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Taxing International Income: Further Thoughts

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TAXING INTERNATIONAL INCOME: FURTHER THOUGHTS

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In the short time allotted, I will limit my comments on this wide-ranging paper to Professor Michael Graetz's critique of concepts and principles developed in my own work. I am flattered by his assertion that my early work in the 1960s has been a strong and lasting influence on subsequent work on international taxation, and only can add that I wish it were so. He then suggests that those principles and concepts which I advanced at that time and the policies which flow from them are now outdated and need considerable rethinking.

I should first point out that my own thinking also has evolved over the 40 year period since I broke new ground in the application of economic analysis to the subject, and my paper in this session is a condensation of where that evolving thought has led me.[1]

Professor Graetz points out that times and circumstances have changed, invalidating pursuit of the standard of capital export neutrality via taxation of worldwide income together with the foreign tax credit (FTC). He thus rejects the notion that U.S. policy should support efficiency in the international allocation of capital and thus the maximization of worldwide welfare, instead suggesting that policy should be focused on national self-interest. I have never argued that worldwide welfare should be the sole consideration in tax policy, and as my paper at this Symposium indicates, the foreign tax credit represents a considerable revenue sacrifice by the U.S. in the

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1. *See* PEGGY B. MUSGRAVE, TAX POLICY IN THE GLOBAL ECONOMY: SELECTED ESSAYS (Edward Elgar Publishers 2001).

interests of an orderly and efficient international tax system. While it well may be true that present-day circumstances make implementation of the FTC more complex, so long as there are significant differences in corporate tax rates among countries, it remains a valid construct and its adoption should be seen as a cornerstone of a cooperative world tax order.

It is not clear to me what tax regime Professor Graetz would substitute for the FTC if tax policy is to promote the national rather than international interest. In his summary he suggests that the FTC should be abandoned where the host country's rate is similar to that of the U.S. Of course I agree with that, for there is no point in imposing administrative and compliance costs where little or no revenue is involved and little neutrality is lost. But it is important to emphasize that a blanket exemption for foreign income promotes tax competition abroad while the FTC acts as a protection against tax competition. While public choice economists have been writing on behalf of tax competition as a means of curbing the growth of government, I do not share that view, believing it can develop into a destructive "race to the bottom," an important feature especially for developing countries with strong need for government-financed infrastructure. It also should be noted that tax neutrality for foreign investment achieved through use of the FTC need not be incompatible with standards of tax equity for the income tax as it applies to individual shareholders.

Professor Graetz also rejects substitution of the foreign tax deduction (FTD) for the FTC system. Nearly 40 years ago I suggested the FTD as a means of maximizing the national gains from foreign investment and in recent years others have suggested FTD as a protectionist device in the national interest. In this regard, I strongly have been critical of the general practice at the policy-making level of putting free capital movement and free trade in goods and services in the same basket. Foreign investment involves a transfer abroad of productive resources whereas free trade promotes the most productive use of existing national resources. Transfer of capital abroad has strong distributional implications both for domestic income groups and between nations, an important aspect that is not mentioned by the author. Where national self-interest may well support free trade, it does not necessarily support free capital movement, whether in the form of direct or portfolio investment. I believe that a country has a right to deter the loss of its national savings, just as it has the right to protect itself from unfettered immigration. A tax policy, such as the FTD, which acts as some deterrent to capital outflow, is an appropriate option which should be on the table. Furthermore, FTD would represent great simplification of the present FTC regime.

While Professor Graetz appears to support source-based taxation, he rejects the concept of capital import neutrality (CIN) as its justification, but without exactly explaining why. I also reject CIN as a normative concept for there seems no good economic reason why capital which emanates from different countries should be taxed at the same source rate. The only neutrality that is economically meaningful is CEN. Horizontal equity and the integrity of each home country's tax system calls for inclusion of foreign income in the tax base. True, source country taxation alone, implying exemption by the home country, also may result in a larger share of foreign investment for those countries with above-average tax rates than would a FTC approach, but this result carries no normative value, and I am skeptical of Professor Graetz's support for larger market share.

Professor Graetz does not appear to embrace the idea of worldwide cooperation in international taxation, except for the exchange of information which I also enthusiastically endorse. But I go beyond this purpose to say that cooperation is essential to achieve inter-nation equity about which Professor Graetz has little to say. Inter-nation equity, as my own paper indicates, is a standard applicable to countries of source and involves the concepts of a fair division of tax base and reciprocity of tax rates. I also should add that the withholding tax is an integral part of each source country's effective tax rate and as such should play an important role in the attainment of inter-nation equity. Beyond that, cooperation is needed if a neutral tax regime for foreign investment is sought, *i.e.* to promote international efficiency (as opposed to national efficiency) in the allocation of investment, analogously to free trade agreements. Indeed, a "comprehensive review" of the taxation of foreign investment which Professor Graetz calls for, leads me in an opposite direction from where he seems to point. I am increasingly of the opinion that some kind of internationalization of the corporation income tax is needed as the taxation of foreign income by individual countries becomes ever more complex and investors' capacity to evade that taxation ever greater. Such a move need not interfere with the equity of each country's individual income tax differences in which it (including the degree of integration of the corporation tax) could coexist with a uniform rate of corporation tax.

Finally, Professor Graetz briefly advocates introduction of a destination-type value-added tax in the U.S. to allow a near abolition of the individual income tax. I am disturbed by the taxpayer equity implications of such a move. If applied unilaterally, it would result in massive non-neutralities as investment from abroad would receive a strong tax incentive to invest in the U.S. I have written extensively on this subject so I will not say more. In any case, I think Professor Graetz would agree with me that tax policy for foreign investment needs to be given the same international consideration as has been given to tariffs and other policies with regard to trade. For that to happen, there must be a separation of the two, with pursuit of free trade no longer necessarily calling for unimpeded capital movements.