity, this "should not generate much immediate pressure to rethink domestic tax policy in either country"; however, the article notes that certain existing provisions such as the tax treatment of leasing and indexing taxable income to inflation in Mexico will distort the location of economic activity).

[FN115]. For a description of the corporate shareholder tax structures of the Member States, see Arnold & Harris, supra note 104, at 586-90 (describing distortions caused by the different corporate-shareholder tax regimes of the Member States).

[FN116]. John P. Steines, Jr., Commentary, Income Tax Implications of Free Trade, 49 Tax L. Rev. 675, 689 (1994).

[FN117]. Along with this decentralization trend, it is likely that the states and provinces will become more concerned with threats against their taxing authority posed by NAFTA. See Amy Hamilton, Threat of GATT, NAFTA to State Taxing Powers Analyzed at Florida Tax Seminar, Tax Notes Int'l, Feb. 9, 1996, at 288--7.

[FN118]. See Francois Vaillancourt, Subnational Tax Harmonization, Canada and the United States: Intent, Results, and Consequences, in Canada-U.S. Tax Comparisons 323 (John Shoven & John Whalley eds., 1992).

[FN119]. See Iqbal, supra note 18, at 12.

[FN120]. Rates ranged from 44% to 69% in 1995 as a percentage of basic federal tax. See infra tbl. 2.

[FN121]. The average subnational sales tax (including state, cities, and counties) in the United States in 1995 was 8.17%. See Deborah Lohse, Average Sales Tax Rates, Wall St. J., Jan. 24, 1996, at A1.

[FN122]. The average for state payroll taxes was 2% in 1993. See Iqbal, supra note 18, at 5.

[FN123]. Most Canadian provinces have a tax collection agreement with the federal government for corporate and personal income taxes and have generally forgone the right to choose their own income tax base and apportionment formulary. See M. Daly, Tax Coordination and Competition in Canada: Some Lessons for the European Community, in Ruding Committee, supra note 5, Annex 9A ("In the case of Canada, therefore, the benefits of tax harmonization (together with federal equalization payments) have, up to now, been considered by the provinces to be sufficiently great to persuade them to forego a large degree of their sovereignty in tax matters.").

[FN124]. See Arthur J. Cockfield, A New Corporate Minimum Tax for Ontario, 23 Tax Mgmt. Int'l 345 (1994) (explaining that Ontario's provincial government implemented a minimum corporate tax as a result of a public perception "that some corporations were not paying their fair share of taxes").

[FN125]. See Chen & McKenzie, supra note 18, at 25 ("We also examined METR [marginal effective tax rates] across provinces and sectors within Canada and found that the variation in [these rates] across provinces is quite pronounced. This suggests that the tax system encourages an inefficient allocation of capital across the provinces.").

[FN126]. See, e.g., Utz, supra note 99, at 768 (indicating that growing state tax burdens within the United States may influence the "rolling recessions" that afflict one region of the United States and then another).

[FN127]. See Joann E. Weiner, Tax Coordination and Competition in the United States of America, in Ruding Committee, supra note 5, Annex 9C (stating that the independence of state tax policies "arises from the federal nature of the [[[U.S.] system. States vigorously protect their sovereignty over tax policy. The inability of the [U.S.] Congress to impose uniformity in multistate taxation, despite apparent benefits of uniformity to both taxpayers and tax administrators, reflects the strength of this sovereignty").

[FN128]. See Vaillancourt, supra note 118, at 331 (arguing that even if the federal tax systems of Canada and the United States were completely harmonized, the differences in the subnational tax systems would continue to distort resource allocation between, and within, the two jurisdictions).

[FN129]. See H. David Rosenbloom, Sovereignty and the Regulation of International Business in the Tax Area, 20 Can.-U.S. L.J. 267, 269 (1994).

[FN130]. For a discussion of the problems associated with the current transfer pricing rules, see infra text accompanying note 148. Subsequent discussion of formulary taxation in this Article is based on McDaniel, supra note 34, at 691, 706-09. See also Robert S. McIntyre & Michael J. McIntyre, Commentary, Using NAFTA to Introduce Formulary Apportionment, Tax Notes Int'l, Apr. 5, 1993, at 851.

