

***Tax Reform in Open Economies:
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Perspectives***

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Chapter 6

International Taxation and Company Tax Policy in Small Open Economies

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6.1 Introduction

Company tax policies around the world are in a state of flux, as many countries have reformed their corporate income tax systems in response to the ongoing process of globalisation, in an environment characterised by highly mobile international capital, international tax competition, and aggressive international tax avoidance by many multinational corporations (MNCs).¹ This environment is especially difficult for countries that can approximately be characterised as small open economies, that is, countries that face a perfectly elastic supply of capital at a rate of return that is determined in international capital markets as well as fixed prices for internationally traded goods; New Zealand is often characterised as an especially open economy (New Zealand Treasury, 2008). Tax competition for highly mobile capital has placed downward pressure on company tax rates, as countries strive to be competitive in attracting highly prized and highly mobile capital investments, especially those that promote the transfer of technology and have the potential of increasing productivity and growth rates, and New Zealand is no exception (New Zealand Inland Revenue, 2008). At the same time, however, such pressure is countered by a variety of factors, including arguments for taxing relatively immobile investments that generate economic rents at high rates and for aligning tax rates under the corporate and personal income tax systems to limit opportunities for domestic tax avoidance. In addition, increasingly aggressive efforts at tax avoidance, especially by large multinational corporations, further complicate the issue.

This chapter examines company income tax policy from the perspective of a small open economy operating in an environment characterised by international capital mobility, tax competition and tax avoidance, focusing on issues related to the company taxation of inbound foreign direct investment (FDI).² It begins by briefly considering various positions regarding company income tax policy in a small open economy that have appeared in the

¹ See Zodrow (2008, forthcoming) for discussions of recent evidence on the extent of international capital mobility, international tax competition and international tax avoidance.

² See Devereux and Sørensen (2006), Altshuler and Grubert (2008), and Griffith *et al.* (2008) for discussions of company income taxation that include excellent treatments of outbound FDI, including the choices between territorial and residence (both accrual and deferred) tax systems, and destination-based and residence-based taxes; see Head (2009) for a recent discussion of the integration of corporate and individual tax systems.

literature, focusing first on arguments for tax exemption of capital income and then on the many qualifications to these arguments that in practice have led to significant, if arguably declining, levels of taxation of capital income. This analysis pays particular attention to the implications of the existence of firm-specific and location-specific economic rents and the issues raised by various forms of international tax avoidance. The paper then traces out the implications of the analysis for evaluating various potential company income tax reforms, including brief discussions of applications of the analysis to the case of New Zealand – a topic that is covered in depth in the chapter by Benge and Holland in this volume.

6.2 General Discussion of Company Tax Policy in a Small Open Economy

This section of the chapter begins with a discussion of the standard argument that a small open economy should not apply a source-based (production-based) tax on internationally mobile capital, and then considers the many qualifications to that argument.

6.2.1 The Standard “Zero Tax” Argument

A now well-known argument is that a small open economy should not apply a source-based tax to internationally mobile capital (Zodrow and Mieszkowski, 1983; Gordon, 1986; Razin and Sadka, 1991).³ The intuition is the imposition of such a tax on perfectly mobile capital will simply cause it to migrate to other jurisdictions until its after-tax return increases to the internationally determined rate of return. This emigration of capital lowers the productivity of the fixed factors in the taxing country – land and labour (or at least relatively immobile labor), so that local factors of production ultimately bear the entire burden of the capital income tax, including both the revenue raised and the efficiency costs of the tax. These efficiency costs include suboptimal capital intensities, a tax bias favoring labor-intensive goods (Gordon and Hines, 2002), and a tendency toward under provision of public services in the presence of international tax competition (Zodrow and Mieszkowski, 1986; Wilson, 1986). Indeed, Harberger (1995, 2008) argues that in a small open economy, immobile labour and land may bear more than one hundred percent of a corporate income tax, once general equilibrium effects across business sectors are considered.

