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Sovereignty, Entitlement, and Cooperation in International Taxation

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PANEL II: REVISITING THE THEORY OF INTERNATIONAL INCOME TAXATION

PRINCIPAL PAPERS

SOVEREIGNTY, ENTITLEMENT, AND COOPERATION IN INTERNATIONAL TAXATION

*Peggy B. Musgrave**

I. INTRODUCTION

As its title suggests, this paper deals with certain aspects of international tax policy which range outside the more traditional concerns of most economic discussion of the subject. But since this is a law school symposium, I am bold enough to think that the legal scholars among you will find it of some interest. Furthermore, experience has convinced me that these aspects play a large role in the shaping of unilateral, bilateral, and multilateral tax arrangements and therefore deserve to be thought about systematically. This is likely to be increasingly the case in a world economy which promises to become ever more closely integrated, and with administrative challenges associated with new technologies.

While the paper discusses principles which are relevant to all taxes which apply to investment, goods, and services mov-

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ing across national boundaries, focus is on income taxation, although the paper concludes with some brief comments on consumption taxation. Furthermore, the discussion centers on the taxation of income generated by direct investment abroad, in particular direct investment by corporations. Consequently, the corporation income tax is the primary focus with some attention given to the individual income tax on dividends.

There are two universally recognized and widely practiced national entitlements to tax income in an open economy setting. One such entitlement adheres to the country of source of income and the other to the country of residence[1] of the income recipient. The economic consequences of the interaction of these entitlements will differ in settings of conflict and cooperation.

II. TAX SOVEREIGNTY OF THE RESIDENCE COUNTRY

I begin with the proposition that so long as there are nation states serving populations with common purposes and interests, such states will wish to retain a degree of sovereignty over the tax treatment of the income-earning activities abroad of their residents. Indeed, this national right to tax the global income of residents is recognized in international law.[2] Residents are held to owe tax allegiance in return for the rights and privileges which they receive as residents, giving rise to what is commonly referred to as the "residence principle." Exercise of this tax sovereignty over foreign source income also is necessary to achieve equitable tax treatment of resident taxpayers by making all income, wherever earned, subject to tax, consistent with the accretion principle. It also is needed to provide a policy instrument for affecting the outflow of capital in line with national policy objectives. It also may be justified in benefit terms, as a payment for productivity-enhancing benefits provided by the country of residence to its own factors of production prior to transfer abroad. What is important is that the country of residence is the residual tax-

1. The United States also includes citizenship with residency as bases for its right to tax individuals. *See infra* note 10, for the conditions establishing the residency of the corporation.

2. An extensive discussion of the international legal basis for residence and source taxation is given in Nancy H. Kaufman, *Fairness and the Taxation of International Income*, 29 No. 2 LAW & POL'Y INT'L BUS. 145, 148 (1998).

ing authority and thus has sovereignty over the total tax burden on the foreign-source income of its resident taxpayers.

A. Policy Options and Goals in Absence of Cooperation

The residence (home) country then has various choices with regard to its treatment of the host country's tax on that income: (1) it may make no allowance for such tax, applying its own tax on foreign income gross of foreign tax; (2) it may apply its tax on foreign income net of the foreign tax (treating the latter in effect as a deduction); (3) it may allow full or limited crediting of the foreign tax, treating the latter as its own; or, (4) it can choose to surrender its tax sovereignty over the foreign income of its residents, exempting it from its own tax. In addition, in the first three cases, taxation may be deferred until foreign earnings are repatriated as dividends.[3] Each of these rules will have very different consequences for the taxpayer's behavior and in turn for the amount and direction of capital outflow. There is extensive literature which deals with the theoretical and empirical aspects of these effects,[4] but which will not be discussed in this paper. Suffice it to say that application of (1) would serve as a strong deterrent to capital outflow, application of (2) would ensure that the national return on investment made abroad (net of foreign tax) will not fall below the gross rate of return on domestic investment,[5] and application of (3) as a full credit would secure an efficient international allocation of investment,[6] even though the national return to foreign investment (net of foreign tax) may in

3. The U.S. defers tax, with certain restrictions, for undistributed earnings of foreign incorporated subsidiaries of U.S. corporations, but not of unincorporated foreign branches of U.S. firms.

4. *See, e.g.*, David G. Hartman, *Tax Policy and Foreign Direct Investment*, 26 J. PUB. ECON. 116 (1985); Hans-Werner Sinn, *Taxation and the Birth of Foreign Subsidiaries*, *in* TRADE, WELFARE AND ECONOMIC POLICIES (H. Herberg & N. V. Long eds., University of Michigan Press 1993); James R. Hines, Jr., *Credit and Deferral as International Investment Incentives*, 55 J. PUB. ECON. 323 (1994); Harry Grubert, *Taxes and the Division of Foreign Operating Income among Royalties, Interest, Dividends and Retained Earnings*, 68 J. PUB. ECON. 269 (1998).