[FN131]. Critics suggest that formulary methods are arbitrary because they allocate profits without any sound relationship to market conditions or the facts surrounding the transaction. For discussions of the debate surrounding the implementation of international formulary apportionment, see Reuven S. Avi-Yonah, The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation, 15 Va. Tax Rev. 89, 147-59 (1995); Sylvain Plasschaert, An EU Tax on the Consolidated Profits of Multinational Enterprises, 37 Eur. Tax. 2, 3-10 (1997); John Turro, The Battle Over Arm's Length and Formulary Apportionment, 65 Tax Notes 1259 (1994).

[FN132]. NAFTA-wide formulary apportionment has been criticized for, among other things, increasing compliance and enforcement burdens, creating the technical problem of defining "unitary enterprise," and ignoring the difficulty of approximating existing revenues and of using standard formulas where industry practices vary. See John S. Brown, Commentary, Formulary Taxation and NAFTA, 49 Tax L. Rev. 759, 761-67 (1994).

[FN133]. The unitary enterprise, however, would file a tax return using the income determination rules of each NAFTA Member State. The determined income (or loss) would then be apportioned to each country pursuant to the agreed-upon formula. Each country's tax rate would then be applied to the taxable income apportioned to that country. See McDaniel, supra note 34, at 714.

[FN134]. See Alvin C. Warren, Jr., Commentary, Alternatives for International Corporate Tax Reform, 49 Tax L. Rev. 611 (1994); see also Brown, supra note 132, at 767 ("In practice, the [several] states [of the United States] have never agreed on a standard apportionment formula, and there is no reason to expect otherwise from the NAFTA countries.... Given the complexity and the economic interests at stake, it is highly unlikely that consensus could be reached.").

[FN135]. See, e.g., Avi-Yonah, supra note 131, at 154 (indicating that the United States pursued its own interests when it developed its new profit split regulations, which include the cost of developing intangibles, since this cost is likely to be incurred in the United States).

[FN136]. In Europe, the Ruding Committee rejected formulary taxation for a number of reasons: "Firstly, and foremost, allocation is suitable only if States have reached an advanced degree of integration, such as common currency, common company law, common accounting standards and common expertise in the tax administrations." Ruding Committee, supra note 5, ch. 5; see also McDaniel, supra note 34, at 734-37 (addressing criticisms of the Ruding Committee and finding it highly desirable that corporate tax rates of countries in a common market be harmonized to achieve the benefits of the free trade zone).

[FN137]. See Richard M. Bird, Commentary, A View from the North, 49 Tax L. Rev. 749, 750 (1994) ("To twist and paraphrase a famous sentence of Gertrude Stein ('A rose is a rose is a rose'), however, a free trade area is not an economic union is not a federation is not a unitary state.").

[FN138]. See id. at 749.

[FN139]. As explained previously, these two forces have been described as the "double movement of history." See Polanyi, supra note 2, at 76. This approach comports with that of international relations theorists who believe that, within the global economy, there are still opportunities for the development of governance mechanisms at the international level that neither undermine national governance nor hinder the creation of national strategies for international control. See, e.g., Paul Hirst & Grahame Thompson, Globalization in Question 170 (1996).

[FN140]. The tax authorities of the Member States currently hold trilateral meetings regarding compliance issues. See Kathleen Matthews, U.S. IRS and Practitioners Discuss International Compliance Issues and 1996 Legislation, Tax Notes Int'l, Feb. 10, 1997, at 475, 477.

[FN141]. This Tax Working Group could resemble the current NAFTA Working Group on Trade and Competition which is charged with reporting within five years on aspects of the relationship between competition laws of the Member States and trade within NAFTA.

[FN142]. Unlike most negotiations between countries, which are handled by diplomats, tax treaty negotiation is routinely conducted by governmental tax experts.

[FN143]. In Europe, the Ruding Committee found that, despite an extensive network of bilateral tax treaties among the member states of the European Union, their disuniformity led to economic distortion of the European market. The Committee suggested that the member states adopt a common tax treaty policy to combat these distortions. See Ruding Committee, supra note 5, ch. 10.