³ These arguments of course supplement the traditional efficiency case against the corporate tax, especially when applied to multinational corporations (Nicodème, 2008).

6.2.2 Extensions of the “Zero Tax” Argument

The discussion thus far has implicitly considered a marginal effective tax rate applied to capital investments in the absence of tax avoidance. However, much of the recent research on international taxation has focused on the role played by investments that earn economic rents and the implications of tax avoidance activity, especially by multinational corporations, for statutory corporate income tax rates.

The Role of Firm Specific Economic Rents

Another key element of setting tax policy in a world characterised by increasing globalisation is its effects on investment by multinationals. The economic theories underlying the formation of MNCs stress their potential to earn significant firm-specific economic rents, attributable to factors unique to the firm such as specialised technological knowledge, superior managerial skills or production techniques, or valuable product brands, trademarks, reputations and other intangible assets (Dunning, 1981). Moreover, there is some indirect empirical evidence suggesting that the relative importance of such rents is increasing over time, as Auerbach (2006) shows that the dispersion of relative profitability for US corporations has increased significantly in recent years, suggesting an increase in the importance of investments that generate above-normal returns made by a relatively small number of highly profitable firms.

Economic analyses have stressed that multinational decisions regarding the location of investments expected to generate significant economic rents are typically made among numerous mutually exclusive discrete choices; for example, a firm may want to take advantage of significant economies of scale due to large fixed costs by choosing a single location to serve multiple national markets. Under these circumstances, Devereux and Griffith (2003) argue that the average effective tax rate, which is a function of the statutory rate as well as the effective marginal tax rate, is the key determinant of MNC investment location decisions. Because investments generating firm specific economic rents are also highly mobile (and indeed may be especially highly prized by national governments as they are most likely to be associated with high levels of technology transfer, access to skilled labour and the generation of other external benefits, including a competitive environment that fosters invention and innovation), the logic underlying the standard tax competition

model implies that the statutory tax rate applied to such investments should also equal zero (Gordon and Hines, 2002).

The Role of Income Shifting

The pervasive phenomenon of income shifting by multinationals through various financial accounting manipulations accentuates the downward pressure on statutory tax rates attributable to international tax competition for investments that earn firm specific economic rents. In particular, it is corporate statutory tax rates that are relevant for income shifting as they determine the value of deductions and the tax cost of incremental revenues; that is, in the presence of income shifting, any country with a relatively high tax rate will receive a disproportionately large share of worldwide deductions while losing its fair share of worldwide revenues. Furthermore, a low statutory rate may make a country attractive for investment by MNCs simply because it creates the potential for additional income shifting (Slemrod, 1997). Serious concerns about income shifting have been expressed in New Zealand, including concerns that tax avoidance is encouraged by relatively high effective tax rates on labour income and will create the perception that the tax system is unfair and reduce compliance (New Zealand Inland Revenue, 2008; New Zealand Treasury, 2008).

6.2.3 Qualifications to Arguments for Low Corporate Income Taxes

It is clear that, notwithstanding the arguments made thus far, corporate income tax rates have not converged to zero and that the corporate income tax is still an important source of revenues in most developed and developing countries. A wide variety of arguments have been offered in support of company taxation, all of which qualify the argument that a small open economy should exempt capital income from tax. Although it is difficult to judge the relative importance of each of these qualifications, the pervasiveness of corporate income taxation around the world suggests that together these arguments have been taken seriously by policymakers.