5. *See* PEGGY B. RICHMAN (MUSGRAVE), TAXATION OF FOREIGN INVESTMENT INCOME: AN ECONOMIC ANALYSIS (Johns Hopkins Press, 1963). *See also* Martin S. Feldstein & David G. Hartman, *The Optimal Taxation of Foreign Source Investment Income*, 93 Q. J. ECON. 613 (1979).

6. *See* Joel Slemrod, *Free Trade Taxation and Protectionist Taxation*, 2 INT'L TAX & PUB. FIN. 471 (1995).

this case fall short of the national return to domestic investment (gross of domestic tax).[7] Put another way, the foreign tax credit implies a substantial revenue sacrifice by the country of residence to satisfy an international efficiency standard.

The choice by the country of residence (hereinafter referred to as R) of how to exercise its tax sovereignty is, therefore, largely a choice of how its own tax is to relate to the tax imposed by the country of source (hereinafter referred to as S). Acting unilaterally, in the absence of cooperation, the principal considerations in making that choice are equitable tax treatment for its residents/citizens and its national economic interests. Such interests include the level and growth of national income, the distribution of such income, and its balance of payments with the rest of the world; the latter bearing on its exchange rate and its terms of trade.[8]

B. Taxpayer Equity

The basic consideration for the residence country is to preserve the integrity of its comprehensive income tax. Integrity of such a tax system requires the inclusion of all income earned abroad by R's residents in the tax base and subjecting it to national standards of tax equity. Without that basic provision, standards of both horizontal and vertical equity are violated. For individuals, the exercise of the residence entitlement suggests the use of a personalized income tax—in contrast, as will be discussed later, to an impersonal tax—called for exercising source entitlement. However, a rule for the equitable treatment of the foreign income taxes paid on that income is not clear cut, since a case can be made for either crediting, deducting, or even disregarding the foreign S tax.[9] Full crediting for the foreign tax is called for if an "international" view of taxpayer equity is taken, with the foreign tax regarded as equivalent to, and substitutable for, the domestic tax. On

7. *See* PEGGY B. MUSGRAVE, UNITED STATES TAXATION OF FOREIGN INVESTMENT INCOME: ISSUES AND ARGUMENTS 130 (1969).

8. In a 1993 report, the U.S. Treasury proposed five international tax policy objectives: simplicity of compliance and administration, preservation of the U.S. tax base, consistency with international standards, economic efficiency and competitiveness. *See Treasury Report on International Tax Reform*, 6 TAX NOTES INT'L 269 (1993). Needless to point out, there are likely to be inherent conflicts among these national objectives.

9. *See* Musgrave, *supra* note 7.

the other hand, country R might define taxpayer equity in "national" terms. In this case, the S tax could be regarded as a cost to the taxpayer and, therefore, deducted from taxable foreign income, just as lower level domestic taxes usually are treated. Yet again, the definition of national equity might well disregard the foreign tax entirely, with R's tax applied to foreign income gross of the foreign tax with no allowance for the latter, on the ground that the standard of taxpayer equity should be applied to R's tax only and that the foreign tax is irrelevant in this regard. Which rule is followed, as in most other equity issues, has to be a matter of judgment by national consensus.

Although the concept of equity is more readily applied to individual taxpayers, the corporation is an essential halfway house for foreign income flowing to resident individual shareholders and similar principles should apply to its taxation. For resident corporations,[10] these again call for a corporation tax which includes all income-foreign and domestic. For reasons familiar in the context of domestic taxation, both efficiency and equity call for taxation of corporations on an accrual basis without deferral until distribution. This applies to income earned abroad by the resident corporation, whether arising in a foreign affiliate or branch, or foreign-incorporated subsidiary form.[11] But again on equity grounds, there is no definitive rule as to the treatment of foreign tax.

C. National Economic Interests

The transference of economic activity abroad may have a profound effect on the national economic interests of the residence country. None looms larger in this respect than overseas investment which affects the overall level and distribution of

10. The question arises, how is "residency" of the corporation to be defined? Is it country of registration, of principle management, or of majority shareholder residence? The U.S. rules define it as the country where the corporation is registered or incorporated. *But see infra* note 11.

11. Under the definition of "residency" of the corporation as country of incorporation, a conflict arises between the residence taxation by the country of parent corporation and residence taxation by the country of incorporation of the subsidiary. The U.S., with some notable exceptions, resolves this conflict by taxing only the earnings of foreign-incorporated subsidiaries when remitted to the U.S. parent, thus giving rise to a substantial tax preference to investment in low-tax jurisdictions abroad by way of deferral of U.S. tax.

national income within the capital-exporting country. Consequently, tax policies which affect capital outflows are an important instrument of economic policy. Countries of residence can shape their tax policy to manipulate the size and type of capital outflow to their own advantage, rather than contribute to the worldwide gains obtained through a neutral tax policy, which promotes efficient international allocation of capital,[12] or redistributional considerations calling for investment in the low-income countries.

