Bootstraps and Poverty Traps: Tax Treaties as Novel Tools for Development Finance

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Current shortfalls in financing required for full achievement of the Millennium Development Goals have led to calls for consideration of novel means of development finance. This Article describes such a novel means of development finance based on a radical rethinking of the typical allocation of tax entitlements in bilateral income tax treaties. The central proposal is for a developing country to surrender, by tax treaty, a portion of its taxing authority in exchange for an upfront capital transfer from the developed country. The developed country would then recoup some portion of the upfront capital transfer through exercise of the expanded tax authority it has secured under the treaty. The Article describes a number of ways in which the proposal represents an advance over existing forms of development finance, including for example, effects on administrative burdens, tax competition, and risk shifting. The Article also addresses a number of potential criticisms of the proposal, relating especially to issues of sovereignty and enforceability.

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Introduction

A little over a decade ago, the United Nations Millennium Declaration articulated the Millennium Development Goals (MDGs), a series of aspirational targets related to poverty reduction and sustainable development across the world.1 The “deadline” for most of these MDGs is 2015, a rapidly approaching date. Regrettably, at least some areas in the developing world are not presently on track to meet the MDGs.2 The reasons that any particular region or country is in danger of falling short of the MDGs are likely to be manifold, and as complex as the broader process and puzzle of economic development. Without question, though, a central problem is the inadequacy of resources. Resource gaps are not an unforeseen hurdle. From the outset it has been well understood that the achievement of the MDGs would require revenues in excess of what could plausibly be raised through internal sources of financing.3 Likewise, the


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standard sources of external financing have seemed inadequate to the task. For example, official development assistance (ODA) has been on a declining trend over the last two decades and in most countries remains well below the agreed UN target contribution rate of 0.7 percent of gross domestic product (GDP).\(^4\) The usual candidates for private sector flows raise their own set of problems. Debt finance, whether through syndicated bank loans or through securities, has encountered numerous problems, leading to devastating sovereign defaults and ultimately coordinated calls for widespread loan forgiveness.\(^5\) Equity finance, such as foreign direct investment, can be a promising source of external funds but tends to be highly skewed away from regions that are in greatest jeopardy of falling short of the MDGs.\(^6\) These various deficiencies have led to calls for examination of novel financing sources to assist in filling the predicted financing gap, which has been estimated to be in excess of $50 billion per year.\(^7\) The result has been a series of proposals for novel financial flows, both from the public sector and the private sector. In the private sector one finds proposals, for example, for securitization of receivables, diaspora bonds, increased emigrant remittances, and increased voluntary donations.\(^8\) Some of the more prominent public sector proposals include new forms of environmental taxation, a Tobin tax, IMF special drawing rights, and the international finance facility.\(^9\) Regrettably, most of the proposals remain just

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\(^4\) ORG. FOR ECON. COOPERATION & DEV., DEVELOPMENT CO-OPERATION REPORT 2010, at 32 tbl.1 (2010), available at http://www.oecd-ilibrary.org/docserver/download/ fulltext/4310031 e.pdf?expires=1333500463&id=id&accname=guest&checksum=ADEFA82E25D9D0F 2F88EE5ED41A06B1E. Admittedly, the 0.7% target may not be accepted by everybody as an appropriate amount of development assistance. Compare Editorial, Missed Goals, N.Y. TIMES, Sept. 22, 2010, http://www.nytimes.com/2010/09/23/opinion/23thul.html, with Editorial, Hopeful Words: On Helping the Poor, N.Y. TIMES, Sept. 15, 2005, http://www.nytimes.com/2005/09/15/ opinion/15thu2.html. Over the years the target has, however, repeatedly been re-endorsed by donor nations. See, e.g., Michael Chibba, The Millennium Development Goals: Key Current Issues and Challenges, 29 DEV. POL’Y REV. 75, 78 (2011) (noting that the goal of having each developed country donate 0.7% of GDP to aid was “the UN target that was set in the late 1960s” and that this goal “has been reaffirmed many times over during the past four decades”). Moreover, the proposal in this Article—and the assumed need for additional development finance that underlies it—has merit even if one takes the view that the optimal level of assistance is below 0.7%. For example, adequate funding of the MDGs, a goal to which the proposal could be directed, has been estimated to require a scaling up of assistance from current levels but at a level lower than the 0.7% target. See JEFFREY D. SACHS, THE END OF POVERTY 299-301 (2005) (reporting the predicted cost of the MDGs at a level between 0.44% and 0.55% of “rich world” GNP).


\(^8\) See WORLD BANK, INNOVATIVE FINANCING FOR DEVELOPMENT (Suhas Ketkar & Dilip Ratha eds., 2009).

that. Capacity for creative thought has far exceeded global appetite for implementation—a serious financing gap remains.

The purpose of this Article is to introduce and defend an additional novel development financing mechanism—what I term the “tax treaty finance proposal”—which could be used to redress capital shortfalls in the developing world. Such finance could be used to help meet the MDGs. Or, it could be used to assist with the project of economic development in impoverished countries more generally, regardless of the particular benchmarks used to measure such development. The bulk of this Article will be concerned with explaining the details of the proposal and its relative benefits (and detriments) compared to existing, or proposed, finance mechanisms. It will be helpful, though, to have a basic sketch of the proposal, including its relationship to other mechanisms, on the table to review.

At the heart of the proposal is the idea that where a developed country provides external finance to a developing country, the typical allocation of taxing rights over productive investment across the two countries ought to be flipped. Under widely accepted norms, the primary right to tax runs according to a source principle. Thus, if a multinational firm in a developed country deploys productive capital in a developing country (by building a factory, for example), the primary right to tax the return to that activity would run to the country where the factory is physically located rather than to the country where the parent firm is based. My basic suggestion is that developing countries should surrender that primary taxing right. The surrender would not be given for free, of course, but rather in exchange for an upfront capital transfer, which comprises the basic financing element of the proposal. More specifically, one can break the proposal into two discrete components.

First, a developed country would transfer an amount of capital for the benefit of a developing country. There are some essentials of implementation regarding such transfer about which the proposal, as put forward in this Article, is non-committal. (I take such silences not as defects of the proposal but rather as beneficial and necessary instances of flexibility.) The proposal does not, and need not, commit to a specific magnitude of capital transfer. Such magnitude will ultimately depend on a multitude of factors, including, most importantly, the view taken on the general necessity of external capital as a precursor to economic growth; the conditions in the particular country receiving the benefit of the capital transfer; and the magnitude of other sources of external financing. Notwithstanding such uncertainties about magnitude, it is still possible to state the basic conceptual goal of the transfer, which is to generate sufficient

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10. I speak at this point in generic terms about a developed country capital transferor and a developing country capital recipient. That level of generality is consistent with the basic proposal, which could be implemented between any pairing of countries interested in implementing financing on terms contemplated by the proposal. In most of the discussion below, however, I will cast the discussion in terms involving the United States specifically as capital transferor and countries of Sub-Saharan Africa as capital transferees. The reasons underlying that particular focus are explained below.
improvements in the infrastructure and institutions of the capital recipient so as to generate meaningful economic growth generally and to render the jurisdiction an appealing destination for investment by the developed country's resident firms more specifically. Note, additionally, that the proposal does not mandate specific channels of delivery for the capital transfer. This vexing question will ultimately have to be solved by development experts. The proposal here, and the capital transfer it urges, should thus be understood as about a beneficial means of finance, not as about specific ways of using the capital contemplated by the financing.

Second, the developed and developing country would enter into a tax treaty (or amend an existing tax treaty) which achieves the essential reordering of existing taxing rights. In essence, this second prong of the proposal provides the legal mechanism by which the developing country will "pay" for the financing. More specifically, the developed country obtains repayment on the financing by asserting taxing rights (which otherwise would have run to the developing country) over its own firms. The proposal elaborates on the substance of such a treaty mechanism in a number of important ways, involving issues of both tax base and tax rate. Regarding tax base, the idea is that the capital transferor would obtain the primary (and sole) right to tax returns from productive activity of its multinational firms, where such activity is located in the developing country. Regarding tax rate, the proposal envisions that the treaty will specify that the developed country will tax such returns on a current (not deferred) basis and at a rate specified by the treaty. Such rate, which I term the "target" rate, will be described below in conceptual terms (rather than by reference to a particular number). The basic idea is that where the upfront capital transfer is used to produce better infrastructure and institutions, pre-tax returns to capital should rise compared to the status quo. Such increase in pre-tax returns should provide space for the imposition of increased capital taxation, as compared to the current state of affairs, while also achieving increased amounts of external private capital. Finally, the treaty should also specify that the developing country would apply such "target" rate to the productive investments owned by third-country multinationals. As developed in detail below, the basic point of this last requirement is to prevent the developing country from offering favorable tax rates (that is, below the target rate) to third-country firms, thereby undercutting the ability of the original capital transferor to recoup the financing.

As with the initial capital transfer, a number of important features are intentionally left unspecified in the proposal. Most importantly, the proposal leaves open what portion of the upfront transfer the developed country should ultimately recoup (either on an ex ante expected basis or on an ex post basis). This flexibility is important because it may well be that it is in the interest of both countries to offer the financing on a concessional basis. The desired degree of concessionality can be built into the treaty through certain terms, such as how and when the primacy of the taxing right of the developed country
multinationals will revert to the developing country, and whether some sort of general obligation of the financed country arises if developed country tax collections under the treaty do not meet specified amounts.

The tax treaty finance proposal offers important advantages as compared to both traditional and novel means of development finance. Regarding traditional means of finance, the proposal bears a surface resemblance to straight sovereign debt. As with typical debt flows, the first component described above contemplates a financial flow running to the developing country and the second component contemplates a financial flow running in the opposite direction. Additionally, the proposal is grounded on the premise that the funds directed to the developing country will finance the precursors to economic development. So too, straight loans have been undertaken as a means of external finance thought to be necessary to fuel economic development. These surface resemblances, however, ought not to conceal crucial differences between the tax treaty finance proposal and straight debt, which render the former advantageous compared to the latter. These differences will be developed at length below, where I will show that substantial advantages can be achieved under the tax treaty finance proposal through the following features: cost savings from having the developed country obtain repayment by collecting taxes directly under its own tax system; the removal of the possibility of costly sovereign defaults; and the tax-revenue advantages from having a coordinated rate-setting mechanism under a treaty which should stem tax competition.11

Regarding the relationship between the tax treaty finance proposal and novel finance mechanisms, it is helpful to distinguish between public and private sector finance, which are the two basic categories into which novel finance mechanisms can be sorted. Consider public sector finance first. Innovations in development finance from this perspective are typically seen to involve a search for new taxes as sources of public sector revenue for development finance. Prime examples are calls for a Tobin tax or various forms of environmental taxation.12 A basic challenge for any such proposal, though, is to explain both why new taxes are preferable to existing tax bases and why revenue from any new taxes, assuming they are superior to existing instruments, should be directed to development. As we shall see, the case for tying novel tax instruments to development is somewhat attenuated and the advantages here are mostly of a rhetorical or political nature.13

By contrast, the proposal in this Article takes a rather different approach to the relationship between taxation and public sector development finance. It does not propose any new taxes but rather urges reconsideration of the way in which jurisdictions currently allocate primacy of taxing rights with respect to

11. See infra Sections III.B-.C.
12. See Atkinson, supra note 9, at 8.
13. See infra Section II.A.
the *overlapping* nature of tax jurisdiction under presently existing domestic tax bases. The suggested payoff is that this can yield gains in a structural sense rather than in a merely rhetorical one. That is, the resulting financing mechanism is meant to create incremental value that is uniquely tied to the very act of development finance, as opposed to merely making it easier to garner popular support for raising development finance.

The tax treaty finance proposal also offers important advantages as compared to novel means of development finance which focus on private sector external capital. The issue here is again related to the overlapping nature of taxing jurisdiction but plays out in a rather different way. Along this dimension, the central concern has been the way in which developed countries may thwart developing country attempts to use tax incentives to attract *private* capital. Specifically, attempts by developed countries to tax capital which is owned by home country residents but deployed in a developing country can erase, or at least diminish, the effect of the offered tax incentives. The typical pro-development prescription is for the developed country to contract its tax base, in essence leaving space for the incentive to operate. As a doctrinal matter this can be accomplished through an “exemption” from the base of income that arises in the developing country, through “deferral” (i.e., taxing profits only upon repatriation), or through the practice commonly known as “tax sparing,” under which a developed country would award notional tax credits for taxes not actually paid to the developing country.

Regarding exemption, deferral, or tax sparing, the tax treaty finance proposal advanced here flips the typical thinking on its head. In the face of overlapping tax jurisdiction, conventional approaches urge *source*-country priority with the ultimate goal of attracting incremental *private*-sector capital through the use of tax incentives. My approach, by contrast, urges greater *residence* country priority with the goal of furthering effective private sector capital transfers. Under plausible assumptions, I argue this approach could deliver the seemingly impossible—increased revenue and increased capital for developed countries.

Obviously, much is left to be filled in with respect to the details of the relative advantages of the tax treaty finance proposal as compared to traditional and currently discussed novel means of finance. That will be the basic function of this Article. First, however, an essential limitation on the geographic scope of the proposal is offered here, both with respect to the developing countries and developed countries covered under the proposal.

From the perspective of developing countries, note first that the MDGs are stated as *global* goals. For example, regarding poverty reduction the stated goal is to halve, from the reference time period of 1990-2015, the proportion of
people with income below one dollar per day. Similarly, MDG costing predictions may typically be stated at the level of global financing needs. More nuanced inquiries, however, immediately note that satisfaction and financing of the MDGs can only be approached at a regional or country level, as the demands are very different across different areas of the world. At the regional level, it is often noted that the countries of Sub-Saharan Africa present particular challenges. For example, the most recent MDG progress report from the UN predicts that the first goal, regarding poverty reduction, is likely to be satisfied on a global basis. Sub-Saharan Africa considered in isolation, however, is not on track to achieve the requisite fifty-percent reduction in extreme poverty. Such regional variations in development are relevant in two ways. First, if Sub-Saharan Africa is going to contribute to the fullest extent possible towards the satisfaction of the MDGs on their stated terms (that is, as global rather than regional development goals), the need for additional external capital to this region would appear to be particularly pressing. Second, satisfying the MDGs on a global basis is surely a laudable goal—but not an ultimate one. The development project should strive to achieve such goals (and more ambitious ones) as minimum standards across all regions. Again, from this perspective, the need for external capital is most pressing in Sub-Saharan Africa. For these reasons the proposal in this Article is very much directed towards the countries of Sub-Saharan Africa as recipients of upfront capital transfers. In principle, the proposal may translate to other contexts, but it seems less persuasive there.