Questioning the Basic Assumptions of the Small Open Economy Model

Gravelle and Smetters (2006) argue that, at least in the US context, both the assumptions of perfect capital mobility and perfect substitutability between imports and domestically produced goods that underlie the zero tax result may be inappropriate. In this case, domestic labour does not bear the full burden of a corporate income tax, which is to a

perhaps significant extent borne by capital, including foreign capital owners. Moreover, Gravelle and Smetters stress that even if a perfectly elastic supply of capital is a reasonable approximation for a small open economy, these same incidence results obtain if the substitution elasticity between domestic traded goods and imports is sufficiently low. These results, however, have been questioned by Randolph (2006) who argues that results similar to those in the standard model are obtained if the Gravelle-Smetters model is extended by allowing the corporate sector to produce both a good that is imperfectly substitutable with imports and a second good that is perfectly substitutable. In addition, several recent studies have obtained relatively high estimates of import substitution elasticities, consistent with the conjectures of Harberger (2008) and others. Thus the relative importance of the Gravelle-Smetters argument is a subject of ongoing debate.

The Role of Location Specific Economic Rents

Perhaps the most important argument in support of a relatively high level of company income taxation is that it allows the government to obtain significant revenues from the taxation of location specific economic rents. Such rents, which may accrue to both domestic and foreign firms, can reflect resource rents as well as economic rents that arise because of factors such as local economies of agglomeration, productive government infrastructure, easier access to consumers, lower transport costs, and inexpensive but relatively productive local factors of production including skilled labor, in addition to the ability to avoid trade barriers such as tariffs and quotas.

The taxation of location specific economic rents provides an efficient and thus highly desirable source of revenue. Moreover, such taxes are especially attractive from the standpoint of domestic residents and thus from a political perspective if the rents accrue to foreigners (Mintz, 1995), and empirical evidence suggests that a higher share of foreign ownership in a country results in a higher average corporate income tax rate (Huizinga and Nicodème, 2006).

The potential for taxing location specific economic rents may be particularly important in an island economy such as that of New Zealand where access to local markets is especially critical. Indeed, a significant fraction of FDI in New Zealand seems to service the domestic market, including banking and finance, communications and media, automotive, insurance,

retail wholesale distributors, industry and community services, construction and trade services, or to access New Zealand's natural resources (primary food production, food processing, oil, gas, minerals and electricity). Combined with a desire to tax rents earned by relatively immobile domestic capital and empirical evidence that rates of return to capital in New Zealand are relatively high (Hall and Scobie, 2005), the opportunity to tax location specific rents provides an important qualification to arguments for low source-based taxes on capital income.

The Personal Income Tax Backstop Argument

The traditional rationale for a corporate income tax – independent of international considerations – is that it is essential to limit avoidance of the personal income tax; that is, in the absence of a corporate income tax, individuals could incorporate and defer personal income tax on labour income by retaining the earnings in corporate form while financing consumption with loans from their companies. Although commonly provided as a rationale for corporate taxation of domestic companies, this argument extends to foreign companies to the extent that domestic individuals or firms can establish corporations that are nominally “foreign” (e.g., in a tax haven) and thus largely avoid domestic tax liability on their sheltered income (Gordon and Mackie-Mason, 1995; Gordon and Slemrod, 2000). In New Zealand, a top individual marginal tax rate of 39 percent⁴, relative to a 30 percent tax rate on corporations (as well as on portfolio investment entities) and a 33 percent tax rate on trusts, creates clear incentives for income shifting, and concern about increased income shifting due to the deviation from the traditional policy of rate alignment naturally permeates discussion of reducing the corporate statutory rate (New Zealand Inland Revenue Department, 2008).

A key factor in determining the importance of this argument is whether the sheltered labour earnings are likely to be exempt from individual level tax or taxed eventually when distributed to the owners of the corporation. In the latter case, the central issue is whether the combined tax burden due to current taxation at the statutory corporate income tax rate

⁴ The top statutory individual marginal tax rate is scheduled to decline to 37 percent in 2011. Effective tax rates at relatively low incomes can also be quite high due to the phase out of various credits (New Zealand Treasury Department, 2008).