Viewing the treatment of foreign taxes in national efficiency terms, it will be to R's advantage to maximize the contribution of investment made abroad to the national welfare. It then may seek to ensure that the national returns to investment made abroad are at least equal to those obtained on domestic investment. Since the foreign tax may be regarded as a subtraction from the national return, this goal of national efficiency is secured by allowing foreign income taxes as deductions from taxable income rather than as credits against the home country tax.[13] Under this regime, investors will be inclined to invest abroad only if returns after foreign tax are equal to or greater than those obtainable before tax in the domestic economy. In this way, investment made abroad will be less than that called for on worldwide efficiency grounds, but will be consistent with a standard of national efficiency imposed by the country of residence.

There is a further national argument which can be made by R for the deduction treatment of foreign taxes. Provided that the combined effective tax rate of R and S on investment made abroad is similar to that on R's domestic investment, the net result will be an overall increase in the combined national income of R and S. However, the general assumption in neoclassical economics is that the decision of investors resident in country R, to invest R's savings in country S (the country of source of income), rather than in R, will raise the income of R's investors and S's labor, while lowering that of S's investors and R's labor. Thus, even if tax neutrality ensures efficiency with overall income gains, there will be redistributive effects in

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12. *See* James R. Hines, Jr., *Tax Policy and the Activities of Multinational Corporations*, *in* FISCAL POLICY: LESSONS FROM ECONOMIC RESEARCH 401 (Alan J. Auerbach ed., 1997).

13. *See* Richman, *supra* note 5.

both R and S (presumably equalizing in S and the reverse in R). Furthermore, allowing for the tax take of country S in foreign investment earnings, there well may be a net income loss to the capital-exporting country R, with the presumption of larger income gains to S.[14] Since direct investment abroad has powerful redistributive effects within and among participating countries, in terms of capital and labor earnings as well as sources of tax revenue, it is to be expected that the country of residence would wish to exercise some degree of control over such investment. Short run effects of capital outflow on the balance of payments may be a further concern for the home country R.

Thus, just as it generally is accepted that a country has the right to retain sovereignty over population immigration, it also is logical that sovereignty be exercised over the outflow of its capital. In the absence of direct capital controls, taxation is the favored instrument, and in particular the corporation income tax. Furthermore, it follows that pursuit of national interests generally will result in a tax penalty on investment made abroad by the country of residence.

III. TAX ENTITLEMENT OF SOURCE COUNTRY

While nations, in practice, do not always exercise their full tax sovereignty as countries of residence, choosing to exempt foreign income or to tax it only when repatriated, most countries claim their entitlement to tax the income arising within their borders but accruing to foreign investors. Indeed, this entitlement to tax at source is the bedrock of most international tax treaties. The right of a jurisdiction to tax all income arising within its geographical borders is recognized as a fundamental entitlement. This permits a country to share in the gains of foreign-owned factors of production operating within its borders; gains which are generated in cooperation with its own factors, whether they be natural resources, an educated and/or low-cost work force, or the proximity of a market. The tax revenue so obtained may be thought of as a national return to the leasing of these complementary factors to non-resident investors or temporary workers, or, such taxation may be thought of in benefit terms, as a *quid pro quo* payment for

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14. *See id.*

cost-reducing, profit-enhancing services provided by the host country.

A. *Policy Options and Goals in Absence of Cooperation*

In exercising its entitlement, the country of source requires an *in rem* or impersonal form of taxation, since a personal form of income taxation is not appropriate to a situation in which only part of the taxpayer's global income is to be taxed and the taxing authority is entitled to such income earned only within its own borders. Source taxation of income is, therefore, best implemented by a corporation income tax, a payroll tax (in the case of labor income), withholding taxes, or an income-type value-added tax based on the origin principle.[15] In applying the chosen tax, the source jurisdiction has two primary instruments in exercising its entitlement to tax income accruing to non-residents. One is its definition of source, which in turn determines its share in the tax base, and the other is the tax rate which it applies to that share of the base. In the absence of international treaty rules, each source country can choose policy options with respect to each aspect to serve its own interests.

1. Division of Tax Base

Corporations resident in R and investing in S usually derive income not only from operations in S, but also from other countries of source (of which R itself is one). Consequently, each S has to determine what share of the worldwide profits of the multi-national corporation can be claimed by it for tax purposes. In other words, the total profits tax base has to be divided among and assigned to the various countries in which such profits had their source. The current international practice of assigning the profits of a multi-national company to separate business entities operating in source countries by means of unilateral separate accounting is proving to be increasingly arbitrary as international business operations become more intertwined and integrated with shared costs and overheads, and other interdependencies.[16] In the absence of

15. *See* Peggy B. Musgrave, *Consumption Tax Proposals in an International Setting*, 54 TAX L. REV. 77 (2000).
16. *See* Charles E. McLure, Jr., *Defining a Unitary Business: An Economist's*

international agreements to the contrary, each source country will adopt accounting rules and transfer pricing which assign to it as large a share of the base as is possible. With each country following its own source rules, both gaps and overlaps in the assignment of the tax base may result.