[FN144]. Many of the differences among the tax treaties can, however, be arbitraged away through "treaty shopping." For example, a Canadian investor who plans to invest in Mexico can take advantage of more favorable benefits in the U.S.-Mexico tax treaty by setting up a flow-through entity (for tax purposes) in the United States. The ability of sophisticated tax arbitrage strategies (and accompanying waste of resources) to circumvent the bilateral nature of tax treaties, however, only highlights the appropriateness of a multilateral model.

[FN145]. But see Rosenbloom, supra note 129, at 268 ("Although there is near unanimity at the level of principle [concerning the negotiation of multilateral tax treaties], in practice and administration it is virtually impossible to pass beyond the bilateral level.").

[FN146]. See Arnold & Harris, supra note 104, at 578-79 (recommending that tax treaties in North America be negotiated with a view to harmonizing the provisions of the treaties to the maximum extent possible and arguing that it is preferable, if not necessary, for these negotiations to be conducted on a trilateral rather than a bilateral basis); see also McDaniel, supra note 34, at 739 ("The NAFTA countries need to have a coordinated tax treaty policy with non-NAFTA countries whether or not [a formulary taxation] system is adopted.").

[FN147]. See Avi-Yonah, supra note 131, at 92.

[FN148]. One criticism leveled at the arm's length method is that it does not reflect economic reality since intrafirm transfers are not the same as those among nonaffiliated groups. See, e.g., Plasschaert, supra note 131, at 7.

[FN149]. The United States and the most recent version of the OECD guidelines developed a more flexible approach toward arm's length pricing in which, although the traditional transactions-based method continues to be favored, a profit-based formula can now be adopted (i.e., comparable profits derived from similar uncontrolled companies). See id. at 5. For a review of the OECD guidelines, see Robert E. Culbertson, A Rose By Any Other Name: Smelling the Flowers at the OECD's (Last) Resort, Tax Notes Int'l, Aug. 4, 1995, at 150.

[FN150]. The tax authorities of Canada and Mexico already use, at times, a profit-based method in order to come to a solution with respect to transfer pricing disputes. But see Turner, supra note 42, at 18 ("It is suggested that, while detailed legislation may be attractive from a purely domestic perspective, it may not allow for the degree of judgment and flexibility required in an international context."). Draft legislation was introduced in Canada in 1997 to, inter alia, increase the required amount of documentation used to substantiate transfer prices. See Steven Audereth, Canada Proposes Transfer Pricing Bill Requiring More Documentation, Harsh Penalty, U.S. Tax'n Int'l Operations, Sept. 8, 1997.

[FN151]. For American issues, see Thomas C. Louthan, Building a Better Resolution: Adapting IRS Procedures to Fit the Dispute, Tax Notes Int'l, Oct. 28, 1996, at 209. For Canadian issues, see Scott Shaughnessy, Spotlight on APAs in Canada, Tax Notes Int'l, Dec. 4, 1995, at 232. For Mexican issues, see Albertina M. Fernandez, Mexico Issues First Maquiladora APA, Tax Notes Int'l, Nov. 13, 1995, at 218.

[FN152]. The revised protocol between the United States and Canada sets up a mutual agreement procedure to resolve disputes under the tax treaty. See U.S.- Canada Treaty, supra note 101, P 1903.26. The U.S.-Mexico tax treaty also contains provisions dealing with mutually agreed dispute resolution procedures. See U.S.-Mexico Treaty, supra note 101, art. 26. The Canada-Mexico tax treaty also establishes mutual agreement procedures. See Canada-Mexico Treaty, supra note 101, P 34,709.

[FN153]. See Convention 90/436/EEC on the Elimination of Double Taxation in Connection with the Adjustment of Profits of Associated Enterprises, Tax Notes Int'l, Apr. 24, 1995, at 78.

[FNd1]. The figures are for 1993 unless otherwise noted. The comparisons should be used to gain a general impression only. There are differences in definition, data collection methods, and other factors.