and eventual individual level taxation of capital income falls significantly below the tax rate applied to individual labour income. Retention in corporate form implies that tax will be deferred, but given the widespread availability of tax-deferred savings in most nominally “income tax” countries, this may not be a serious problem. For example, Griffith *et al.* (2008) argue that rough neutrality between the taxation of labour income and capital income is achieved if the pattern of tax rates satisfies $(1-t_c)(1-t_r) = (1-t_L)$, where t_c is the statutory corporate tax rate, t_r is the individual level tax on capital income, and t_L is the top individual tax rate on labour income.⁵ Of course, earnings retained in the corporate sector that are ultimately taxed as realised capital gains will benefit from deferral. If deemed desirable, this advantage could be negated by adjusting the taxation of realised capital gains on shares of closely-held corporations to reflect the benefit of deferral (Auerbach, 1991), although such taxation of capital gains effectively on an accrual basis would be perceived as unusually harsh. Alternatively, income shifting can be reduced by placing limits on the extent to which investment income earned by closely-held corporations is subject to reduced tax rates (New Zealand Inland Revenue, 2008).

On the other hand, if the labour earnings are effectively exempt from taxation – for example, because capital gains are never taxed, even at death – then incorporation is an effective tax sheltering tool to the extent that the statutory corporate tax rate falls below the individual’s personal income tax rate. For example, in New Zealand, capital gains are not taxed and corporate income earned by trusts is exempt from further taxation; a recent dramatic increase in the amount of imputation credits held by closely-held companies suggests a sizable increase in sheltering activities by these companies (New Zealand Inland Revenue, 2008).

More generally, in the presence of a corporate income tax, the effectiveness of incorporation as a sheltering device depends on the differential between the corporate and individual income tax rates and the extent to which the two tax systems are integrated.

⁵ Of course, in the case of New Zealand, this argument would apply for retained earnings only if capital gains were made subject to tax as part of base broadening of the personal income tax (New Zealand Treasury, 2008), although the calculation of tax on such gains should in principle reflect adjustments for corporate taxes paid and inflation.

Specifically, more effective integration increases the attractiveness of incorporation as a tax shelter because it reduces the incorporation tax penalty that must be paid in the form of a separate corporate income tax. In addition, even with a fully integrated system, a corporate tax is likely to facilitate tax administration by serving as an effective tax withholding device.

Several factors limit the relevance of the backstop argument for a corporate income tax. First, the scope of the argument is limited as it applies only to self-employed individuals or the owners of closely-held corporations. Second, the extent to which the corporate tax serves as an effective backstop to the personal income tax is unclear, given the relatively low income tax compliance of sole proprietors and small businesses in most countries.

Nevertheless, in the absence of a corporate income tax or the presence of a significant tax rate differential favouring the corporate tax, the potential for tax avoidance and evasion could be significant, implying serious equity and perception problems, and empirical evidence suggests that the extent of such income shifting may be significant (Gordon and Slemrod, 2000; de Mooij and Nicodème, 2008). It is clear that the backstop argument provides a potentially important rationale for a company tax in New Zealand, and underlies its long tradition of rate alignment.⁶

The Role of Tax Avoidance Revisited

As discussed above, the relative ease with which multinational corporations can use financial accounting manipulations to shift income across jurisdictions provides a powerful additional argument for lower statutory corporate income tax rates. However, this argument must be qualified to the extent that possibilities for such tax avoidance by MNCs mitigate the otherwise negative effects on FDI of relatively high statutory and effective tax rates. Indeed, to the extent that such tax avoidance opportunities are available primarily to MNCs and such firms are more mobile than domestic companies, a relatively high statutory rate may be desirable as an “optimal capital income tax” strategy that attracts FDI at minimal revenue cost by imposing a high tax burden on relatively immobile domestic capital but a

⁶ Note, however, that the backstop function could be served with a corporate cash flow tax assessed at the top individual rate (Hubbard, 2002; Zodrow and McLure, 1991; Zodrow, 2006).

low effective tax burden, taking into account tax avoidance activities, on relatively mobile international capital (Gugl and Zodrow, 2006). An aggressive version of this strategy would include lax enforcement of the many rules currently used to limit tax avoidance by MNCs or even explicit regulations that facilitate such tax avoidance – the “new” variation of international tax competition stressed by Altshuler and Grubert (2006).⁷ Of course, the pursuance of such a strategy will understandably be viewed as highly inequitable by domestic firms and may be difficult to maintain politically.