From the perspective of the developed countries, my chief focus is on the United States as a potential provider of public and private sector external capital. As will become clear, this focus arises in key part because the tax system of the United States, as it stands, is particularly amenable to the proposal that I put forward. Notwithstanding this limitation, other developed countries play an important part in the proposal in the sense of being cooperative actors that do not actively use their tax systems to undermine the financing efforts I describe in the Article. In addition, with modification it is again at least in principle possible to expand the proposal to fit with the tax systems of other countries, but the focus of the analysis will rest where the fit is best.


The argument of the Article is broken into four Parts. In Part I, I explain the basic case for upfront public sector capital transfers to countries in Sub-Saharan Africa. This case can be justified under the view that such countries are caught in "poverty traps"—that is, doomed to negative growth absent external assistance in achieving a capital threshold. Or, it can be justified under weaker assumptions that do not require one to accept the notion of a capital threshold but rather only that such countries experience increasing returns to capital and that it is desirable to achieve certain development goals within externally set time constraints. In Part II of the Article, I explore the ways in which novel development finance mechanisms are supposed to be desirable. I describe the basic weaknesses in current novel approaches that involve the relationship between tax and either private or public sector finance, while demonstrating why my proposal does not fall victim to the same problems. In Part III, I describe the tax treaty finance proposal in detail and explain various advantages to the proposal relative to conventional ways of thinking about public and private sector finance. In Part IV, I address a number of possible objections to the proposal.

I. Poverty Traps, Increasing Returns, and the Case for External Public Sector Capital

The basic proposal that I advance in this Article involves the use of tax treaties to facilitate increasing external public sector capital transfers from the United States to countries in Sub-Saharan Africa, with the aim of attracting additional private sector capital. The idea that public sector transfers should or must precede private sector transfers being controversial, to say the least, I offer in this part a review of the basic arguments in their defense. The case for external public sector capital transfers is strongest under the view that certain nations are stuck in poverty traps and require a "big push" or substantial scaling up of aid to break the cycle of poverty.\(^{17}\) The case for external transfers can also be made, however, under a different set of assumptions, particularly if a country is experiencing increasing returns to capital and one has set some time delimited development goal or benchmark. In this Part, I set out the basic economic theory underlying the poverty trap concept, adducing the causes of the predicament and explaining why a big push of external capital is arguably required to achieve self-sustaining growth. The discussion here follows standard treatments in the literature. I also explain the relationship between the poverty trap case for external public sector transfers and the case based on

\(^{17}\) For a survey of the intellectual history of the "big push" concept, see William Easterly, *Reliving the 1950s: The Big Push, Poverty Traps, and Takeoffs in Economic Development*, 11 J. ECON. GROWTH 289, 293–97 (2006). Although he did not use the actual term "big push," the basic concept of using a large external public sector transfer of capital to achieve development goals is attributed to Paul Rosenstein-Rodan. *Id.* at 293 (citing Paul Rosenstein-Rodan, *Problems of Industrialization of Eastern and South-Eastern Europe*, 53 ECON. J. 202 (1943)).
increasing returns coupled with time constraints. I believe this alternate case for external public sector transfers is often subsumed within the broader arguments based on poverty traps, rather than being explicitly broken out.\(^\text{18}\) The failure to make this distinction is unfortunate because rebuttals to the poverty trap argument do not necessarily refute the case for external transfers based on increasing returns and time constraints, even though critics of public sector external transfers sometimes speak as though the case for transfers turns exclusively on the case for poverty traps.

If we begin by limiting ourselves to the analysis of individual households, as distinguished from entire economies, the economic theory underlying a poverty trap is easily stated. Also, the existence of such household-level poverty traps in practice would seem beyond doubt. The foundational idea is that below some threshold of income it is impossible for the household to save, all income being required to meet basic subsistence needs. Holding household size, productivity, and existing capital constant, at best household income levels will stagnate. More likely, capital depreciation or increase of size in the household will actually lead to negative growth—that is, a decline in per capita household income. Moreover, even if the household can begin to save, growth will still be negative so long as the rate of per capita savings is lower than the rate of per capita capital depletion (from depreciation and population growth).\(^\text{19}\) Thus the trap. Unless savings can reach some threshold level, which it cannot in light of adverse conditions, the household cannot achieve positive growth in per capita income.\(^\text{20}\) The difficult question is whether the existence of such household poverty traps translates on an aggregate basis into a national level poverty trap.\(^\text{21}\)

\(^\text{18}\) See, e.g., ROBERT J. BARRO & XAVIER SALA-I-MARTIN, ECONOMIC GROWTH 49-50 (3d ed. 2001) (describing a poverty trap model under which a production function includes an interval over which returns to capital are increasing).

\(^\text{19}\) This assumes no gains in factor productivity in the household.

\(^\text{20}\) The household trap could be broken with perfect credit markets. The household could borrow to invest in physical and human capital, thereby raising productivity sufficiently so that savings could outpace capital depreciation and household growth. However, very poor households may face insurmountable obstacles in borrowing, both because of lack of collateral and general incompleteness of credit markets for investment in human capital. See, e.g., Kamit Flug, Antonio Spilimbergo & Erik Wachtenheim, Investment in Education: Do Economic Volatility and Credit Constraints Matter?, 55 J. DEV. ECON. 465, 466-67 (1998); Richard A. Posner, Utilitarianism, Economics, and Legal Theory, 8 J. LEGAL STUD. 103, 125-26 (1979); Priya Ranjan, Dynamic Evolution of Income Distribution and Credit-Constrained Human Capital Investment in Open Economies, 55 J. INT’L ECON. 329, 330 (2001). As we shall see the relationship between credit markets and sovereign borrowers will also play an important role in the analysis presented in this Article.

The conditions that would lead to a household poverty trap can certainly be transposed as a conceptual matter to the level of a national economy. Specifically, if the aggregate national decline in per capita capital (as a result of population growth plus capital depreciation) necessarily exceeds the aggregate national increase in per capita capital resulting from savings (because all resources are devoted to subsistence and there is nothing left to save), then the national capital stock will decline over time, resulting in negative growth. The difficulty arises when one tries to explain why those conditions might arise at the aggregate level. When exactly would aggregate savings be insufficient to counteract the effects of capital depreciation and population growth? We could be confident that those conditions hold in the aggregate if we were to make two crucial assumptions: (i) that the economy is closed and (ii) that all households in the economy are stuck in a poverty trap. Condition (i) ensures that there is no external source of funds for investment and condition (ii) ensures that there is no internal source of such funds. But these strong assumptions do not hold in any economy that we would observe in the world today. Accordingly, the departure from these conditions means that we cannot simply extrapolate from widespread and pervasive poverty at the household level to a national level poverty trap. More is needed by way of a theory.

Under the standard Solow neoclassical growth model, national level poverty traps should not exist. The key assumption that drives this result is

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22. To guarantee an actual trap, one would need a further assumption about technology. In theory it would be possible to have positive growth even with declining capital stocks if the existing capital stock could be put to more productive use because of technological advance. The point in the text, though, is simply to state the conditions for a possible trap. It is certainly possible that there is no technological advance, in which case the declining capital stock should lead to negative growth.

23. On the second assumption it is implicit that the household income level is defined to include income from claims on firms and government transfer payments. Thus the household income function includes returns to all capital in the economy, whether held by household, firm, or government.

24. The type of poverty trap I have described at the household level is referred to as a “saving trap” in the literature. See, e.g., Sachs et al., supra note 21, at 126-28 (explaining the conditions that would give rise to a “saving trap”). My simple claim in the text is that you could create a saving trap at the national level if every household were itself in a saving trap and there were no external sources of capital. Because not every household is at subsistence level—even in the poorest economies—this strong claim does not get us very far. This is not to say that one cannot have a saving trap where some households are above subsistence level. It is only to say that the a priori case for a saving trap is harder to make than for other types of poverty traps, which I will focus on in the text. Also, there are other reasons to shift focus away from saving traps. See infra note 32.

25. For an exposition and overview of the model, see BARRO & SALA-I-MARTIN, supra note 18, at 16-38. The Solow model built upon the earlier Harrod-Domar model, which sought to explain economic growth in terms of the level of savings, capital productivity, and capital depreciation. The Solow model added a number of important features, including the separate modeling of capital and labor; the assumption that returns to each of capital and labor are diminishing; and a variable for technology, which was separate from the productivity of capital. I initially focus on the Solow model because this is the model that underlies much of the basic analysis in descriptions of the poverty trap concept in the literature. See, e.g., Sachs et al., supra note 21, at 123-30 (building argument for different types of poverty trap by making modifications to the standard neoclassical growth model). The so-called new, or endogenous, growth theories, which have occupied much attention in the more recent literature, depart from the Solow model in important ways. The distinctions between the Solow exogenous growth
that in the neoclassical model marginal returns to capital start out very high but are diminishing thereafter. In the closed economy, even very poor countries would necessarily grow (indeed quite rapidly at first) so long as there is some amount of domestic savings. That is, the first dollars of domestic savings would fuel high-return capital investment. Even if domestic savings were zero (or negative), in an open economy, the prospect of very high returns for the first units of invested capital should quickly attract foreign investment. Such investment would again produce positive growth, rapidly at first and then tapering off until the economy reaches a steady-state equilibrium. But the assumption that drives this result is implausible in very poor countries. Because the country may well lack the basic forms of infrastructure, marginal returns on the first units of capital are predicted to be very low rather than very high. This prospect provides the basic theoretical foundation for the existence of a national level poverty trap. Specifically, the poverty trap model predicts two possible long-run equilibria. So long as capital remains below a threshold, the amount that can be saved in light of low returns to capital is outpaced by capital depreciation and population growth. The country will experience negative growth until it reaches the low-state equilibrium. Depending on the model, the actual level of per capita income in the low equilibrium state could be at the subsistence level or somewhat higher. By contrast, if the country can accumulate enough capital to take it above the threshold (that is, the point where capital is sufficiently productive such that the amount that can be saved exceeds capital depreciation and population growth) then it will grow until it reaches a high-state equilibrium.
The basic position of development economists who endorse the poverty-trap models is that an influx of capital is required to get countries stuck in a trap past the capital threshold and thus on the path to the high-state equilibrium. Where should the capital come from? One should recall here that in the development economics literature, the concept of a poverty trap is used to justify external state transfers of capital. For such a justification to work, the theory must not only show the import of a capital threshold, but also explain why the threshold cannot be met either through (i) internal or external private investment or (ii) internal state investment. There are plausible reasons why neither of these sources of investment capital would be adequate to exceed the capital threshold.

With respect to private investment, there is a collective action problem. No individual private investor will be willing to make the first capital investments, which by definition have very low returns. In light of low returns, foreign investment with higher returns or increased consumption might well become preferable alternatives. Of course, if one can get to the point in the production function where marginal returns to capital are very high, it might make sense to accept the low-yielding investments along with the high-yielding investments. The overall return could well exceed the opportunity cost of capital. But that proposition may well involve far too large an investment for any private investor, or syndicate of private investors.

This leads us to the possibility of internal state investment. Even if many, or most, households in a state are living at a subsistence level (and essentially untaxable), it still may be the case that there is sufficient aggregate wealth in the nation that the state could, through taxation, accumulate sufficient capital to exceed the capital threshold. This solves the collective action problem. The problem, though, is that this degree of taxation may be a political impossibility, particularly in states with very highly concentrated wealth, and may simply drive mobile capital out of the country. Taken together, these points seem to offer a theoretical justification for a large scaling-up of foreign aid and debt relief.

Note that the concept of a capital threshold provides not only a theoretical explanation for how a country could get stuck in a poverty trap but also a theoretical explanation for why only certain countries might get stuck in such a trap. The precise capital threshold should vary by country, depending on such factors as how expensive it is to build infrastructure. For example, all else equal, one could expect a mountainous landlocked country to face a higher capital threshold than a flat coastal country.

In addition to the minimum capital threshold theory summarized in the text, the development economics literature includes other theoretical explanations of how poverty traps can arise. Two notable examples are the so-called "saving trap" and the "demographic trap." See, e.g., Sachs et al., supra note 21, at 126-30 (describing conditions underlying these variants of poverty traps). In the saving trap model, the domestic savings rate varies as a function of aggregate capital stock. Specifically, savings rates are zero, or close to zero, at very low levels of capital accumulation. If this is correct, then one could arguably encounter a poverty trap without dropping the assumption of continuously diminishing returns to capital. In other words, a nation could be so poor that there simply is no money to
But not everybody accepts the poverty trap story. This is an area of wide-ranging dispute in the development economics literature, but four objections seem to arise repeatedly. First, claims that a big push will break countries out of a poverty trap are, as noted above, not new. Indeed, the claims first surfaced in the 1950s, essentially at the time that development economics was first emerging as a distinct area of study. At that time, the typical claim was that aid was to be a short-lived phenomenon. If poor countries could only break free of the poverty trap with the help of external capital, then they could achieve self-sustaining growth and would no longer need aid. The difficulty for modern proponents of a big push is that the rhetoric of the 1950s looks very similar to modern day rhetoric. There is sufficient continuity to the claims that modern calls for a big push have been characterized by critics as part of the “classic narrative” for justifying aid. The difficulty for proponents of aid is that there has been a lot of aid in the interim. If proponents of aid were wrong about the path to self-sustained growth then, why should we have more confidence now?

Second, a number of empirical studies have questioned the existence of poverty traps. Third, the general theoretical description of a poverty trap based on capital thresholds would seem to generalize to all countries. But clearly the developed countries of today were able to escape the trap without any external aid transfers. Fourth, there is the recurring statement that the central cause of poor growth relates to bad governance rather than to poverty traps.

make those first, admittedly very high-yielding, capital investments. The problem with this argument, though, is that it does not tell us why we need external state transfers of capital to break out of the trap. If there are high-return investments to be made, then foreign private investors should be willing to undertake them. The existence of saving traps has also been questioned on empirical grounds. See Aart Kraay & Claudio Raddatz, Poverty Traps, Aid and Growth, 82 J. DEV. ECON. 315, 320-37 (2007). In the model of the demographic trap, it is population that varies as a function of capital accumulation. The model assumes diminishing returns to capital throughout (and savings as a constant proportion of output) but still produces negative growth below a certain capital threshold. Specifically, at very low levels of capital accumulation the population grows so fast as to outpace any gains from new capital investment. As with the saving trap, this model fails to provide a reason why one needs external state transfers to break out of the trap—and for the same reason. With diminishing returns to capital, foreign private investors should be willing to make initial capital investments and thus allow for sufficient capital accumulation to break out of the demographic trap. Thus, of the various theories underlying poverty traps in the development economics literature, it would seem that it is the theory based on capital thresholds and modifications to the neoclassical production function that is crucial. Lack of domestic savings and rapid population growth certainly may worsen the situation, but it is really the assumption of initially increasing returns to capital that drives the argument for external state transfers. See Easterly, supra note 17, at 297-98. For this reason, it is this understanding of the poverty trap that is the focus in the text.