2. Rate of Tax

The tax claim of the source country is a product of both its claim to base and the rate of tax which it applies. The latter involves both the corporation tax on basic profits and the withholding tax applied to the remitted dividends. In the absence of treaty agreements, the choice of rates may be subject to conflicting purposes, namely the desire (1) to capture as large a tax share of profits and dividends accruing to non-residents as possible, and (2) to attract as large an inflow of capital as possible by offering tax incentives. This trade-off can, to some extent, be avoided by offering profits tax incentives to attract incoming investment, while applying relatively high withholding rates to encourage reinvestment of earnings.[17]

B. Tax Competition

This pattern of tax behavior by the countries of source can lead to tax competition among capital-importing countries with the result that no one country can obtain enough additional investment from abroad to justify the lower tax. Furthermore, such tax competition can have damaging effects on domestic tax equity and possibly on the conduct of the public sector if the tax incentives offered to non-resident investors have to be extended to domestic investors.[18] This especially will be the case where the country of residence either exempts foreign income from tax or treats foreign income taxes as deductible costs. These are highly relevant problems for the developing countries where foreign capital is needed for the development

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View, *in* THE STATE CORPORATION INCOME TAX: ISSUES IN WORLDWIDE UNITARY COMBINATION 89 (C.E. McLure, Jr. ed., Hoover Institution Press 1984).

17. Those countries which depend heavily on investment inflow from one particular capital exporter which offers a foreign tax credit, often adopt "soak-up" tax rates which just absorb the credit.

18. *See* Peggy B. Musgrave, *Merits and Demerits of Fiscal Competition*, *in* PUBLIC FINANCE WITH SEVERAL LEVELS OF GOVERNMENT 281 (R. Prud'homme ed., 1991).

process, yet government revenue also is needed to create the infrastructure for that development.

IV. COOPERATION

A. *Need for Cooperative Rules*

In the absence of international agreements and treaties, it is evident that the taxation of foreign income earned by residents and of domestic income earned by non-residents, can raise problems of inefficiency in the allocation of foreign investment and predatory inequities in the tax shares of that income. Cooperative rules are needed both for reasons of economic efficiency and inter-nation equity. Cooperation also is essential for administrative reasons, in particular for reporting purposes. Such cooperation can take various forms. It may be represented by the current network of bilateral tax treaties between countries of residence and source; which broadly follows an internationally accepted model tax treaty format.[19] Such tax treaties might be supplemented by multilateral agreements, particularly among countries of source to prescribe rules for the division of base and rates of tax. Finally, for reasons discussed below, a higher degree of international cooperation may be called for which assigns certain taxes, such as the corporation income tax, to an international tax authority.

B. *Inter-nation Equity*

As it has been argued elsewhere, the share of base and tax rate applied to that share by the countries of source should be viewed as a matter of inter-nation equity calling for international cooperation.[20]

1. Share of Tax Base

In current practice, the division of tax base at the international level, generally is determined unilaterally by the process

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19. *See* ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT COMMITTEE ON FISCAL AFFAIRS, MODEL DOUBLE TAXATION CONVENTION ON INCOME AND CAPITAL C(23) 5-7 (1992).

20. *See* R.A. Musgrave & Peggy B. Musgrave, *Internation Equity*, *in* MODERN FISCAL ISSUES: ESSAYS IN HONOR OF CARL S. SHOUP 63 (R. M. Bird & J. G. Head eds., University of Toronto Press 1972).

of separate accounting applied to separate business entities, with profits derived from actual or notional arms-length pricing and accounting practices of one country; often in conflict with those of others.[21] With business operations integrated in various ways across borders, the untangling of profits and their assignment to different jurisdictions of source becomes an artificial exercise and rules-of-thumb measures often have to be adopted. Furthermore, this practice lends itself to profit shifting by the taxpayer. Most fundamentally, rules are needed to assign an equitable share by the countries of source in the income accruing to multi-national corporations. Common source rules employing unitary combination and uniform formula apportionment are needed to avoid arbitrary and predatory practices for determining source.[22] Furthermore, with the prevalence of highly integrated business operations, there is no single formula based on economic theory alone which correctly can be claimed to assign income to source. Consequently, it is necessary to adopt a formula which, by mutual international agreement, generally is acceptable for reasons of fairness. For instance, one possible formula among many might contain elements which measure on the supply side each country's share of the firm's factors of production, such as labor and capital, and on the demand side its contribution to the firm's sales.[23] Whichever formula is adopted, it is critical that there be international agreement on its general adoption.[24]

2. Rate of Tax

The rate of tax applied at source also should be a matter of international agreement and again be based on a standard of inter-nation equity. An obvious rule would call for internationally equal rates of tax on income accruing to non-residents. Bilateral tax treaties usually call for such reciprocally equal rates to be applied to withholding taxes, but profits taxes are

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21. *See generally* ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT (OECD), TAXING PROFITS IN A GLOBAL ECONOMY (1991).