The Treasury Transfer Effect

An often-invoked rationale for imposing a relatively high tax burden on FDI in countries that import capital from capital exporting countries that tax their MNCs on a residence basis but allow credits for foreign taxes paid, including the US, the UK and Japan, is the “treasury transfer” effect. The essence of this argument is that, under certain circumstances, a host country that imports capital primarily from countries that grant foreign tax credits (FTCs) should raise its tax rate approximately equal to the rate utilised by those countries, since such a rate increase will essentially transfer revenues from the treasury of the home country to the treasury of the host country without having any deleterious effects on FDI. This result obtains because the rate increase in the host country is offset by foreign tax credits that reduce the final domestic tax liability of the MNC.

The prospect of such a “free” source of tax revenue is naturally appealing. However, in practice, the treasury transfer effect is often of limited relevance. Most obviously in the case of New Zealand, the US and UK are by a considerable margin secondary to Australia as a source of FDI. Australia operates a territorial corporate income tax system and thus does not grant any foreign tax credits to its multinationals.⁸ But even apart from this consideration, several arguments suggest a limited role in practice for the treasury transfer

⁷ Indeed, Hong and Smart (2007) argue that tax havens should be “praised” for allowing this flexibility, which implies that FDI will be less sensitive to cross country tax rate differentials, thus allowing higher corporate tax rates in host countries to be welfare-increasing for their citizens. In contrast, Slemrod and Wilson (2006) note that this is not the case when tax havens also facilitate sheltering of domestic labour income.

⁸ Australia accounts for roughly half of FDI in New Zealand, with the shares of the US, the Netherlands and the UK ranging from 6-12 percent.

effect. First, because of various limitations placed on the use of foreign tax credits, many US multinationals are in an “excess foreign tax credit” position – that is, they already have more credits than they can use currently, so that additional credits are of limited value.⁹ Second, the treasury transfer effect may be illusory in many cases because host country taxes are assessed currently but foreign tax credits in the home country are not granted until the funds are repatriated to the parent firm; as a result, the home country repatriation tax may have little or no effect on investment financed with the retained earnings of the subsidiary (Hartman, 1985; Sinn, 1987). Under this view, investments financed with retained earnings are affected only by host country taxes.¹⁰ Together, these arguments suggest that the treasury transfer effect should play little if any role in the determination of company tax policy in New Zealand.

The Political Desirability of Business Taxation

Political realities may make some form of corporate income taxation inevitable, given popular demands to tax “rich” corporations owned by wealthy investors. In particular, the long history of company taxation in most countries suggests that taxing both domestic and foreign corporations may be indispensable from a political viewpoint, regardless of how compelling the arguments against such taxation may be to economists (Bird, 1996). In addition, source countries often assert a sovereign “right” to tax the income generated within their boundaries, beyond any royalties that are imposed on the extraction of natural resource (Musgrave, 2000). Finally, the corporate income tax is an excellent example of a “hidden tax,” one whose burden is not readily apparent and is thus attractive from a political, if not a public choice, standpoint.

⁹ Moreover, the likelihood that a US firm is in an excess foreign tax credit position has been increased by (1) the use of tax avoidance techniques that effectively separate foreign taxes paid, which can be credited currently, from the associated foreign source income which can then be deferred – perhaps indefinitely provided that the multinational does not need to repatriate the funds back to the US – from US tax liability, and (2) the rules used by the US to allocate expenses to foreign source income; see Zodrow (2008) for further discussion.