33. See Easterly, supra note 17, at 292.
34. Between 1946 and 2006, United States foreign aid has ranged between $15 billion and $60 billion per year, with aid disbursements peaking at over $40 billion annually in the mid-1950s and reaching lows of about $15 billion per year in the late 1990s. CURT TARNOFF & LARRY NOWELS, CONG. RESEARCH SERV., 98-916, FOREIGN AID: AN INTRODUCTORY OVERVIEW OF U.S. PROGRAMS AND POLICY 15, 16 fig.7 (2005), available at http://fpc.state.gov/documents/organization/45939.pdf.
35. See, e.g., Easterly, supra note 17, at 315; Kraay & Raddatz, supra note 32, at 316.
36. Easterly, supra note 17, at 292-93.
37. See id. at 307 (rejecting the claim of poverty trap proponents that there is good evidence of well-governed poor countries).
Some of these criticisms have fairly obvious and powerful rebuttals. For example, past failures can be attributed at least in part to the fact that the referenced aid flows often were motivated by political or strategic goals of donors that had little to do with actual economic development in the recipient country.38 Also, the historic economic growth in the developed world, which clearly did take place without external capital transfers, is of dubious relevance given the vastly different circumstances in which that growth took place (e.g., colonialism and absence of already existing developed countries).39 But some of these criticisms are more serious, most notably the empirical findings that call into question the very existence of poverty traps and the argument that governance failures inhibit growth.

Consider the governance critiques first. Given potential governance failings, we cannot simply assume that public sector capital transfers to developing countries will produce salutary development effects. Increased capital flows could simply be squandered in a sea of corruption. Without meaning to reject the theoretical possibility that a country could experience slower growth with aid than without it, I would observe that this criticism seems to blur questions of finance with questions of use. Recall that what I am interested in at this point is simply to motivate the case for a capital transfer, without committing to anything specific regarding terms between the transferor and transferee countries. In order to conclude that a particular capital transfer actually retards growth, one needs to tell an additional story about how funds are used. For example, maybe the funds do not actually produce any increased capital investment because everything is consumed by corrupt officials. Or maybe the funds are directed to ill-advised projects that not only yield no positive benefit but cause actual harm. I do not reject these possibilities. To do so would fly in the face of the historical record. But I do contend that these are more properly considered issues regarding use of funds and there is substantial value to separating financing issues from use issues.40 In this respect I follow the approach in leading treatments of novel development finance which draw a

38. See, for example, ROGER C. RIDDELL, DOES FOREIGN AID REALLY WORK? 105-06 (2007), which argues that

[a]id always has been, and still is, provided for non-developmental purposes, contributing to and shaping the way it has been allocated, and the forms it is provided. Overall, the evidence forcibly shows, although not as rigorously as one might like, that these influences have reduced and continue to reduce aid's potential development and welfare effects. In many cases, political influences have also accentuated the volatility of aid-giving, reducing its potential impact still further.

39. See Irma Adelman, Fallacies in Development Theory and Their Implications for Policy, in FRONTIERS OF DEVELOPMENT ECONOMICS: THE FUTURE IN PERSPECTIVE 103, 121-26 (Gerald M. Meier & Joseph E. Stiglitz eds., 2001) (describing the varying paths that presently developed countries have taken to achieve development); see also SACHS, supra note 4, at 130-31 (proposing five structural factors that have made Sub-Saharan Africa particularly vulnerable to persistent poverty).

40. Cf. Atkinson, supra note 9, at 3 (endorsing a methodology of distinguishing source of funds from use of funds).
sharp distinction between finance and use. More generally, one can call for more capital originating from the public sector of the developed world without making any commitments about the channel of delivery. If the concern is with corrupt officials in the central government there may well be ways to deliver capital that diminishes the influence of such officials. Indeed, it is consistent with the approach that such funds ultimately be deployed through private sector transfers (for example, where the funds are used to subsidize private sector investments that would not otherwise occur).

This brings us to the conflicting empirical evidence regarding the very existence of poverty traps. If the theory underlying public sector transfers cannot be confirmed empirically, this obviously raises serious questions about the wisdom of continuing along the path of transferring funds under such theory. Proponents of poverty traps can point to empirical evidence supporting their claims.\textsuperscript{41} Given that we cannot empirically confirm the existence of poverty traps unequivocally, however, it is worth considering whether the case for capital transfers falls apart if it turns out that the theoretical predictions are simply wrong.

The case for capital transfers does not fall apart, especially if one assumes that a country is experiencing increasing returns to capital and is seeking to satisfy particular development goals under a time constraint. To see why this is the case, it is helpful to contrast the poverty trap with its theoretical opposite: the notion of convergence.\textsuperscript{42} Convergence is the basic prediction of the Solow growth model. With diminishing returns to capital, an economy cannot grow indefinitely by adding incremental units of capital.\textsuperscript{43} Under the Solow model, then, the only way to achieve an increase in per capita output in the long run is through advances in technology.\textsuperscript{44} The basic thesis of convergence is that all economies in long-run equilibrium will converge to the same level of per capita income and then grow at the same rate (because the model assumes that technological advance is freely available to all countries). This is the strong claim of so-called “unconditional convergence.”

The empirical support for unconditional convergence is very limited, however.\textsuperscript{45} This is not surprising. In the Solow model the level of per capita income in equilibrium depends upon savings, population growth, and capital


\textsuperscript{42} See Easterly, supra note 17, at 297 (casting poverty trap and convergence as opposites).

\textsuperscript{43} More exactly, the economy cannot grow by increasing the capital-labor ratio. For a given capital-labor ratio, the economy could grow indefinitely in terms of aggregate output by adding capital and augmenting labor through population growth, but of course this will not increase per capita output.

\textsuperscript{44} See WILliAM EasterLY, THe ELUSIVe Quest For GROWTh: ECONOMISTS’ AVENTURES AND MISAdVENTURES IN THE TROPICS 47 (2002).

\textsuperscript{45} See DEBRAJ RAY, DEVELOPMENT ECONOMICS 75-80 (1998).
Thus, we would expect countries to converge to the same level of per capita income only if these important parameters were the same across economies, an unlikely state of affairs to say the least. The absence of convergence has led economists to advance a weaker form of convergence, typically referred to as "conditional convergence." The prediction of conditional convergence is that one should observe countries converging to the same long-run level of per capita income if you control for differences in the relevant parameters. Crucially, under conditional convergence, countries may have different levels of per capita income in the long run (due to the effects of savings, population, and depreciation), but they all still grow at the same rate—namely, the rate of technical progress.\(^4\) If conditional convergence holds, there are important implications for policy. Unlike in poverty-trap models, which predict multiple equilibria depending upon a country's ability to surpass a capital threshold, there is no such threshold. All countries grow at the same equilibrium rate. Pick any target amount of per capita income. Every country will get there, without external capital, given enough time. If such models are an accurate depiction of growth, this would count as a powerful argument against external transfers.

But consider two additional factors of relevance here. The first relates to the relevance of a country manifesting increasing returns to capital. As discussed above, poverty-trap models are multiple-equilibria models, in which a period of increasing returns to capital is crucial to the conclusion. In other words, the fact of increasing returns to capital, wherein initial returns to capital investment are relatively low, makes plausible the prediction that the capital depreciation and population growth could outpace the return to savings. Note crucially, however, that one can posit increasing returns to capital and yet reject the application of a multiple-equilibria model. The interpretation here would be that although returns are initially low, they are still sufficient to outpace depreciation and population growth. The relevance of increasing returns here is temporal. In the extreme, one could imagine a case where a country experiencing increasing returns to capital demonstrates sufficient returns to savings such that the returns just barely exceed population growth and capital depreciation. The country will experience increasing capital stocks and positive growth, but such growth will occur at a very slow pace. This slow pacing leads to the second factor of relevance, which is time. It should go without saying that time is of the essence. The MDGs themselves are, of course, very much grounded in the idea that it is appropriate to set a timeframe in which to accomplish certain development goals. Thus, several of the goals are evaluated

\(^4\) See id. at 67-68 (discussing how parameters affect the steady state in the Solow model).
\(^7\) See id. at 82. The conclusion that all countries grow in the long run at the rate of technical progress still assumes that such knowledge is freely available across all countries. For a discussion of the validity of this assumption, see id. at 82 n.22.
by reference to a twenty-five-year window (1990-2015). More ambitious goals that go beyond the MDGs would plausibly require more time. Thus one can reject the claim that poverty traps exist on empirical grounds, and yet still call for substantial upfront external capital transfers, particularly with the assumption of increasing returns to capital and some time-delimited development goal.50

Supposing the case for a substantial transfer of capital from the public sector to certain developing countries can be made, how should one effect the transfer? Assuming that private sector external transfers are also crucially important to filling the MDG financing gap, what is the appropriate relationship between public sector and private sector transfers? I begin to tackle these questions in the next Part.

II. Innovations in Development Finance

In connection with the perceived shortfalls in funding for the MDGs, the UN has recently urged the consideration of so-called novel means of development finance to fill the financing gap. For example, the following have all been discussed as possible novel finance tools: a carbon tax, the Tobin tax, a global lottery, greater reliance on emigrant remittances, IMF special drawing rights, the international finance facility, and increases in charitable donations.51

The tax treaty finance proposal I sketch in this Article could be described as one type of novel financing approach. In Part III, I will explain the details of how the proposal would work, but first it is quite useful to understand the general way in which my proposal presents a marked departure from current ways of thinking about the relationship between tax and development finance. To see this, we can begin with the general question of what makes novel

49. See Sachs, supra note 4, at 266-87 (discussing various development goals to be achieved by 2025).
50. I have focused my attentions on the implications of the Solow model, which is an exogenous theory of growth (that is, long-run growth occurs only because of increasing technology, which is specified exogenously in the model). This can be contrasted with endogenous theories of growth, in which the determinants of long-run growth are endogenous to the model (typically either human capital accumulation or endogenously specified technological advance). Endogenous models allow for long-run differences in growth rates, whereas the Solow model does not, as it permits only differences in levels of per capita income. The broad conclusion I draw, however, would not differ. Specifically, endorsement of one of the endogenous growth theories should not by itself be viewed as inconsistent with substantial upfront external capital transfers. Indeed, the new growth theories have introduced new theoretical bases for how poverty traps could arise, based on low domestic accumulation of either human capital or technology. For a survey of this literature, see Costas Azariadis & John Stachurski, Poverty Traps, in Handbook of Economic Growth 295 (Philippe Aghion & Steven N. Durlauf eds., 2005). The empirical evidence on the existence of poverty traps in the new growth literature is mixed, however. Compare Danny T. Quah, Twin Peaks: Growth and Convergence in Models of Distribution Dynamics, 106 Econ. J. 1045 (1996) (arguing for multiple-equilibria result), with Michael K. Kremer, Alexi Onatski & James Stock, Searching for Prosperity, 55 Carnegie-Rochester Conf. Series on Pub. Pol'y 275 (2001) (rejecting the multiple-equilibria result).
51. For a detailed discussion of these proposals, see Atkinson, supra note 9.
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instruments worth pursuing in the first place. How exactly do they add value and assist in filling a financing gap? And what is the general relationship to taxation? It is easy, of course, to state the supposed advantage in a superficial way. Novel instruments are supposed to raise additional funds for development. But this begs the question why they are desirable as compared to alternate means of raising money. For these purposes it will be important to distinguish public sector finance from private sector finance. The manner in which novel instruments in each of these camps is meant to secure improvements is rather different. Accordingly, the relative advantages my proposal hopefully brings to the table is also somewhat different across the two cases. Below I consider the issue of novelty in each of these channels in turn.

A. Public Sector External Transfers

I begin with a barebones stylized characterization of the basic finance chain for public sector external transfers to developing countries. It involves four steps: (i) the transferor country raises funds through its normal tax system (or issues debt and taxes later); (ii) the transferor country transfers capital to the transferee country taking back a promise to be repaid some percentage of the capital; (iii) the transferee country raises funds through its normal tax system; and (iv) the transferee country transfers capital back to the transferor in satisfaction of its obligations. We could abbreviate the steps in this basic chain as follows: taxT-transfer-taxR-remit. The subscripts “T” and “R” here refer to “transferor” and “recipient,” reflecting taxes of the developed and developing country, respectively.

The bulk of experimentation with the relationship between taxation and public sector external flows generally focuses narrowly on “taxT.” That is, the nature of innovation involves the introduction of some type of new tax to raise revenues in the developed country. Prime examples are calls for the use of a Tobin tax or environmental taxation to generate financing for developing countries. While acknowledging that the focus on “taxT” is an important part of thinking about development finance, the actual case for genuine novelty here faces an uphill battle. What value do such novel instruments offer relative to existing taxes? The types of taxes proposed (e.g., environmental taxes and Tobin taxes) suggest that they correct some externality. If one is attempting to fill a finance gap, then why not look to a fiscal instrument that has other salutary benefits? For example, why not choose an instrument, such as a carbon tax that prices the harm from carbon emissions, or a financial transactions tax that prices the harm from noise currency trading? But as a matter of sound public finance, this is an unconvincing basis for using novel tax instruments to finance development. If it is sound policy to impose an externality-correcting tax on carbon emissions or financial transactions, then this should be the case.

52. See id.
regardless of any connection to development finance. Assuming that such instruments are feasible in the first place, then presumably domestic economies should have already enacted them. To forge the connection to development finance it would be necessary to make an explicit comparison between the new tax and the alternate traditional financing source. The case for the novel instrument is thus a relative one. The novel instrument could displace a relatively more distorting tax (such as an income tax) if revenues are to be held constant. Or, if overall revenues are to increase, it could forestall the need to increase the relatively distorting instrument. Such a comparative assessment is essentially the basic “double dividend” argument common in analyses of environmental taxation in the domestic context. That argument generally posits that externality-correcting environmental taxes achieve the dual benefit of addressing the environmental problem while also displacing labor supply-distorting income or consumption taxes.