22. *See* Peggy B. Musgrave, *Principles for Dividing the State Corporate Tax Base*, *in* THE STATE CORPORATION INCOME TAX: ISSUES IN WORLDWIDE UNITARY COMBINATION (C.E. McLure, Jr. ed., Hoover Institution Press 1984).

23. *See* Musgrave & Musgrave, *supra* note 20 (discussing the possibilities).

24. Experience with attempts to reach uniformity of formula apportionment among the states in the U.S. is not encouraging.

held to be subject to a rule of non-discrimination whereby resident and non-resident taxpayers should be subject to the same rate of tax. However, for this standard of inter-nation equity to be met, reciprocity should apply to such taxes in combination with withholding taxes. The rates applied to resident corporations are governed by domestic tax policy considerations such as taxpayer equity and economic growth, whereas those applied to non-residents should be determined by the appropriate share of their income earned at source; a share which is set by international agreement and applies to all source countries. Clearly, the usual treaty requirements of non-discrimination with respect to the corporate income tax combined with reciprocity of withholding tax rates is unsatisfactory with respect to inter-nation equity. If, for administrative or other reasons, the non-discrimination rule must apply to the corporation income tax, then withholding tax rates on the remitted income might be adjusted to yield, in combination with the profits tax rate, an internationally agreed rate. Thus, if country S's statutory rate of corporate tax is 25 percent, and the internationally agreed rate is 30 percent, then S's permitted withholding rate (WT) would be obtained from the equation {.30 = .25 WT(1.0 - .25)} or 6.7 percent. If, on the other hand, country S's corporate rate were 40 percent, its withholding rate would be negative, calling for a refund rate of 1.7 percent.

C. Neutrality

While the exercise of source entitlement involves the claim by the source country on the income accruing to non-resident—and is a matter of inter-nation equity which must be resolved by international agreement—that of residence sovereignty determines the ultimate tax burden which is borne by its resident corporations with investments abroad. Allocative efficiency, as it applies to foreign investment, requires a situation of international tax neutrality whereby investors of a country face the same tax rate whether they choose to invest at home or abroad. This can be achieved with the use of the foreign tax credit, with a refund if the foreign tax exceeds the resident country's tax on the same income, and without deferral of tax until income is repatriated. While this situation of "capital export neutrality," as it has been termed,[25] is needed

25. A term coined by R.A. Musgrave. *See* R.A. Musgrave, *Criteria for Foreign*

for allocative efficiency,[26] it requires some sacrifice on the part of the residence, or capital-exporting country, in the interest of worldwide welfare. Capital outflow will be larger and tax revenue will be less than if country R pursued a tax policy designed to serve only its national economic interests. Cooperation is thus required of the residence country in the interest of international welfare, just as cooperation is required of the source countries in the interest of inter-nation equity.

D. Shareholder Versus Corporation

While cooperative agreements among nations are necessary to secure efficient allocation of international capital and inter-nation equity, there is no reason why individual taxpayer equity need be surrendered in the process. It was noted earlier that it is possible to take different views of taxpayer equity, each calling for different treatment of the foreign tax. The standard of "international" equity would call for the foreign tax to be treated as the domestic tax on the same income, and this view is consistent with the foreign tax credit approach. This treatment for foreign-source corporate income is not only necessary to secure a neutral tax treatment for investment, but also (taking the "international" equity approach) to preserve equity for individual shareholders by equalizing the underlying corporate tax on shareholders' dividends. In the same spirit, if dividends are distributed directly from a foreign subsidiary to the resident shareholder, country R's corporate tax should be interposed with a credit for foreign tax before the dividends are taxed to the individual shareholder.[27]

If a residence country for domestic purposes applies a partial or full integration of corporate and personal income taxes, international cooperative agreements of the kind discussed in this paper would allow such a country to decide for itself whether the foreign corporate tax on income earned abroad should be integrated with the domestic personal income

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Tax Credit, in TAXATION AND OPERATIONS ABROAD (Tax Institute Symposium 1959).

26. *See* Harry Grubert & John Mutti, *Taxing Multinationals with Portfolio Flows and R & D: Is Capital Export Neutrality Obsolete?*, 2 INT'L TAX & PUB. FIN. 439 (1995) (discussing an efficiency-based defense of the policy of capital export neutrality).