¹⁰ This argument applies the logic of the “new view” of dividend taxation in an international context and is subject to the same criticisms; in particular, Grubert (1998) finds that repatriation flows are negatively related to repatriation taxes, a result that is consistent with the “traditional view” that such taxes do have an effect on investment behavior.

Nevertheless, in New Zealand as elsewhere around the globe, the political arguments favoring relatively high corporate income taxation are increasingly offset in public discussion of tax policy by the specter of increasing globalisation and international tax competition. Accordingly, it is far from clear that political considerations present an insurmountable obstacle to reductions in corporate income taxation, although they are likely to preclude the elimination of the company tax.

6.3 Evaluation of Specific Company Tax Reform Options

The discussion thus far demonstrates clearly that setting company tax policy in a small open economy is an exceedingly difficult task, and that no single tax structure will simultaneously deal with all the issues discussed above. Accordingly, it is not surprising that countries attempt to strike a balance between the various competing forces described above, that the balance struck differs across countries depending on their individual circumstances, and that this balance is continually being reconsidered especially in light of the economic forces associated with increasing globalisation and a more highly integrated global economy. For example, while noting that numerous arguments suggest that corporate tax rates will not follow a “race to the bottom” of a zero rate, the New Zealand Treasury (2008) argues that competition for mobile capital is likely to put downward pressure on corporate tax rates – and that the tax rate in Australia, currently under review by the government, is naturally a critical benchmark. Within the context of striking such a balance between exemption and full taxation of mobile international capital, a wide variety of company tax reform options might be considered in any small open economy. The following discussion focuses on several of these options, beginning with several revenue neutral base broadening approaches and then turning to options that would reduce the overall amount of revenue obtained from capital income taxation.

6.3.1 Revenue Neutral Base Broadening and Rate Reducing Income Tax Reform

The traditional arguments supporting income tax reform in the direction of broadening the base by eliminating tax preferences and other deviations from the accurate measurement of real economic income and using the resulting revenues to reduce statutory tax rates for both domestic and foreign firms are largely strengthened by the international taxation considerations discussed above. Base broadening, rate reducing corporate income tax

reforms are in general desirable because they reduce the efficiency costs associated with tax distortions across assets and business sectors (unless such “distortions” are desirable to offset important externalities) as well as distortions of the choice of organisational form, method of finance, and payout policies, simplify tax administration and compliance, and eliminate both the perception and the reality of inequitable government favoritism toward certain industries. Although New Zealand has historically been known for its extremely broad tax bases (with the exception of the exemption of capital gains at the individual level), some tax preferences have been creeping into the system implying some limited scope for a base broadening, rate reducing reform (New Zealand Inland Revenue, 2008; New Zealand Treasury, 2008).

These standard arguments are significantly reinforced if one considers the possibilities for international tax avoidance, as a lower statutory rate reduces incentives for multinationals to shift revenues out of, and deductions into, a taxing jurisdiction. Lower statutory corporate income tax rates are also likely to be effective in attracting foreign direct investments that generate firm specific economic rents by lowering the average effective tax rate applied to such rents. The combination of lower rates and eliminating tax preferences, however, is not likely to reduce effective marginal tax rates on average to any significant extent, and thus will not increase the equilibrium level of investment at the margin.

Several objections are commonly raised to the base broadening, rate reducing approach to company income tax reform. A standard criticism is that reductions in statutory rates are very costly in terms of revenue relative to the additional investment incentives they generate because the lower rates apply to the income earned by existing capital. A closely related point is that reductions in statutory rates financed with base broadening reduce the taxation of both domestic and foreign investments that earn location specific rents or are otherwise immobile. Finally, to the extent that a lower statutory corporate income tax rate creates or increases a rate differential between personal and corporate income tax rates, it exacerbates incentives for tax avoidance in the form of shifting income from the personal tax base to the corporate tax base.