If the central case for novelty in taxation and development finance rests on a double dividend, however, then one confronts immediate problems. First, the so-called double dividend has frequently been called into question even in the domestic context on the grounds, for example, that environmental taxes can be expected to raise consumer prices. Such a price increase functions as an implicit consumption tax and thus also distorts labor supply. Second, even if one overcomes this basic issue, one is still left with the issue noted above: what is the conceptual link between the double dividend and development finance? If the double dividend arises based on the relationship between the externality correcting tax and other taxes, then this benefit, too, should be realizable strictly through the domestic system. The strongest rebuttal to this point is that some externalities are global. Jurisdictions then lack incentives to impose costs through taxation on home-country persons when the externalities are borne outside the country. This is no doubt true, but the argument is really more about the under-provision of global public goods (absent national coordination) than it is about development finance. In other words, one could favor global coordination to address climate externalities, for example, without necessarily taking the further step of committing associated revenues to development. The possible exception is the case in which transfers to certain countries are required to correct the externality, and such transfers align with development goals. For example, one could imagine revenues from carbon taxation transferred to a developing country to induce reforestation, which would be a

53. See id. at 25.
55. See id. at 19-24, 56.
56. See Atkinson, supra note 9, at 26.
57. For an extended discussion of financing for global public goods, see generally PROVIDING GLOBAL PUBLIC GOODS: MANAGING GLOBALIZATION (Inge Kaul et al. eds., 2003).

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result that is broadly consistent with the environmental sustainability aspect of the MDGs. This type of argument, however, would not seem to generalize across all aspects of development. Considerations such as these are consistent with general critiques in the literature of attempts to tie new taxes to development finance. In general it would seem that the basic case for linking new taxes and public sector development finance is attenuated, at best.

What the above discussion suggests is that most novel approaches to development finance for external public sector transfers do not involve the creation of independent value from modification or restructuring of the public sector finance chain. In other words, if we think of “financing” and “development” in terms of a means-ends relationship, then we can see that modifying “taxT” may well create value as a means (i.e., the bare act of financing). However, this is conceptually divorced from the ends (i.e., specific development goals).

This aspect of modifications to public sector financing stands in sharp contrast to proposed modifications to private sector financing, which I take up below. In the private sector case innovations in finance follow from matters such as credit enhancement through the provision of additional collateral. These modifications create value through structural alterations to the finance chain in ways that cannot simply be peeled away from the act of financing. As we have just seen, adoption of a Tobin tax can proceed irrespective of development finance. Provision of additional collateral, by contrast, is an act necessarily tied to the creation of a particular financing chain. This basic contrast is extremely useful in framing my tax treaty finance proposal because its chief merits on the public sector side derive from the fact that it invites inquiry into the structure of the public sector finance chain in ways that mirror the sorts of innovation floated in the private sector case. To be clear, this is not a call for displacing public sector flows with private sector ones. To the contrary, the whole proposal is grounded in the idea that public sector transfers

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58. See J.A. Mirrlees, Global Public Economics, in NEW SOURCES OF DEVELOPMENT FINANCE, supra note 9, at 204 (arguing that “people's apparently simple-minded intuition that increased (environmental) taxes make them worse off is essentially correct, and that governments should not be told that they are... better off and can afford to be more generous when they find that they ought to introduce these new taxes”).

59. I do not deny that the distributional impact of a certain funding source, considered alongside the distributional impact of a particular manner of spending such funds may well affect the political acceptability or feasibility of either a new tax or spending proposal, quite aside from a strict analysis of the costs and benefits of the various proposals. Consider here the key proposals relating to a Tobin tax and to environmental taxes. The political economy underlying adoption of a Tobin tax is arguably affected to the extent that the tax is presented as a way to finance development and that voters hold the view that the tax is borne by currency traders who have caused detrimental effects in the international capital markets that have harmed developing countries. The political economy underlying adoption of a carbon tax likewise may be affected if the tax is presented as a way to finance development and if voters hold the view that carbon emissions are likely to harm equatorial (largely poor) countries disproportionately. See Anja Kollmuss, Carbon Offsets 101: A Primer on the Hottest—and Trickiest—Topic in Climate Change, WORLD WATCH, July/Aug. 2007, at 9, 11, available at http://www.worldwatch.org/node/5134.
are required in advance of private sector flows under the conditions discussed in Part I. The claim rather is that we can have similar structural advances in the public sector finance chain that we observe in the private sector finance chain. Put in terms of the stylized description of the chain set out above, my focus is not on "tax_T" (and finding new incarnations of tax_T) but rather on the "tax_T-tax_R" aspect of the public sector chain. More specifically, I am interested in the interactive aspect of the tax systems of countries. That interactive aspect has been a central concern, perhaps the central concern, of scholars of international tax law though not usually in a way that has paid much attention to questions of development finance. My premise is that this focus can be imported into the study of novel development finance with beneficial effects.

B. Private Sector External Transfers

Consider next the case of innovations in private sector finance. Matters are somewhat more complicated here, because private sector financing takes on a greater variety of forms and accordingly interacts with the tax system in different ways. For example, some types of private sector financing runs straight to a sovereign government (as in the case of government issued debt); sometimes the financing can run to an unrelated private party in a developing country (as in the case of a commercial loan to a private party); and sometimes the financing can be contained within a single private entity (as in the case of foreign direct investment). As suggested above, innovations in this area often involve elements that, unlike the public sector case, transcend the merely political and add true value based on structural elements of the relevant finance chain. Thus, the target of such innovations relates to matters such as risk mitigation, credit enhancement, and risk spreading. A nice example is the case of future flow securitization. For example, a developing country seeks to securitize a future flow of revenues, such as utilities receivables. Such a financing structure would typically involve directing the revenues underlying the securitization to some offshore trust in the first instance, thus reducing the risk of conversion by the sovereign. Note that in contrast to the public sector case considered above, any such gains from this type of innovation are not contingently related to development finance. It would not be possible to peel off the risk mitigation achieved through such a structure and realize the gains from this independently of the finance chain. With only a handful of

60. See WORLD BANK, supra note 8.
61. See id.
62. See id.
63. It is conceivable that the structure has spillover effects. For example, it might lower the sovereign's overall cost of borrowing with respect to other debt. This does not, however, detract from the point in the text, which is that the trust cannot be used to generate value unless the sovereign institutes some finance chain in which the trust plays a role. This can be contrasted with something like the implementation of a new environmental tax which might create value by correcting for negative externalities regardless of whether any revenues raised by the tax are put towards development finance.
exceptions, though, this type of innovation in private sector finance does not have much to do with taxation.  

The chief intersection of taxation with private sector finance, rather, has been seen as the effect that a developing country’s tax system may have on its ability to attract external private capital. The standard orthodoxy is that the small, open economy should not tax inbound capital at all. Such an economy is a price taker in international capital markets and any attempt to decrease the return to capital through a capital tax will just result in the capital being driven away. In pure form this would argue for zero capital taxation. In real world terms, where immediate revenue needs may be pressing, the more likely implementation will be in the form of targeted tax holidays and incentives. Following the line of analysis above we can refer to a highly stylized private sector finance chain that involves the following steps: (i) private sector capital transfer to the developing country; (ii) deployment of capital in profit-making ventures; (iii) payment of taxes to the country of capital deployment; (iv) payment of taxes to the country of capital ownership; and (v) remission of the after-tax proceeds to the capital owners. In abbreviated form this could be summarized as: transfer-deploy-taxR-taxT-remit. As far as taxation is concerned, the focus would be on lowering the burden of taxR, as just discussed. But it would also necessarily be on the lowering of the burden of taxT as well. That is, taxR and taxT should be understood here as overlapping tax claims by distinct sovereigns with respect to the same economic flow of income. This is why the standard package of tax advice with respect to development finance has involved both the call to reduce capital taxes with respect to taxR but also a reduction or removal of residual tax in the jurisdiction of capital ownership, that is taxT, that would simply reverse the effect. The basic theoretical frame here, then, has been to prioritize the claim of taxR over that of taxT—and to strive to have a zero rate. As we shall see below, this too, stands in rather sharp contrast with the tax treaty finance proposal that I offer in this Article. My suggestion is that we actually prioritize taxT—the tax of the developed country—and strive to impose some positive rate of taxation with respect to external private capital. I save the details of the argument for the discussion below. The thumbnail sketch, however, is relatively simple. First, if one accepts the increasing returns story set out above, then it should in theory be possible to impose positive rates of tax, indeed increased rates of tax against the current baseline, such that we get the seemingly impossible—both more revenue and more capital attractions. The simple reason is that capital attraction is driving the rate of return up, creating some space for positive tax rates and some revenue collection. That makes out the basic case for non-zero tax rates. Second, the case for the primacy of taxT is related in part to the way in which

64. The exception is the case where the securitized future flow is a stream of tax revenue. As a general matter this has not been a successful approach. See WORLD BANK, supra note 8, at 28.
65. See infra notes 102-105 and accompanying text.
this facilitates the transfer of public sector capital (as discussed above). It is also an important element in stemming inter-jurisdictional tax competition, which could erode the prospect of achieving simultaneously greater amounts of capital and revenue.

III. Tax Treaties and Novel Development Finance

In this Part of the Article, I first set out a basic description of my tax treaty finance proposal. I then turn to an explanation of the merits of the proposal relative to current approaches to public sector capital transfers and private sector capital transfers. (As noted in the Introduction, the focus is on the United States as potential public sector capital transferor.)

A. The Proposal

The starting point for my proposal is the overlapping nature of taxing sovereignty in the international setting. Countries may generally tax income in the cross-border setting on either a residence basis (i.e., by reference to the fact that the income is owned by a resident individual or entity) or on a source basis (i.e., by reference to the fact that the income is earned in the taxing jurisdiction, irrespective of ownership). For example, consider a corporation formed under the laws of Delaware that operates a factory through a division in a foreign country. The United States would tax this corporation on its worldwide income, including manufacturing profit from the foreign division, based on a principle of corporate residence. The foreign country where the division is located may also tax the manufacturing profit based on a source principle. Where these entitlements overlap in such a fashion, double taxation can result, to the detriment of cross-border capital flows. The problem of international double taxation is frequently resolved through bilateral treaties, in which either the source or residence jurisdiction agrees to offer double taxation relief under its domestic law.66 In addition, countries sometimes adopt provisions that afford double-tax relief unilaterally, with no underlying treaty obligation. Yet whether or not the relief is compelled by treaty, the allocation of taxing sovereignty is roughly constant throughout the world. Consider the basic paradigm where income is earned in one jurisdiction by a taxpayer considered to be resident in a different jurisdiction. The generally applicable norm in this context is that the source jurisdiction has primary taxing authority in cases where the income qualifies as active, whereas the residence jurisdiction maintains primary taxing authority in cases where the income is passive.67 The details regarding the


67. Some scholars argue that the norm is so persuasive that it rises to the level of customary international law. See Reuven S. Avi-Yonah, International Tax as International Law, 57 Tax L. Rev. 483 (2004).
distinction between active and passive income for these purposes need not detain us here. Suffice it to say that active income in this context comprises a substantial tax base, covering a large portion of foreign direct investment (FDI).

Keeping this background in mind, my proposal can be described as comprising four basic components. First, if we are careful to distinguish a source jurisdiction's authority to tax future inbound investments from the future tax streams themselves, then it becomes possible to modify the standard public sector finance chain with, as we shall see, multiple salutary effects. Specifically, rather than borrowing money and financing repayments through its tax function, a developing country could simply transfer, or cede, a portion of its taxing authority (here, to the United States) over future tax base in exchange for a capital transfer now. Following the terms introduced above for the basic public sector finance chain, such a revised financing chain could be abbreviated as transfer-tax{T}. This could be accomplished through the basic format of existing bilateral income tax treaties, an example of which I have provided by offering modifications to the relevant article of the OECD Model Treaty in the Appendix. The modified treaty would have to both (i) shift the primary taxing claim, as compared to typical treaties, and (ii) provide some method of shifting such authority back to the transferee country.68 Regarding the initial shift of authority, the treaty would have to include language that grants the United States exclusive taxing authority over FDI (originating in the United States) into the transferee country. In the case where a U.S. firm conducts FDI through a foreign branch this presents no particular issues mechanically. The treaty could simply specify that only the transferor country can tax its enterprises. Matters become somewhat more complicated where a company operates through a subsidiary incorporated in the transferee country, a situation that requires us to ask: At what threshold of ownership should the transferor country attain the primary taxing claim? This scenario is one instance where the focus on the United States as the potential capital transferor has the benefit of leveraging existing U.S. law. Specifically, my suggestion would be to piggyback on the U.S. rules regarding controlled foreign corporations (CFCs).69 That is, taxing authority would transfer to the United States with respect to profits of a foreign subsidiary only if it is a CFC under U.S. law. Regarding the transfer back of primary taxing authority, the precise terms of this should be subject to negotiation. I imagine two broad approaches. One possibility is that the transfer of taxing authority could be time-delimited, say for some set number of years. Alternatively, the transfer of taxing authority

68. The treaty could also cover the details of the initial upfront capital transfer or this could be left to some other bilateral instrument that is tied to the provisions of the tax treaty. Wherever located, the agreement regarding the capital transfer would at the very least involve terms relating to the amount of the transfer and the timing of disbursement. It would also likely be desirable to handle the identity of the recipient in the treaty, which need not be the central government of the transferee country.

could be amount-delimited, either by amount of tax base over which the United States gains primary taxing authority or by amount actually collected on such base. Such limitations could also be combined. For example, the treaty could specify that the transfer of taxing authority is amount-delimited, but in no case will it exceed a certain period of time.

Second, the U.S. exercise of tax_T in this reconstructed finance chain would involve a truncated base (as compared to the entire base typically available under its domestic taxing power). Specifically, tax_T here would refer to corporate tax collected on income that is the product of FDI of U.S. multinationals and that is sourced to the transferee country.

Third, the United States would impose tax at some specified rate, call it the target rate, on such income on an accrual basis. Thus, in the case of the United States, this would mean that for FDI conducted through foreign subsidiaries, the proposal would necessitate ending the normal practice under which controlled foreign subsidiaries can generally defer tax on such profits pending repatriation. For FDI conducted through foreign branches, the proposal would require applying the target rate instead of the otherwise applicable domestic rate.  

Fourth, the transferee country would agree by treaty to tax inbound FDI from other countries at the target rate. As above, this presents no particular technical issues where the enterprise is a foreign one operating through a local branch. If the FDI is conducted through a local subsidiary, it will become necessary to adopt a definition that distinguishes CFCs of foreign parents from true local companies (unless the source country is content to tax all domestic corporations at the target rate, irrespective of the firm’s ownership). 

Note that this is the chief aspect of the proposal which renders it relatively more amenable to the U.S. tax system. The United States is currently something of an outlier in that it maintains a so-called "worldwide" tax system, under which home country firms are taxed on foreign source income. The possibility of double taxation is addressed through the provision of foreign tax credits. By contrast, most other countries now take the approach of simply exempting foreign source income (at least in the case where it is active business income). To mesh my proposal with the current U.S. system does require key changes as noted in the text—specifically, the end of deferral for a sub-class of foreign income and the modification of the applicable rate. Other countries could also adopt such an approach but it would require greater modification to their existing systems as it would involve departing from an exemption-based system and bringing foreign source business income back into the tax base.