27. This follows the French "avoire faire" system.

tax on shareholders. Preservation of tax sovereignty of the residence countries over the degree of integration chosen is compatible with the cooperative rules outlined. This has been a matter discussed in connection with the principle of "subsidiarity" in the European Union.[28]

E. Administrative Cooperation

It goes without saying that there are considerable administrative difficulties to be faced in implementing a cooperative model, as outlined above, and cooperation among national tax administrations including exchange of information would be vital to its success.

V. HIGHER LEVELS OF COOPERATION

It is likely that in the absence of cooperative agreements both source and residence countries will exercise their entitlements in a way to serve their national interests and that these interests may conflict with each other and with standards of inter-nation equity and allocative efficiency. The present international tax regime is deficient in these respects despite an extensive network of tax treaties. A higher degree of cooperation is necessary in the interests of an orderly, just, and efficient international tax regime which comes closer to meeting these criteria. Whereas the question of inter-nation equity has to be resolved among the source countries, international efficiency in resource allocation is a standard determined by the policies applied by the residence countries. Creation of an international tax order of the kind outlined calls for a high degree of international cooperation, analogous to that leading to international agreements on trade liberalization. This process might begin with design of an improved model tax treaty since model treaties currently in use leave much to be desired.

The process would be facilitated if responsibility for the corporation income tax were acquired by central authorities of groups of countries forming free trade areas, or economic un-

28. "Subsidiarity" is a term used to denote the degree of independence of member nations permissible within the rules of harmonization, in the spirit of permitting a maximum degree of tax diversity among member states consistent with the goals of tax harmonization.

ions (*e.g.*, European Union), which could negotiate agreements to set source rules and common rates of tax. Member countries, as countries of residence, would then be free to set their own rules governing the relation between their personal income taxes on resident shareholders and the corporation income tax on profits whether earned within or outside the union.[29]

Ultimately, many of the foregoing problems associated with the establishment of a reasonable international tax order may call for an international tax administration of the corporation income tax, imposed at a uniform rate. This would meet the efficiency criterion; although the primary task of such an administration would be the distribution of corporate tax revenue among source countries according to a single mutually acceptable formula, a procedure followed in some federal systems today.[30]

Looking to the coming new millennium, it can be expected that corporations will become ever more internationalized with interlocking relationships both in operations and ownership. Electronic commerce and the rapid transmission of funds across borders will further complicate the task of tax administration and enforcement. It may well be that these continuing developments eventually will compel the transfer of national responsibility for the corporation income tax to an international authority. Nevertheless, if the revenue is to be returned to source, this again will require cooperation in selection of an equitable distribution formula.

A. International Aspects of Consumption Taxation: A Brief Note[31]

The leading tax debate in recent years concerned the merits of broad-based consumption taxes as compared with the traditional income tax.[32] Although U.S. interest in substitu-

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29. *See* Peggy B. Musgrave, *Interjurisdictional Equity in Company Taxation: Principles and Applications to the European Union, in* TAXING CAPITAL INCOME IN THE EUROPEAN UNION: ISSUES AND OPTIONS FOR REFORM (S. Cnossen ed., Oxford University Press 2000).

30. For example, Germany and Canada.

31. This concluding section is based (in summary form) on the following papers: Peggy B. Musgrave, *International Coordination Problems of Substituting Consumption for Income Taxation, in* HEIDELBERG CONGRESS ON TAXING CONSUMPTION 453 (M. Rose ed., 1990). *See also* Musgrave, *supra* note 15.

32. *See* DAVID F. BRADFORD ET AL., BLUEPRINTS FOR BASIC TAX REFORM (2nd

tion of consumption for income taxation has more recently declined, it well may be revived in the future. Several, specific proposals have been made in the United States to replace the corporation and personal income taxes with consumption taxes. They include familiar devices such as a retail sales or value-added tax,[33] as well as new approaches. Variously named cash-flow taxes, individual prepayment tax, the Unlimited Savings Allowance (USA) tax,[34] and the Flat Rate Tax,[35] offer a complex and sometimes confusing pattern.[36] My purpose here is not to compare the taxes with respect to their equity properties, but briefly to assess the international implications of a substitution of such broad-based consumption taxes for the corporation and personal income taxes. This will be viewed in terms of the foregoing discussion, in which sovereignty, entitlement, and cooperation were considered as the leading issues in international taxation within the traditional context of income taxation.

B. Nature of Entitlements with Consumption Taxation

The residence and source countries' entitlement to tax is now defined in terms of consumption rather than income. As a residence country, tax sovereignty now applies to the worldwide consumption of its residents. Origin of consumption goods now substitutes for the source of income as a geographic-based tax entitlement. Analogous to income tax entitlements, consumption tax entitlements call for a personal expenditure tax on individuals and an *in rem* tax on consumption at origin, the latter met by a consumption-type value-added tax applied on the origin principle.

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ed., Tax Analysts 1984).

33. *See* CHARLES E. MCLURE, JR., THE VALUE-ADDED TAX: KEY TO DEFICIT REDUCTION? 1-2 (American Enterprise Institute 1987).

34. *See generally* Alliance USA, *USA Tax System*, 66 TAX NOTES 1481 (1995).

35. *See generally* ROBERT E. HALL & ALVIN RABUSHKA, THE FLAT TAX (2nd ed., The Hoover Institution 1995).

36. The plans are surveyed in Charles E. McLure, Jr. & George Zodrow, *Advantages of a Hybrid Direct Tax on Consumption*, *in* PROCEEDINGS OF THE 88TH ANNUAL CONFERENCE ON TAXATION (National Tax Association 1996).

C. Comparison of Principal Consumption Tax Proposals

The three major consumption taxes (value-added tax, USA tax, and Flat tax), under discussion in the U.S., differ somewhat in the composition of their bases and in turn on how they fit in with the two entitlements outlined above.

1. Value-Added Tax (VAT)

Beginning with the familiar consumption-type value-added tax, the firm's base equals sales minus purchases of inputs from other firms, minus purchase of capital equipment. If the tax is aimed at production at origin, exports are included and imports excluded from the base; if aimed at consumption at destination, exports are excluded and imports included in the base. As an *in rem* tax, the VAT is appropriate as an instrument for exercising the consumption entitlement at origin. At the same time, the tax does not fulfill the role of exercising residence sovereignty via a personal consumption tax.

2. USA Tax

Under the USA or "Unlimited Savings Allowance" plan, a tax would apply at both the business and the personal level. At the business level, the corporation income tax would be replaced by a "business tax." This tax no longer would be aimed at profits. Instead, it would have a cash flow base which equals sales receipts less purchase of materials and equipment. Wage payments and imports are included in the base but exports are excluded. Thus, the business component of the tax is similar to a consumption-based, value-added tax of the destination type. But, since exports are excluded, this component of the tax falls short of meeting the origin entitlement role. The USA tax also includes a personal consumption tax component the base of which equals income receipts from all domestic sources (including wage and capital income) less savings measured as the increase in net worth held in qualifying assets. However, foreign-source income and the change in value of foreign net worth are not included in the base, and thus it does not allow the exercise of residence sovereignty. In combination, although the USA tax provides for consumption taxation in both *in rem* and personal form, it falls short of meeting either entitlement requirement.

3. Flat Tax

The Flat Tax plan again offers taxation at both the business and personal levels. The base of the business tax now differs from a value-added tax by excluding wage and salary income, which then becomes the base of the personal tax. Furthermore, unlike the USA tax, the tax includes exports and excludes imports, and thus has an origin rather than destination base. Although the *in rem* business component is origin-based, it is again defective in meeting origin entitlement because of the wage exclusion. At the personal level, only domestic-source wages and salaries are included in the base. The Flat Tax, therefore, fails to implement residence sovereignty over worldwide consumption.

Moving from an income-based to a consumption-based tax system would mean first of all an abandonment of the income-based source and residence principles. In other words, the adopting country would fail to exercise its entitlement to tax income of non-resident corporations and individuals which have a domestic source, and surrender its tax sovereignty over worldwide income of its residents. In its place, adoption of any of the three above plans would allow exercise only partially, or not at all, of a country's entitlement to tax consumption associated with trade flows and cross-border shopping. This loss might be corrected partly by abrogation of the tax treaties to which it is a signatory and by reversion to a high withholding tax on income paid to foreign recipients. However, this would represent a cumbersome combination of consumption and income tax bases, and in any case treaty partners are not likely to accept such a violation of existing treaty terms without retaliation.

D. International Economic Aspects of Substitution

Moving from an income to a consumption base also would affect trade and capital flows, but the outcome would differ somewhat under the three plans.[37]

Introduction of a destination-type value-added tax would be neutral with respect to trade flows since the tax would

37. *See* Musgrave, *supra* note 15 (providing a fuller analysis specifically concerning the U.S. case).

apply equally to imported and domestically-produced consumption goods. An origin-type value-added tax, on the contrary, would interfere with trade flows at least in the short run until depreciation of the currency restored neutrality. However, substitution of a value-added tax could be expected to have a substantial effect on international flows of direct investment. Bearing in mind that if capital exporting countries tax capital income on the source principle only, this leaves foreign investment by their residents to be taxed by the host country alone. With the host tax on corporate profits now abolished and the consumption-type value-added tax imposing a zero tax on such income, foreign investors may be expected to respond to the strong tax advantage gained by investing in the consumption-tax economy. The country substituting consumption for income taxation would become an attractive tax haven for new incoming investment, and provide large windfalls (unless somehow prevented by transitional arrangements) to existing investments owned by non-residents. At the same time, resident investors would be deterred from investing abroad due to strong differentials between the rates of foreign source-based income taxes and the home country's zero rate. Without response from other capital-importing and capital-exporting countries, the expectation would be for a substantial shift in international flows of direct investment away from foreign countries and towards the country introducing the substitution.