My proposal bears a certain surface resemblance to tax increment financing (TIF), an important financing mechanism used by U.S. localities to fund improvements to economically depressed areas. See Richard Dye & David Merriman, Tax Increment Financing: A Tool for Local Economic Development, LAND LINES, Jan. 2006, at 4. The basic idea underlying TIF is to finance investment through a bond issue secured by future tax increments, as measured against some pre-investment baseline, that result in virtue of the investment. As with my proposal, TIF leverages future tax receipts in a creative way to allow a financing that credit markets are not otherwise providing. Ultimately, however, TIF and my proposal are quite different. TIF bonds will carry a higher interest rate than general obligation (GO) bonds (because holders may look only to a fund holding the tax increment for repayment). A locality may be willing to borrow at the higher TIF rate in order to bypass constitutional debt limitations or the requirement for debt elections. Also, TIF bonds may not count as "debt" and thus may avoid the need to demonstrate the type of public benefit requisite for an issue of GO bonds. The types of hurdles that TIF seeks to overcome are not present in the developing country sovereign financing that I am concerned with in this Article. Those hurdles, rather, are distinct features of burdens.

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To summarize the relevant financial flows and the way in which the proposal melds considerations of public and private sector finance, it may be helpful to have the following diagram in mind:

**Figure 1: Diagram of the Relevant Financial Flows**

1. U.S. Fisc sends up-front capital to developing country; developing country concludes treaty granting taxing primacy to the United States
2. Developing country invests in infrastructure and institutions to raise pre-tax returns
3. Attracted by higher returns, firms undertake FDI in the developing country, as these returns are favorable even on an after-tax basis under the target rate
4. Tax payments repay part of the up-front capital transfer

A reversal of source-residence taxing primacy, as envisioned in my proposal, represents a marked departure from standard lines of thinking about tax and development. Note that the framework that governs taxation in the cross-border setting is very much grounded in the economic relations of developed countries. In the typical bilateral setting this means that the treaties are executed against the common expectation that there will be an important flow of capital running in each direction between the treaty partners. That dynamic, of course, typically does not apply between a developed and developing country, where capital flows are likely to run almost exclusively in a single direction. This has created a need to think about ways in which international tax policy generally, and treaty policy specifically, ought to respond to starkly asymmetric capital flows. In the context of tax relations between developed and developing countries, proposals typically seem to

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72. As proof of the point, consider the simple fact that the two most important model treaties, from which actually executed treaties owe a substantial debt, are the OECD Model Treaty and the U.S. Model Treaty.
coalesce around a single theme. Specifically, it would seem generally accepted that the goal should be to increase developing country ability to control the taxation of income that arises within its borders. Indeed, this can be seen as the raison d'être of the UN Model Treaty, which is meant to establish terms that are relatively more favorable to the developing countries, as compared to the OECD Model. For a specific example, consider tax sparing. That practice involves a country (typically developed), which would otherwise tax on a residence basis, offering tax credits in excess of tax actually paid to a country (typically developing) with source basis taxing authority. Tax sparing is supposed to allow the developing country to use its tax system to provide incentives to attract foreign investors, without having such investors' home country negate the incentive (by offering reduced foreign tax credits to reflect lower tax paid). In effect, the developing country is permitted to exercise its source-basis taxing authority (or not exercise it, as the case may be) without regard to the effect of other tax systems that may have overlapping taxing claims. Likewise, a preference for preserving source-country taxing authority can be seen in proposals that the United States move towards a targeted exemption system, in which profits from developing countries, or at least some subset of them, would be exempt from tax while profits from other countries would remain subject to worldwide taxation.\[73\] Set against calls for greater developing country control over source basis taxation, then, my proposal advocates the exact opposite—the wholesale transfer of primary taxing authority to the residence country.

This departure from typical approaches will have greatest appeal if one ascribes to the view that certain developing countries are caught in poverty traps due to an inability to surpass a requisite capital threshold. The idea would be that the upfront capital transfer could be used to surpass the capital threshold.\[74\] The poverty-trap theory would predict that at this point the country would be on the path to self-sustaining growth and the country should also now be attractive to foreign investment because returns to capital would have risen.\[75\] (Again, as suggested above, the proposal could have appeal even if you rejected poverty traps, so long as you thought the upfront capital transfer could be used to accelerate the improvement of the investment climate in the


\[74\] Of course, just because one transfers enough capital to exceed the threshold does not mean a poverty trap will dissipate. The capital must be put to proper use. This raises a range of difficult questions. They are not questions unique to my proposal, however. This is the same set of questions one would have to face regardless of the financing mechanism.

\[75\] Reliance on a poverty trap theory invites the empirical question whether future tax collections on inbound FDI would be of the right magnitude to surpass a capital threshold. This would raise very difficult questions of measurement, given the disputes surrounding the theoretical basis for poverty traps. In some sense, though, the question is misguided because my premise is that the financing is occurring on at least partially concessional terms.
developing country facing a situation of increasing returns.) I turn now to a
detailed description of the particular advantages of this proposal.

B. **Comparison with Traditional Approach to Tax and Public Sector Finance**

I discuss here the specific ways in which the tax treaty finance proposal
described above improves the traditional approach to public sector external
financing. As suggested in Part II, the essence of my claim for novelty here is
that the proposal revises the standard finance chain (tax→transfer→tax→remit) in
a way that creates value which is intrinsically attached to the very act of
development finance. Such gains cannot be peeled off and used as part of the
broader system of public finance (again, contra new environmental or financial
transactions taxes).

1. **Tax Administrative Efficiencies**

Under the proposal I advance here, the full or partial repayment of the
initial capital transfer is funded through taxes levied by the United States under
the U.S. tax system. This marks an important departure from the standard
arrangement, in which repayments are funded by taxes levied by the
government of the transferee state. I suggest that this represents the possibility
for important cost savings. Implementation and administration of tax systems,
particularly income tax systems for cross-border activities, is complex and
expensive. But many of the costs related to establishing an effective tax system
can be considered fixed start-up costs. The time and resources spent on drafting
statutory language, adopting regulations, and judicial interpretation, are
generally fixed, regardless of the number of taxpayers covered or amount of
revenue collected through the system. In this sense, countries with developed
tax systems have a tremendous advantage over countries that lack such systems
in collecting tax revenues. This advantage is borne out by standard comparisons
of developed country and developing country tax systems, which demonstrate
that developing countries typically collect substantially less in tax revenue (as a
percentage of GDP) than developed countries, notwithstanding the fact that
developing countries may like to collect more in tax revenue. Within the
specific country-to-country dynamics addressed in this Article, it seems clear
that the United States has massive advantages in collecting tax revenues, at
least from a corporate income tax on U.S. resident companies, as compared to
the countries of Sub-Saharan Africa.77

NAT'L TAX J. 299, 303 (2000) (estimating that the average tax revenue, as percentage of GDP, is 18.2% for
developing countries and 37.9% for OECD countries, and citing OECD and IMF statistics).

77. Note that this claim runs counter to the conventional wisdom in international tax policy
circles that collecting tax at source is easier than collecting residence basis taxes, given the greater
informational problems with the latter. But this point has much more salience with portfolio flows than
with direct investment. No doubt the United States confronts difficult problems with taxation of
Indeed, at least from an efficient revenue collection standpoint, the manner in which the cash flows run in the standard financing chain (taxT-transfer-taxR-remit) begins to look hopelessly inefficient. Why have the relatively inefficient tax collector recoup the capital funds rather than the relatively efficient tax collector? It is not difficult to understand why arrangements like this have arisen historically. First, until one takes note of the overlapping taxing jurisdiction, the possibility of the transferor collecting tax revenue directly, rather than looking for repayment raised through the transferee’s taxing jurisdiction, would not have been apparent. Second, this might represent, to some extent, a failure to grasp the ways in which sovereign transactions differ markedly from private counterparts. For example, in the case of ordinary private credit markets, it would be common to think of the market as bringing together one party (the lender) who is capital rich and relatively skilled at monitoring credit risk and another party (the borrower) who is capital poor but relatively skilled at earning a return on capital deployment. It is the return on the capital deployment, of course, that can be used to repay the debt obligation. This does not transfer neatly to the sovereign context. Although one country may well be capital rich and one country capital poor, and though there may be good reasons to deploy capital in the transferee country (satisfying development goals of both countries), the ability to generate a revenue stream to repay the obligation depends crucially on the ability of the sovereign to levy taxes. Here, unlike in the private sector case, it is the transferor country that may well have the comparative advantage in levying taxes.

The administrative gains sketched above occur at the government level. Gains may also be realized at the taxpayer level. This is particularly the case with U.S. CFCs because of the complexities associated with anti-deferral rules under Subpart F and foreign tax credit calculations. Currently U.S. CFCs

multinational, arising, for example, from disputes over transfer pricing. Notwithstanding this point, however, the United States is generally able to collect information required to tax this type of income.

78. In this respect we can take note of the fact that the international tax system we have is contingent. The system could have evolved such that there was no residence basis taxation of foreign source profits at all. In such a world, the proposal advanced in this Article could not even get off the ground. Part of the value of the proposal, then, is to recognize the value of, and capitalize on, this particular contingency.

79. The advantages of relying on extant developed country law to regulate activities within the territory of a developing country have been noted in other disciplines. For an interesting discussion of such advantages with respect to regulation of financial services in Nepal, see Howell E. Jackson, Selective Incorporation of Foreign Legal Systems To Promote Nepal as an International Financial Services Centre, in Regulation and Deregulation, Policy and Practice in the Utilities and Financial Services Industries 367 (Christopher McCrudden ed., 1999).

80. The relevant statutory provisions under “Subpart F” appear at 26 U.S.C. §§ 951-965 (2006). These provisions attempt to strike a compromise regarding the taxation of income earned by U.S. corporations through foreign subsidiary corporations. As a baseline proposition such foreign subsidiaries would be respected as independent taxpayers subject to U.S. tax only on a source basis. In the absence of sufficient activity to generate such source-based tax, taxation would be “deferred” until the U.S. parent company actually realizes income, either through payment of a dividend by the foreign subsidiary or through a sale of shares of the foreign subsidiary. Through a set of very complex rules, “Subpart F” removes this deferral benefit for certain classes of (generally) passive income where there is
must not only meet the compliance burdens associated with direct taxation levied by the source country but must also maintain earnings and profits accounts, under complex rules which depart from those rules applicable to domestic corporations. Calculation of earnings and profits is a predecessor activity to complex substantive tax calculations, involving principally the need to distinguish Subpart F income from non-Subpart F income and the calculation of the indirect foreign tax credit. Under my proposal much of this complexity would simply drop away. The U.S. CFC would, at least for direct tax purposes, be much like a domestic U.S. corporation. There would be no source country income tax obligation. There would be no Subpart F or foreign tax credit calculations. One would, of course, have to apply some method to eliminate double taxation at the corporate level, but this could be accomplished in a simplified fashion. For example, one could allow a total, or partial, dividends received deduction for repatriations to the U.S. parent. (Consolidation should generally not be an option because of the possibility that the target rate would differ from the U.S. domestic rate.)

2. Reduction of Enforcement Costs

Although the terms of sovereign borrowing can replicate private sector instruments in certain ways, there are a number of differences between sovereign borrowing and non-sovereign borrowing. One crucial difference relates to the practice of secured lending. Although it was at one time not uncommon for sovereign borrowing to include security interests as a nominal matter, such interests were essentially unenforceable.\textsuperscript{81} Enforcement of sovereign debt obligations thus looks very different than enforcement in more typical credit markets.\textsuperscript{82} For state creditors, the options for enforcement include the threat of suspending future loans and other types of non-legal remedies, including military or political pressure. These are imperfect alternatives as compared to a secured lending.

\begin{footnotesize}
\footnote{sufficient control of the subsidiary to render it a “controlled foreign corporation” (often shortened to “CFC”), within the meaning of 26 U.S.C. § 957.}
\footnote{See Lee C. Buchheit & Jeremiah S. Pam, The Pari Passu Clause in Sovereign Debt Instruments, 53 Emory L.J. 869, 898 (2004) (“In practice, the ostensible security for these bonds was frequently of very little help in getting the bonds paid in the face of a default by the issuer, particularly a sovereign issuer.”).}
\footnote{There is an economics literature addressing the conditions under which lenders would be willing to make loans given the problems with enforceability. See Andrew B. Atkinson, International Lending with Moral Hazard and Risk of Repudiation, 59 Econometrica 1069 (2005); Jeremy Bulow & Kenneth Rogoff, A Constant Recontracting Model of Sovereign Debt, 97 J. Pol. Econ. 155 (1989); Jeremy Bulow & Kenneth Rogoff, Sovereign Debt: Is To Forgive To Forget?, 79 Amer. Econ. Rev. 43 (1989); Herschel I. Grossman & John B. Van Huyck, Sovereign Debt as a Contingent Claim: Excusable Default, Repudiation, and Reputation, 78 Amer. Econ. Rev. 1088 (1988); Harold Cole & Patrick J. Kehoe, Reputational Spillover Across Relationships: Reviving Reputation Models of Debt (Fed. Reserve Bank, Working Paper No. 534, 1994). Some of the key factors in the models that promote willingness to lend are the lender’s ability to call upon other sanctions, including reputational sanctions, and the borrower’s ability to smooth fiscal shocks by means other than borrowing.}
\end{footnotesize}
The proposal I advance here, however, allows the state "lender" to get something that is analogous to a security interest in the borrower's future tax revenues. Prior analysis has overlooked this possibility because it has not taken account of the overlapping taxing entitlements at play here. That is, the problem has been analyzed as if the creditor and debtor economies were in effect closed to one another, other than for the sovereign borrowing. If that were the case, then it would indeed follow that a sovereign lender could not achieve the effect of a security interest in the borrower's tax collections. The debtor country would essentially tax economic activity occurring within its borders; the creditor country would have no legal mechanisms to get the tax revenues in the event of nonpayment. But this picture changes radically once we consider the effect of other cross-border capital flows between the countries. Returns to such capital, to the extent owned by resident companies or individuals of the lender country, are within the scope of its residence basis taxing jurisdiction. Under the typical international tax arrangements, we have seen that the residence jurisdiction cedes this right with respect to non-portfolio capital investments. By reversing the primacy of taxing jurisdiction—that is by making the residence basis authority superior to the source basis authority—the lender country can get the equivalent of a security interest in the debtor's tax collections. Indeed, it gets something even better than a security interest, since it can bypass actual legal enforcement.

To capture the point in a different way, we can think back to the standard finance chain: tax\(_T\)-transfer-tax\(_R\)-remit. Conventional wisdom is that the lender country cannot take a security interest in tax\(_R\). This is true when the economies are closed to one another (other than the sovereign borrowing). But when the economies are open and residents of the sovereign lender invest capital in the territory of the sovereign borrower the sovereign lender could, under its residence basis authority, tax a portion of the economic income that arises in the borrower's territory. In effect, the sovereign lender has the capacity to collect the tax directly from its own residents. Under current norms we do not do this. The capital income is instead taxed, if at all, by the borrower, after which, as we have seen, it is not possible to take a security interest in the income. Under my proposal, the lender can collect revenue from parties (i.e., resident companies or individuals) who are subject to liens rather than waiting to collect revenue from a party (i.e., the sovereign borrower) who cannot be made subject to a lien.

83. Although the structure did not rely on overlapping tax entitlements, there is a quite interesting precedent for my proposal with respect to indirect taxes. It has long been recognized that if a security interest in the borrower's future tax revenues is to be effective, the funds must somehow be prevented from coming under the borrower's dominion. See 1 EDWIN BORCHARD, STATE INSOLVENCY AND FOREIGN BONDHOLDERS 91 (1951). One approach that had been used historically to achieve this result was for bondholders to take over direct collection of customs duties that would have otherwise flowed to the sovereign borrower. See id. at n.57.

84. The exception historically was with respect to indirect taxes that the lender somehow managed to collect directly. Id. at 91.
To be clear, the reduction in enforcement costs described here does not mean that for a particular financing the expected value of repayments that arise through expanded tax authority is greater than the expected value of repayments that arise from straight governmental servicing of debt. Many loans, of course, require no execution on a security interest to enforce. The borrower simply repays the debt because it has the resources to do so and repayment is a better option than the costs associated with default. Thus, it is certainly possible that for a given financing, the full amount meant to be repaid is in fact repaid under standard financing approaches, whereas under my tax treaty finance proposal something less than that sum would be collected because, for example, insufficient cases of foreign direct investment by U.S. multinationals arise. If this state of affairs seems unappealing, it would always be possible to stack a traditional debt obligation on top of the tax treaty finance proposal. Thus, for a given amount of upfront capital transfer, the recipient country could become secondarily liable under a straight debt obligation if increased tax collections (in virtue of the expanded treaty right) failed to surpass a stated amount. This would increase the expected value of repayments under the financing arrangement, but it would do so at the cost of introducing the prospect of a sovereign default. As discussed in the immediately following Subsection, it is a further advantage of the tax treaty finance proposal that, in its straight form, it removes the prospect of costly sovereign defaults. Ultimately, these two interests—the benefit of increased revenue to the financing country and the detriment of increased risk of default for the financed country—must be balanced against one another. It is premature to come to any conclusion on this matter in this Article, other than to note that the tax treaty finance proposal, to the extent it is coupled with traditional financing, has sufficient flexibility to implement a wide range of possible tradeoffs.

3. Risk Shifting

One significant danger of traditional sovereign debt is the effect that such obligations can have during economic downswings. In a world with relatively open markets and cross-border financing, the problem for countries existing on the margin is the way in which concerns about the health of the economy can become self-fulfilling prophecies. For example, if currency traders fear that a country will be unable to make a large impending debt payment, then they may begin to sell off the currency. As panic sets in, more and more parties may dump the country’s currency, leading to downward pressures on the currency’s value and an even greater likelihood that the country will in fact be unable to service its debt. See Ming-Yu Cheng & Sayed Hossain, Malaysia and the Asian Turmoil, 2 ASIAN-PAC. L. & POL’Y J. 125, 128 (2001) (arguing the financial crisis experienced by Malaysia in 1997 was associated, in part, with the activities of currency traders and a wider market overreaction, both of which contributed to a sudden outflow of capital and a plunge in the exchange rate).
imagine that the best way to approach the problem would be to finance on ever more concessional terms, thus diminishing the likelihood of the country defaulting on its debt obligations. But increasing concessionality can also raise political hurdles in transferor countries.

One frequently discussed novel finance instrument of late that addresses this concern is the GDP-indexed bond. The key design feature of GDP-indexed bonds is that the payment terms are positively correlated with transferee country GDP. This operates as a built-in safety valve because as GDP drops, the repayment obligation becomes less onerous.86 The payment terms adjust not only downward (with lower GDP) but also upward (with higher GDP). As compared to straight debt, it is as if the transferor country takes an equity interest in the transferee country's economy. Properly structured, one should be able to create a GDP-indexed bond that replicates the amount of concessionality in a non-adjusting bond. That is, \textit{ex ante} the present value of the repayment obligation under the non-adjusting bond and the adjusting bond could be the same.87

One can easily imagine why this might seem objectionable. Given the relative wealth of the developed transferor country versus the relatively poor transferee country, it might seem exactly contrary to development goals that just when the developing country achieves the actual economic growth that is being sought, the transferor country swoops in and reclaims a portion of the economic gains. Focusing on the \textit{ex post} nature of the obligation, however, is shortsighted. For the developing country, financial crisis is a real and catastrophic possibility. In such circumstances, it makes sense for the transferee country to behave in a risk-averse fashion. In other words, it is perfectly sensible that the transferee country not be indifferent as between transfers that give rise to the same \textit{ex ante} expected repayment obligation. Indexed bonds, in effect, graft an element of insurance onto the capital transfer, thereby spreading risk across the developed and developing country economies. This is a matter of indifference to the developed country, which is likely to be interested in only

86. GDP-indexed bonds would operate by adjusting the interest rate either up or down based on the variance between the GDP at the time of issuance and the GDP in a given year. Borensztein and Mauro give a hypothetical example of a country that has a "trend" GDP growth rate of 3% and access to traditional bonds at a rate of 3.2%. With GDP-indexing, the country could issue bonds with yearly coupon payments of 3.2% plus or minus 0.7 times the amount of the difference between the expected growth and the actual growth achieved. A growth rate of 4% in a given year would mean that year's coupon payment would be 3.9%, while growth of 2% would result in a coupon of 2.5%. Eduardo Borensztein & Paolo Mauro, Reviving the Case for GDP-Indexed Bonds 5 (Int'l Monetary Fund Discussion Paper No. PDP/02/10, 2002), available at http://www.iadb.org/res/centralBanks/publications/cbm34_165.pdf. Indexation to commodities has also been proposed; private Chilean firms have issued instruments indexed to copper, while Mexico has issued bonds indexed to the price of oil. Id. at 4.

87. The caveat that the bond be "properly structured" is important because one could either increase or decrease the amount of concessionality depending on how the repayment obligations adjust to upward versus downward swings in GDP (for example, a bond could adjust downward by a greater factor than it adjusted upward).
the *ex ante* expected returns, given that its economy can easily absorb the shock in the low growth state of the world. To the developing country, however, the risk-shifting performs the valuable function of exchanging rapid growth in economically expansionary periods for manageable debt obligations during periods of low growth.

My tax treaty financing proposal achieves the same type of risk-shifting as GDP-indexed bonds but with two advantages. First, it does not suffer from the same sort of monitoring problems associated with such bonds. That is, with GDP-indexed bonds, borrowers have the incentive—and likely the ability—to manipulate the national income accounts in a way that reduces repayment obligations. Second, GDP-indexed bonds have limits. Where GDP sinks below the baseline, the bonds provide for a downward adjustment to interest rates. Nonetheless, the bonds do not cancel the repayment obligations. Where the transferee country experiences much lower than expected GDP, the expected result can be debt service payments at lower levels—but at levels that are still sufficiently high to threaten the type of panic described above. Under my proposal, however, there are no debt service payments, ever. The transferor country simply recaptures the initial transfer, or some fraction thereof, through tax collections under its own system. If those tax revenues are lower than anticipated, then the transferor country bears the risk of not recouping the full amount anticipated at the time of the initial capital transfer. Of course, the transferor country bears this type of risk under typical debt instruments as well. The crucial difference is that under the treaty proposal in which the risk of loss on the part of the transferor ripens into an actual loss, there is no debt default or other event that might precipitate the type of downward spiral described above.

This type of risk-shifting advantage does come at a cost, however. As discussed above in connection with enforcement costs, the transferor country is dependent for “repayment” upon a much curtailed base. That is, the transferor can look only to FDI owned by its multinationals, whereas in traditional financing the source of repayment would be general revenues of the transferee country, which could be derived from the entire range of potential tax receipts. To make the problem concrete, suppose that the U.S. engaged in my proposal with a certain developing country, which in turn became quite attractive as a destination to FDI. If, for whatever reason, FDI is attracted from third countries, but not the U.S., then there would be no recoupment of the financing.

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89. In theory, one could design a “debt” instrument with the same features. There is no conceptual bar to describing the repayment obligation under a debt instrument in terms of whatever the actual collections would be under my proposal. That is, the debt instrument could state that the repayment obligation is equal to the amount of tax that the United States would have collected on outbound FDI into the developing country had it imposed accrual basis taxation at the target rate. Needless to say, however, such a mechanism would be extremely difficult to implement in practice.
This seems problematic. As noted above, a possible remedy to this problem would be to have a supplemental repayment obligation that kicks in if U.S. tax collections from FDI of its companies fall below a certain amount. This presents once again the inevitable tradeoff between increasing the stated legal obligations to the transferor country and the increasing likelihood of default, two factors which must run in tandem.

4. Reduction of Agency Costs

Structural-adjustment lending has earned a bad reputation in development circles.\textsuperscript{90} However, it is possible to tell a story in which transferor and transferee interests are actually aligned but in which it is difficult for the transferee government to enact a given policy because of political constraints.\textsuperscript{91} If so, tying the capital transfer (and even more powerfully, tying future additional capital transfers) to the enactment of the common policy interest should afford the transferee government some amount of political cover that would not arise otherwise. This strategy, however, requires a credible commitment to enforce the conditions. One strand of the anti-conditionality literature, though, stresses that conditions are rarely enforced. The suggested reason for this is that the actors who ultimately make the decisions about whether there has been compliance with conditions have little or no incentive for enforcement. Those decisions are often made from within the international financial institutions. Moreover, enforcing the conditions will often simply mean that disbursement budgets, and therefore prestige and power, are reduced in the future. So long as the assessment of whether conditions have been satisfied runs through agencies in which parties have incentives to disburse more rather than less funding, it is difficult to see how to break free of this problem.\textsuperscript{92}

\textsuperscript{90.} See Easterly, supra note 17, at 303-05 (noting mixed record of success for IMF adjustment lending); John W. Head, Seven Deadly Sins: An Assessment of Criticisms Directed at the International Monetary Fund, 52 U. KAN. L. REV. 521 (2004) (rejecting criticisms that IMF conditionality tramples national sovereignty and prescribes “bad medicine,” but largely endorsing criticism that IMF conditionality creates distributional inequalities); Joseph E. Stiglitz, Failure of the Fund: Rethinking the IMF Response, 23 HARV. INT’L REV. 14, 14 (2001) (arguing that IMF policies have, in fact, contributed to global economic instability, rather than ameliorating it).

\textsuperscript{91.} See CONG. BUDGET OFFICE, THE ROLE OF FOREIGN AID IN DEVELOPMENT 32 (1997) (noting that “[p]olicy dialogue and conditionality have perhaps been most effective when recipients knew they had to make reforms and wanted to make them but needed some extra political cover to do so”), available at http://www.cbo.gov/sites/default/files/cbofiles/fpdocs/Oxx/doc8/foraid.pdf.

\textsuperscript{92.} See Jakob Svensson, Why Conditional Aid Does Not Work and What Can Be Done About It?, 70 J. DEV. ECON. 381, 390 (2003) (“The key question is, what happens with the committed funds (corresponding to $t$ in the model) when the recipient is perceived as failing to reform? The answer, depicted in Table 2, is ‘very little.’”); id. at 398 (“As a result, there is a strong bias towards ‘always’ disbursing aid to the ex ante designated recipient, irrespective of that recipient’s performance and (irrespective of) the conditions in other potential aid recipient countries.”); see also Steven Radelet, A Primer on Foreign Aid 13 (Ctr. for Global Dev., Working Paper No. 92, 2006) (“Third, conditionality does not seem to work. . . . Many donors continue to disburse aid even when recipients fail to meet conditions, sometimes repeatedly so. Donors are faced with their own internal incentives to continue to
Bootstraps and Poverty Traps

The tax treaty finance proposal offers a possible solution, however. If one believes that the problem with current instruments is with the incentives of the party assessing conditionality, then the solution would be to shift the assessment to some other party. But to which party? Typically conditions have been tied to actual capital transfers. Either the conditions must be met upfront or conditions attach to some future disbursements. With the tax treaty finance proposal there is another possibility. Under this proposal, the transferee finance country is interested not only in the actual capital transfers but also in regaining valuable taxing rights at some point down the road. Attaching conditions to the capital transfers themselves merely replicates the traditional way of doing things. But one could also attach conditions to the terms regarding the transfer back of primary taxing rights to the transferee country. For example, if certain conditions are met, the taxing power might revert more quickly. The advantage to this, as compared to traditional approaches, is that the parties assessing whether the conditions are met would presumably be located somewhere in the executive branch of the U.S. government. Now the incentives would seem properly aligned. Because the desire will be to retain the taxing authority, the parties determining whether conditions are met will actually be pre-disposed to be overly critical rather than too generous. Whether the incentives go too far in this direction raises a difficult design issue. Put simply, the proposal provides an avenue for approaching conditionality that circumvents the problems of non-enforcement that have plagued prior arrangements. If one can structure such conditions so that they are favorable to development (which is obviously a hotly debated issue), then the treaty finance proposal could further this goal.

C. Comparison with Traditional Approach to Tax and Private Sector Finance

It is appropriate to begin a discussion of the relationship between tax and private sector finance with a healthy dose of humility. Although it is an important finding in relatively recent empirical research that firms are in fact responsive to tax rates in their decisions regarding location of foreign investment, it remains the case that non-tax factors may well drown out tax considerations in capital location decisions.\textsuperscript{93} Not surprisingly, then, the bulk of thinking about novel approaches to private sector development finance in development circles has not really focused on the role of taxation at all.\textsuperscript{94} Even so, tax likely remains an important marginal consideration and there has been a long-running debate among international tax policy experts regarding the
disburse aid to support the contractors and recipients that depend on it. They also face a 'Samaritan's dilemma' that withdrawing aid would create short-term pain for the very people it is aimed to help.'


\textsuperscript{94} Cf. \textit{WORLD BANK}, supra note 8 (exploring a range of non-tax private sector finance innovations).
optimal policy here. In the discussion below, I will first sketch the two basic positions that one finds in these debates, and why I find the state of this discourse unsatisfactory. I will then turn to an explanation of how the tax treaty finance proposal offers a promising new way to analyze the relationship between taxation and private sector development finance.