Turning to the Flat Tax, trade flows would now be affected since the combined business and wage components of the Flat Tax resembles the origin type VAT. With exports included and imports excluded from the base, there would be a balance of trade effect. This trade effect would be absent in the case of the USA tax, but there also would remain distorting effects on capital flows similar to those under the value-added tax proposal. Activities by those companies operating abroad would not be subject to the tax, but those by foreign companies operating in the country are taxable. Similarly, wages and salaries earned abroad by residents would not be subject to tax, while earnings by non-residents in the U.S. would be taxed. Since only abnormal profits would be subject to tax, with normal profits exempt, most of the tax burden on capital, the more internationally mobile factor of production, will be shifted to labor, the less mobile factor. Unless other countries were to take measures to neutralize them, wide disparities in tax rates would result in inefficient misallocations of capital. It also would further encourage capital flight from developing and transitional economies (already now fostered in the U.S. case by the failure to tax interest paid abroad), and discourage investment into these countries.

In all, it may be concluded that unilateral substitution of the consumption taxes for the income tax would have major distorting effects on capital flows but only minor effects, limited to the Flat Tax, on commodity flows. Other countries might respond by making domestic investment more attractive to their resident investors via taxing corporate-source income at a lower rate, with a compensating increase in the tax on other income types. Such a response may be characterized as a form of tax competition set in motion by a radical tax change in one country.

It is obvious that with one country adopting a consumption-based tax system, while taxation in other countries remains largely income-based, that inter-nation equity becomes problematical. The country using a broad-based consumption tax would lay claim to but a minor share of income accruing to non-residents compared with other income tax-based countries.

E. Need for Cooperative Coordination

The consequences of one country adopting consumption taxation in isolation is likely to result in strong non-neutralities in the international allocation of capital leading to tax competition, particularly if that country is a large supplier of that capital, together with a departure from any semblance of inter-nation equity. In considering what possibilities there are for cooperative agreements to mitigate these problems, there is the question of how, in an economically interdependent world, tax systems based on different paradigms of entitlement (income and consumption) can be coordinated. Unfortunately, use of the two systems of taxation creates a fiscal disconnect that is not readily bridged by coordinating measures.[38]

There are no ready coordinating measures by which to

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38. *See* Peggy B. Musgrave, *International Coordination Problems of Substituting Consumption for Income Taxation, in* HEIDELBERG CONGRESS ON TAXING CONSUMPTION 453 (M. Rose ed., 1990).

restore neutrality in capital flows while also protecting revenue entitlements. Assertion of their tax sovereignty by the income-tax countries via the residence principle or imposition of a high withholding tax by the consumption tax country would deal with distorting capital inflow to the latter, but not with its tax deterrent to capital outflow. To deal with resident-owned capital, the consumption tax country would need to apply an income tax to its capital located abroad, thereby abrogating the shift to a consumption base. Restoring efficiency to capital flows via coordinating measures would thus be difficult or impossible in the mixed system, especially so while also maintaining the exercise of two different sets of entitlement.

This difficulty would disappear, however, if all countries were to adopt a consumption base. While this paper has focused on the implications of a unilateral substitution, a concluding look at a global system of consumption taxation may be mentioned briefly here. Under such a system, coordination not only would be feasible, but appears simpler than in the income tax setting. The problem of coordinating the taxation of capital income would disappear with the abolition of tax on capital income. However, a need for coordination would remain if the consumption base is applied in the context of a personalized expenditure tax. In that case, inclusion of residents' foreign financial transactions would be a crucial condition for securing a comprehensive tax base and this hardly could be done without cooperation from abroad. The substitution also would affect greatly the extent to which various countries can derive tax revenue in the international arena. The ability to reach domestic income of foreign-owned capital would be traded against the ability to tax foreign consumers of domestically-produced exports. This trade well may be to the disadvantage of developing countries and may call for compensatory revenue transfers.

VI. CONCLUSION

It is evident that replacement of the income tax system by broad-based consumption taxes would eliminate the source country's ability to share in the income gains derived by foreign factors from operation within its borders. Even though there has been a tendency to present the plans as "taxing all income alike," this gives a misleading impression. The taxation of capital income largely is voided by allowance for expensing and the systems should be seen as consumption taxes. As such, they do not permit a significant exercise of the entitlement rule. At the same time, unilateral replacement of consumption for income taxation would (a) abandon tax sovereignty over the allocation of domestic resources, (b) greatly worsen existing non-neutralities in the tax treatment of domestic and foreign investment, and (c) set off a round of international tax competition, with particularly damaging effects on developing countries.

For all the above reasons, and whatever the merits of the substitution might be for a closed economy, these merits do not extend to an open economy heavily engaged in a global capital market.