1. The Traditional Debates on Tax and Private Sector Development Finance

Broadly, this debate over tax and private sector finance is between those who favor the use of targeted tax incentives by developing countries and those who reject the efficacy of such incentives.\(^{95}\) There is an extensive literature setting out both the arguments for and against tax incentives. Proponents view such provisions as essential to development; critics find them inefficacious, at best, outright harmful at worst. The case for targeted tax incentives as an appropriate pro-development mechanism typically relies upon some type of argument about market failure. For example, it may be claimed that private investment in a developed country provides for certain externalities in the form of spillover benefits.\(^{96}\) These relate to matters such as the beneficial effects of introducing new forms of knowledge into the locale, thus leading to a generally more productive local workforce. Such externalities are not captured in private rates of return and, thus, markets would under-allocate resources to the developing jurisdiction. A tax incentive could remedy this defect in market allocations. Similarly, proponents of incentives might hold the view that aside from the issue of externalities, information gaps regarding likely private market returns thwart optimal allocations of capital and tax incentives correct for this.\(^{97}\)

A final type of possible market failure is very closely related to the overall topic of this Article. One factor that likely holds investment in certain developing countries to relatively low levels is the lack of basic infrastructure and adequate institutional arrangements. If so, then it would seem that one way to correct for this is for the jurisdiction to borrow money so that it can redress these shortcomings. The problems with sovereign debt, or the unavailability thereof, can then be seen as a market failure in the sense of inadequate or incomplete credit markets. For proponents, tax incentives could then make up for this.

Critics of tax incentives frequently do not dispute these basic market-failure arguments. It is possible, rather, to call such incentives into serious question, even if the underlying market-failure claims happen to be correct. Specifically, critics of tax incentives frequently highlight the particular costs of

\(^{95}\) For an excellent treatment of the historical contours of this debate regarding tax incentives and tax sparing, see Kim Brooks, Tax Sparing: A Needed Incentive for Foreign Investment in Low-Income Countries or an Unnecessary Revenue Sacrifice, 34 QUEEN'S L.J. 505 (2009).

\(^{96}\) See id. at 533.

\(^{97}\) See id. at 534-35.
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tax incentives. A partial list of such detrimental costs would include the following: revenue loss to developing jurisdictions, the fostering of local firm discontent because they are treated relatively worse than foreign firms granted incentives, the creation (as well as reduction) of various market distortions, or the encouragement of tax competition which may simply have the effect of improving one country's capital shortfall at the cost of worsening the capital shortfall of another.98

Each side in this debate over tax incentives accords with certain doctrinal implications. Because potential tax incentives are enacted in this context against a backdrop of overlapping entitlements to tax the returns to private sector investment (both by the developed country where the capital is owned and by the developing country where it is deployed), such incentives can have meaningful effect only if developed countries do not eradicate tax reductions by stepping in and collecting tax that would have otherwise gone to the developing country in the absence of the incentive. Advocates for the use of tax incentives thus urge some method of ensuring that developed country tax policy leaves space for tax incentives to operate. Critics reject such methods. As a doctrinal matter the goal of allowing a developing country's tax incentive to have operative effect can generally be achieved in one of three ways: the developed country can exempt foreign source income (such as dividend repatriations from subsidiaries in developing countries) from tax; the developed country can offer deferral of the income of foreign subsidiaries (effectively allowing elective exemption pending repatriation of profits); or the developed jurisdiction can offer a tax sparing provision by tax treaty, in which case a credit is given for the developing country tax that would have been imposed in the absence of the tax incentive.99 Because the first two of these approaches (exemption and deferral) have quite broad application outside of the context of development (i.e., they frequently apply to cross-border investments between two developed countries), the focal point of discussion regarding tax policy and private sector capital flows to developing countries often rests on the perceived merits and detriments of tax sparing, and of course the tax incentives the practice is meant to protect.

Given this framework, the obvious way forward regarding both the policy question regarding the desirability of incentives and the doctrinal question regarding the merits of something like tax sparing is to weigh the perceived costs and benefits of tax incentives/tax sparing under a basic cost benefit framework.100 The problem one confronts here is that many of the potential costs and benefits are near impossible to measure. Consider, for example, the case for incentives based on the positive externalities, or spillover effects,

98. See id. at 538-46 for an elaboration of these, and other, costs of tax incentives.
99. See id.
100. For a good example of this methodology, see id.
thought to accompany foreign direct investment.\textsuperscript{101} Such spillovers almost certainly exist to some extent. Quantifying them in a cost-benefit framework, however, is quite difficult. Consider as well the basic problem with lost revenue that follows from tax incentives. The issue here is an informational one. Jurisdictions will inevitably offer some incentives to inframarginal capital that would have been attracted absent the incentive. Again, the fact of lost revenue is near certain, but quantifying a precise amount is quite challenging. Of course, we could do what we often do in such situations—muddle through and take our best shot at estimating the net effects of a policy.

My approach, though, seeks to move beyond this type of analytical framework. I am compelled by two factors. First, irrespective of the net effects of incentives and sparing, it is beyond question that there are substantial costs and problems to the approach. Further, as I suggest below, I believe that the tax treaty finance proposal outlined is capable of bypassing, or at least minimizing, some of the chief costs. Second, supposing that critics of tax incentives and tax sparing are correct in their evaluation that such policies are on net not a good idea, there has been no serious alternative vision put forward regarding the role of taxation in private sector finance. Thinking on the topic has stagnated, such that the only options on the table seem to be fine tuning the incentives/sparing approach to make it relatively better than current incarnations or rejecting tax as an effective policy lever in facilitating private sector development finance. I offer my tax treaty finance proposal as a third way, a new way to think about tax and private sector development finance that addresses some of the chief concerns with the incentives/sparing framework.

2. The Tax Treaty Finance Proposal and Private Sector Development Finance

Consider, then, two powerful indictments of the tax incentives/tax sparing approach: the loss of essential revenue and the pernicious effects of tax competition. These phenomena are related and tend to aggravate one another. The loss of revenue stems from the informational gap mentioned above. Because developing countries (indeed all countries) will have difficulty separating marginal capital (the capital which requires the incentive to relocate) from inframarginal capital (the capital which would have been deployed in any event), costly incentives will inevitably be offered to inframarginal capital, thus resulting in pure revenue loss. Tax competition aggravates this, as it forces ever more generous incentives.\textsuperscript{102}

\textsuperscript{101} For a discussion of the issue, see id. at 531-32.

\textsuperscript{102} On the harmful effects of tax competition for developing countries, see Michael Keen & Alejandro Simone, Is Tax Competition Harming Developing Countries More than Developed?, 34 TAX NOTES INT'L 1317 (2004).
Thus, in the competition for scarce capital, developing countries frequently compete down their tax rates, particularly on inbound foreign investment, through the provision of tax holidays and other incentives. Developing countries thus face a quandary. One way to improve their attractiveness as a destination for FDI would be to borrow to finance improvements. But if resulting inbound capital represents an important component of tax base and rates on such investment are bid down to zero, or very low levels, then the developing country may well lack the ability to raise funds to repay the financing.

My tax treaty finance proposal, however, could allow one to achieve coordinated taxation on inbound investment into developing countries at the target rate. Suppose that the United States were to execute a series of treaties implementing my finance proposal across a set of countries in Sub-Saharan Africa. Then the United States would tax its firms at the target rate on an accrual basis where income is sourced to participating developing countries (prong three of my proposal) and the transferee countries would likewise tax FDI originating in countries other than the United States at the target rate (prong four of my proposal). In essence, the proposal uses the market power of the capital transferor and the coordinating aspect of tax treaties to stem tax competition. Note that the conjunction of prongs three and four of the proposal are crucial. In a world where developing countries are already competing rates on inbound corporate capital down to zero, or close to zero, then the United States could unilaterally end deferral on the profits of its CFCs. One would not need a treaty to accomplish this. But then one would expect that investment flowing into the developing country would simply be channeled through some other jurisdiction that applies a territorial system or allows tax sparing. If one is to achieve a uniform positive rate of taxation on inbound corporate capital then it is necessary to plug the holes through which low-taxed capital could enter the jurisdiction. One way to do that would be to convince developing countries to swear off competition. Thus, a fundamental advantage of my proposal over typical debt financing is that, through centralization of the decision to determine the tax rate on corporate income, it may be possible to preserve a portion of the tax base for repayment of the financing that would otherwise be lost.103

103. This call for a move towards harmonization is not as fanciful as one might think. Admittedly, almost all normative treatments of international taxation begin from the starting point of substantial divergences across tax systems. The basic problems of international taxation involve the construction of appropriate domestic and treaty law against the backdrop of such differences, as opposed to the elimination of such differences at the national level. The elimination of such differences is accepted as politically impossible—and normatively undesirable, as sovereign jurisdictions will appropriately take different views about the appropriate size of the public sector. I accept all of this. The type of harmonization envisioned by the tax treaty finance proposal, however, should be distinguished from a call for broad-based harmonization on at least three grounds, which serve to address both the political pragmatics and the normative considerations. First, the coupling of the coordinating mechanism with an upfront capital transfer makes the deal substantially more appealing for the jurisdiction adopting harmonizing rules, as compared to the case where countries are simply bargaining over what a
This outcome may seem too good to be true. It is a standard result in the economics literature that a small, open economy cannot tax income from capital. The small, open economy is, in effect, a price taker with respect to the return to capital income. It thus lacks market power to affect the equilibrium after tax returns. If the country attempts to levy a capital income tax, then capital stocks will decrease (that is, capital flees the jurisdiction) until the after tax rate of return reaches the worldwide equilibrium. If the small, open economy ignores its status as such a price taker and attempts to levy a tax with nominal incidence on capital income, then the prediction is that economic incidence of the tax simply falls upon the immobile factors in the economy, typically labor. Because of this dynamic, economists generally frown upon source-based taxes of capital income imposed by small, open economies. Such taxes create an inefficiency—the distortion of production location—without the presumably desired distributional effect of imposing a tax burden on capital instead of labor. But how can the mere coordination of rates across some subset of small, open economies get around this problem? That is, my claim is that it may be possible both to raise tax rates (that is, the target rate may well be higher than the rate applicable in the baseline scenario) and to increase foreign direct investment into the developing country. Why would investment stay rather than flee to non-participating developing countries or to the developed world? Again, much depends on whether you buy into the theory that in certain developing countries there may be increasing returns to capital (and a capital threshold below which the country falls back to a low-growth equilibrium). If there are increasing returns, then there is nothing inconsistent with the idea that you can both increase tax rates and increase investment. The key is that the upfront capital transfer be deployed in a fashion that raises returns to capital. In theory there would be some cushion to impose positive tax rates. This is the essential bootstrapping character of the proposal. The revenue collected from the profits of firms investing in a country experiencing increasing returns is used to pay for the public sector financing that makes such returns sufficiently high to be appealing in the first place.

104. See A. Lans Bovenberg, Perspectives on Tax Policy in Small and Open Economies, 96 SCANDINAVIAN J. ECON. 283, 284 (1994).


106. Id.
There are, to say the least, difficult technical problems lurking here. Even if there are increasing returns, one must confront a range of issues, which have plagued development experts for decades, regarding how to ensure the capital transfer is used to good effect. And, in setting the target rate, one would have to make a determination about how much cushion there is to impose positive rates and yet still attract investment. Moreover, one would have to assess the standard tradeoff between revenue and capital attraction. There may be a cushion that allows one to increase rates and attract incremental capital; but of course it remains the case that one could attract even more capital by lowering rates even further. But even for countries that are generally capital-poor, setting policy to maximize the amount of inbound investment may not be the optimal policy. If the inbound capital is a crucial portion of the potential tax base, then one would want to strike the appropriate balance between capital attraction and revenue collection. Striking this balance simply restates the basic problem of marginal versus inframarginal capital that appears in the standard incentive/sparing paradigm. My proposal alleviates this problem to some extent. That is, one can attract more capital by lowering the target rate but then the benefit is likely to be afforded to inframarginal capital as well, yielding a revenue loss without any allocational gain. As compared to the standard setup, however, there is still almost certainly more tax revenue collected than under the standard approach of incentives/sparing.

In principle, if there are increasing returns, then the ideal response in a world with complete information would be for the developing country to tax just those investments offering a premium over the worldwide equilibrium after-tax return. In that way, the country could maximize tax revenue without sacrificing any capital attraction. Moreover, if the developing country had this information, then it would not need to coordinate with other developing jurisdictions that might be experiencing increasing returns. That is, it would not be competing with them for capital. Rather, with the right tax rate it could attract as much capital as it wanted until its returns finally began to decrease and reach the worldwide equilibrium. Alas, jurisdictions do not have this information, as evidenced by the phenomenon of tax competition in the first place. In other words, even without increasing returns, the optimal response would be to tax relatively high return capital investments. As long as the after-tax return did not drop below that available on the marginal investment, then the capital would not be sacrificed. Lacking the ability to sort investments in this fashion, jurisdictions make policy at the margin and thus tax competition persists in the absence of centralization.  

Some scholars have argued for the merits of tax competition. See, e.g., Julie Roin, *Competition and Evasion: Another Perspective on International Tax Competition*, 89 GEO. L.J. 543, 554-85 (2001). To the extent that corporate taxes function as quasi-prices reflecting the provision of governmental services then the efficient result is one in which jurisdictions are able to set their tax rates in accordance with the quality of government services. Forcing harmonized rates in a world with differential services would thus be inefficient. This type of pro-tax competition argument has less force,
IV. Objections

In this last Part of the Article, I address a number of possible complications of the treaty finance proposal.

A. Sovereignty

Likely, the largest complication with the tax treaty finance proposal is the way in which the contemplated transfer of tax primacy runs from the developing to the developed world. This may strike some as unfortunately reminiscent of power arrangements from the colonial era and objectionable on that basis alone.\textsuperscript{108} This objection strikes me more as one of perception (which, to be sure, must be addressed given the ultimately political nature of the problem) than of reality. Note first that entry into the type of tax treaty described in this Article would be a wholly voluntary activity undertaken by the transferee country. The arrangement thus bears little relationship to circumstances in which former colonial powers extracted wealth from poorer nations through military or political influence.\textsuperscript{109}

Indeed, one could even make the stronger claim that the paternalistic stance is actually the one that would reject the treaty finance proposal on sovereignty grounds. It is commonplace for developing countries to undertake debt. We may well worry whether debt levels are sustainable or whether proceeds are being used in a way that maximizes the likelihood of repayment. But we do not reject such arrangements out of hand as neo-colonialism simply because a future repayment obligation will run from the developing to the developed world. Rather, we think the arrangements, at their best, represent an efficient use of credit markets to move capital to its optimal use. Why would the treaty finance proposal be more objectionable on sovereignty grounds? The whole point of the treaty finance proposal is to allow a country to begin with a capital transfer with a specific degree of concessionality and improve upon this state of affairs. As an example, consider the effects on tax competition discussed above. I have suggested that under my proposal one achieves centralization of rate determinations which can stem tax competition. Thus, as a revenue-raising tool, the tax sovereignty that is being transferred becomes more valuable when exercised by the transferor country. One could characterize a

\textsuperscript{108} Perhaps the closest precedents for my proposal are the customs house arrangements under which foreign bondholders would take over direct collection of customs duties that would have otherwise flowed to a sovereign borrower. Much maligned in the developing world, it is necessary to distance my proposal from these arrangements. See supra note 83.

\textsuperscript{109} Cf. Jackson, supra note 79, at 398-99 (critiquing the suggestion that selective, voluntary incorporation of foreign law by Nepal would constitute a loss of sovereignty reminiscent of colonialism).
developing country’s attempt to seize that benefit as a wise exercise of sovereignty.

It is also worth considering the sovereignty objection against the backdrop of current tax collections. For example, for the most recent data available, the Treasury estimated total foreign tax payments to countries in Africa by U.S. CFCs at approximately $1.34 billion. Much of this is attributable to income from natural resource extraction (which might be dealt with separately in my proposal) and payments to South Africa (which would not be a prime candidate for my proposal). In other words, given the current low levels of FDI and high levels of tax competition, the rights ceded under my proposal may not have all that much value in the absence of cession.

A somewhat different version of the sovereignty argument might be based less on concerns about reinstitution of a form of modern day colonialism and more about the effects on the ongoing revenue needs of the transferee country. Does the proposal remove the ability of the transferee country to use its taxing power to finance ongoing costs of government? The simple answer is no, because the transferee country will still have important tax bases open to it. What is surrendered by treaty is simply one aspect of its overall taxing authority.

B. Enforceability

The treaty finance proposal involves some amount of capital transfer in the present in exchange for a promise not to tax certain income in the future. The natural question that arises is whether such a promise is enforceable. Put another way, what recourse would the United States have if one of the transferee countries simply repudiated the treaty and reasserted its right to engage in the source basis taxation of U.S. enterprises?

The most powerful response is that concerns about repudiation through reassertion of taxing rights ignore the basic tax competitive pressures that already exist currently. Although the transferee state would seem to have an incentive from a revenue standpoint to violate the treaty by seeking to tax U.S. firms, the state would also face the countervailing consideration that governments always face with respect to imported capital. Raising tax rates will drive capital, and thus the tax base, away. Put another way, if the treaty finance proposal is implemented against a backdrop of tax competition, then the incentive to breach will not manifest itself in a reassertion of taxing authority but rather the exact opposite—taxing firms at a rate lower than the target rate. Because the ability to adjust the corporate tax rate will no longer be under the control of the developing country, the real risk of breach may be attempts by countries to reduce the rate of tax on FDI indirectly by, for example, offering

110. IRS, STATISTICS OF INCOME BULLETIN 227 (Winter 2011).
subsidiaries of some form or another. If the developing country were simply to offer subsidies to U.S. firms, this would not seem to present any immediate problems. To the contrary, this could well generate additional U.S. investment, increasing the tax base available to the U.S. under its treaty-expanded taxing rights. But the natural incentive of the developing country, acting in its own interest, suggests the likelihood of a different type of breach. To the extent that tax-competitive pressures continue to exist, the developing country would much prefer to offer subsidies selectively to third-country firms. With this move, it could both attract incremental capital and differentially attract capital through firms over which it, rather than the United States, has the primary right to collect tax at the target rate. To address this concern, the treaty could include provisions that seek to curtail the use of subsidies that would have the same effect as reducing the target rate on inbound FDI. Such provisions could take one of two forms. First, they could simply state directly that subsidies that have the effect of lowering the target rate are not permitted. Second, they could attempt to achieve the goal indirectly through a type of non-discrimination provision, providing that any subsidies must be offered to all firms on equal terms. Such a non-discrimination provision would seek to prevent the developing country from establishing differential effective rates for U.S. firms and firms from third countries.111

The above response appropriately shifts the focus of discussion from the risk of the developing country increasing its treaty permissible tax collections to the opposite concern of decreasing the rate contemplated by the treaty. The response does not, however, provide an answer to the question of what to do if the developing country simply ignores treaty specified prohibitions on subsidies. One should acknowledge that such risk cannot be eliminated. Even so, it may be possible to structure matters to minimize the likelihood of such a possibility. For example, the treaty finance proposal could be structured such that some amount of the overall capital transfer is held in trust for some period of time. If the transferee country were to violate the treaty by reasserting taxing jurisdiction, then these additional funds would be forfeited. Although circumstances would vary from country to country, such an approach might also be consistent with overall development policy. While the whole point of the proposal is to facilitate upfront transfers of capital to countries that are capital poor, there may be limits to how quickly an economy can absorb an

111. There is a further possible benefit from a non-discrimination provision, which ideally would be worded to include home country firms, as well as U.S. firms and third-country firms. If the developing country seeks to use a fiscal instrument, such as a subsidy, to attract additional capital, then its optimal strategy would be to preclude the availability of the subsidy for home country firms, where it would function as a straight revenue loss without any capital attraction benefits. Thus, requiring the developing country to offer any subsidy on like terms to home country firms should serve to limit the incentive to offer subsidies in the first instance.
influx of capital without causing adverse macroeconomic consequences such as the inflationary pressures that are associated with Dutch disease.\textsuperscript{112}

Finally, although it is appropriate to focus on the relevance of tax competitive pressures and the likelihood that the developing country might attempt to offer subsidies, one cannot rule out the possibility that the developing country might attempt to exercise taxing authority in excess of that permitted under the treaty. One could attempt to address this type of breach through the sort of trust mechanism just mentioned. Additionally, the United States could attempt to protect its financial interests under the treaty in other ways. One possibility, for example, would be to make any taxes levied in contravention of the treaty non-creditable under the normal U.S. foreign tax credit rules.

C. \textit{Multiple Country Dynamics}

Throughout this Article, I have presented my proposal as involving a bilateral treaty between a transferor country (the United States) and a single transferee country. This narrow focus raises the natural question about implications with respect to other countries, both developed and developing, beyond this narrow bilateral framework.

I consider first the dynamics created by multiple potential transferee countries. For example, suppose the United States were to conclude treaties with only some subset of the potential transferee countries. The potential issue this creates is that U.S. taxpayers would likely face different tax rates for capital deployed in different jurisdictions. In the countries for which no treaty had been concluded, U.S. taxpayers may well face lower rates if such countries offered tax holidays as a means to attract foreign investment. This might suggest that the possibility of the United States recouping any of the initial capital transfer is contingent upon concluding treaties with all potential transferee countries. Such an outcome, however, is not consistent with an important underlying assumption that motivates the treaty finance proposal in the first instance. Specifically, the proposal is premised on the idea that without an external state transfer of capital it is very difficult for the country to attract substantial amounts of foreign private investment. If one accepts this basic premise, then the suggestion would be that the countries with treaties become relatively attractive to U.S. investors, as compared to countries that have not concluded treaties, notwithstanding tax rate differentials.\textsuperscript{113}


\textsuperscript{113.} If I am wrong on this point, another possibility would be for the United States to conclude a multilateral treaty with a range of developing countries, particularly the countries of Sub-Saharan Africa. That approach has some obvious disadvantages, though. It makes the bargaining problem, which involves issues concerning the amount of upfront capital transfer and degree of concessionality, much more complicated. Capital requirements and sustainability issues are likely to
A second set of issues arises with respect to other developed countries. For example, one may query whether the proposal could easily be extended to developed countries other than the United States. The only obvious hurdle in this respect is that countries that apply territorial tax systems generally would have to modify their systems to tax foreign source profits. Otherwise they would never recoup any amounts on the initial capital transfers. That is not an insurmountable hurdle, however. Indeed, the U.S. system itself functions as a territorial system to the extent that countries achieve deferral of tax on profits of foreign subsidiaries. I have suggested above that under my proposal it would make sense for the United States to curtail such deferral opportunities. Such a modification in extant law is very much in the same spirit as the type of modifications that a territorial system would have to make.

Perhaps the more pressing question in this respect is not whether other developed countries could adopt the proposal, but what the consequences would be if they choose not to do so. At first blush, this seems more complicated than the issue of partial participation by potential transferee countries. Suppose the United States were to enter a series of treaties as described in this Article. If all goes as planned, the initial capital transfer will result in an investment climate that is much more hospitable to foreign private capital. If capital originating in such other developed countries faces a relatively low tax burden on investment in the transferee country as compared to the U.S. companies, then U.S. companies may not be competitive. This problem is addressed, however, by the provision in the treaty under which the transferee country agrees to tax all inbound FDI (other than from the U.S.) at the target rate. One might object that there is still a free-rider problem. The United States would have borne the cost of making an initial capital transfer that makes the transferee country more attractive as an investment destination for all parties. However, that is true of any concessional development finance instrument that produces capital used to improve the investment climate. Moreover, it is very well possible that such investments from other countries are consistent with the broader development objectives of the United States, even if not consistent with the narrower objective of recouping some portion of the upfront capital transfer.

D. Political Feasibility

Is the tax treaty finance proposal politically feasible in the United States? Of course, there are serious political obstacles to any level of development finance that involves a concessional element. I take that as a given. The more interesting question is whether, for a given level of concessional finance, my proposal (which I have argued adds real value in meaningful ways) is feasible...
given that some interests will perceive themselves as worse off as compared to a traditional financing approach.

The most obvious seeming losers under the proposal are U.S. multinationals that undertake investment in developing countries covered by the treaty provisions I envision. Under current law, such companies benefit from deferral on active business profits. Thus, U.S. tax can be avoided indefinitely as long as there is no repatriation. Under my proposal, I envision current taxation of CFC profits sourced to the applicable developing countries at the target rate. We would therefore expect the affected U.S. taxpayers to put up roadblocks to the proposal. There is one powerful retort (which is not to say that it would prevail in the political arena). When U.S. multinationals lobby for relaxation of the U.S. rules on taxation of foreign source income, the typical narrative is grounded in concerns of competitiveness. U.S. multinationals are said to be unable to compete (even though they often compete quite well) in light of the relatively harsh U.S. rules, both in terms of substantive tax liability and compliance burden. Under my proposal, however, the competitiveness narrative largely drops away because the treaty would require the target rate to be applied to all FDI, regardless of where it is owned. Thus, we would observe a more level playing field, at least based on the law on the books, than we do currently.

This may point to another political problem: U.S. firms with no foreign activities lobbying against the proposal. U.S. firms with no foreign activities often note that they are taxed onerously compared to firms with foreign activities in the current climate. We might expect those firms to argue that if the United States is going to apply accrual basis taxation to corporate profits it should be at the same rate as applies to domestic corporations. But if this rate is much higher than the optimal target rate, we may well tax the desired FDI out of existence. That is, even with increasing returns the after tax profits may be insufficient to attract capital. Again, there is a powerful retort. The FDI under my proposal would be taxed more onerously than it is now. That ought not be taken as an invitation to push the rate all the way up to the rate applicable to domestic corporations. And yet, this powerful retort might also founder. Once we make the move towards taxing corporate profits currently there is an obvious place to look when it comes time to set the rate. That dynamic will only be aggravated by the conceptual complexities involved in setting the optimal target rate.

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114. See, e.g., The Need for Comprehensive Tax Reform To Help American Companies Compete in the Global Market and Create Jobs for American Workers: Hearing Before the H. Comm. on Ways & Means, 112th Cong. (2011) (statement of Gregory J. Hayes, Senior Vice-President and Chief Financial Officer, United Technologies Corp.) (“The U.S. system for taxing its corporate citizens on their global income, even with the deferral feature, is an outdated remnant that inhibits our ability to compete globally and discourages reinvestment of overseas earnings in the United States. In fact, our system actually hinders success.”).
Conclusion

The call to arms for novel thinking about development finance is understandable, indeed absolutely essential. Regarding the particular connection between taxation and novel development finance, however, current approaches leave much to be desired, both with respect to public sector finance and private sector finance. In the public sector, a persuasive, general case for new taxes has not been made. In the private sector, the debate seems to be between stalwarts who hold fast to the notion of tax incentives coupled with tax sparing, in spite of the frailties of this approach, and their critics, who level powerful challenges to tax sparing but have not offered much in the way of a positive alternative agenda. The basic goal of this Article is to urge a new way to think about the relationship between taxation and development finance. It is my hope that the tax treaty finance proposal outlined here offers promising opportunities for improvements over the current role that fiscal instruments play in both private and public sector development finance.
Appendix: Proposed Modifications to the OECD Model Treaty (2010)

Article 3

General Definitions
1. For the purposes of this Convention, unless the context otherwise requires:

   (i) the term "Transferor State" means the Contracting State that has transferred capital to the other Contracting State pursuant to a Development Finance Agreement;

   (j) the term "Transferee State" means the Contracting State that has received capital from the other Contracting State pursuant to a Development Finance Agreement;

   (k) the term "Development Finance Agreement" refers to any agreement whereby one Contracting State transfers capital to the other Contracting State on condition of acceptance of the terms of paragraph 1(a) of Article 7.

Article 7

Business Profits
1. Until such time as the conditions specified in paragraph 5 have been satisfied:

   (a) Profits of an enterprise of the Transferor State, or of an enterprise of the Transferee State that is controlled by an enterprise of the Transferor State, shall be taxable only in the Transferor State.

   (b) Profits of an enterprise of the Transferee State that is not controlled by either an enterprise of the Transferor State or an enterprise of a third state shall be taxable only in the Transferee State unless the enterprise carries on business in the Transferor State through a permanent establishment situated therein. If the enterprise of the Transferee State carries on business as aforesaid, the profits that are attributable to the permanent establishment in accordance with the provisions of paragraph 2 may be taxed in the Transferor State.

   (c) Profits of an enterprise of the Transferee State that is controlled by an enterprise of a third state shall be taxed by the Transferee State at a rate equal to [the target rate.]

   (d) If an enterprise of a third state carries on business in the Transferee State through a permanent establishment situated therein, the profits that are attributable to the permanent establishment in accordance with the provisions of paragraph 2 shall be taxed by the Transferee State at a rate equal to [the target rate.]
After the satisfaction of the conditions specified in paragraph 5, the profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits that are attributable to the permanent establishment in accordance with paragraph 2 may be taxed in that other State.

...  

5. For purposes of paragraph 1, the conditions in this paragraph will be treated as satisfied:

[on the date that is ___ years after the execution of a Development Finance Agreement.]

[on the date upon which the Transferor State certifies that ___ of profits have become taxable by the Transferor State where, but for the terms of paragraph 1(a), such profits would have been taxable by the Transferee State.]