Although these arguments have some validity, each must be qualified. There is no question that a corporate tax rate reduction benefits existing investments and results in

lower taxation of location specific economic rents. However, as suggested above, the “bang for the buck” from rate reduction may not be as small as is sometimes envisioned, because it may stimulate investments that generate firm specific economic rents. In addition, in some cases increases in alternative revenue instruments, such as production based taxes in the case of resource rents, can be used to maintain the taxation of location specific rents. Assuming that base broadening efforts are designed to result in a tax base that measures real economic income as closely as possible,¹¹ the base broadening, rate reducing approach has the important advantage of creating a tax system that is based on solid economic principles and is hopefully more stable than one based on granting tax preferences that are often as much or more politically than economically motivated. Finally, if rate reduction is perceived to result in an unacceptable level of benefit to existing investments, that tax reform-induced benefit could be eliminated with appropriately designed transitional taxes, such as the “windfall recapture tax” that was proposed, but ultimately not enacted, to deal with this issue under the large rate reductions enacted in the US Tax Reform Act of 1986.¹²

A corporate tax rate reduction that widens the differential between the top personal tax rate and the corporate rate does encourage income shifting from the personal tax base to the corporate tax base, and recent empirical work suggests that the magnitude of this effect may be significant. However, as argued above, the importance of this effect depends on the extent to which tax administration and enforcement are effective in limiting opportunities for such income shifting, and on the extent to which it results only in deferral, rather than complete exemption, of individual level taxation on the shifted income.

On balance, the traditional base broadening, rate reducing approach to company tax reform has considerable appeal. Note that the same logic applies to the personal income

¹¹ A separate issue is whether the measurement of income should be adjusted for inflation, as described in Thuronyi (2000). As long as inflation rates are relatively low and fairly stable, the complexity of a comprehensive system of inflation adjustment can be avoided (although at the cost of some additional complexity in the treatment of asset sales) with *ad hoc* adjustments such as appropriately accelerated depreciation allowances (or partial expensing) and LIFO inventory accounting.

¹² The proposed windfall recapture tax would have calculated the deferred income due to accelerated depreciation deductions (defined as those in excess of the deductions allowed under the “earnings and profits” accounting method) taken prior to the enactment of reform and effectively taxed that income at the pre-reform tax rate; see Zodrow (1988).

tax. In particular, given the relatively high mobility of labour in New Zealand, including highly skilled labor,¹³ low marginal tax rates on labour income are highly desirable as well, and a substitution of labour taxes for capital taxes is less desirable than it would be if labour mobility were lower (New Zealand Inland Revenue Department, 2008; New Zealand Treasury Department, 2008).

6.3.2 Further Rate Reductions under an Income Tax Reform

If the corporate income tax rate reduction that can be achieved with (politically feasible) base broadening is deemed to be insufficient, several other approaches can be utilised within the context of an income tax.

The Comprehensive Business Income Tax

The Comprehensive Business Income Tax (CBIT) was proposed by the US Department of the Treasury (1992) as a means of integrating the corporate and personal income taxes in the US.¹⁴ The CBIT further broadens the base of the corporate income tax – beyond the extent typically associated with a traditional classical income tax – by disallowing deductions for interest expense. In addition, under a fully integrated system, individual level taxation of capital income is needed only to the extent of differences in corporate and individual tax rates (the rate under the CBIT as proposed in the US would have approximated the top individual tax rate), and the extent to which the taxation of capital gains in excess of those attributable to retained earnings is deemed desirable. Thus, for debt financed investment, the CBIT effectively shifts the locus of taxation from the holder of the debt to the corporation. Since much interest income typically escapes taxation at the level of the bondholder, a CBIT would likely raise revenue and allow further rate reduction – estimated to be roughly three percentage points in the case of the US – although in general this depends on whether the revenue increase due to the elimination of interest deductibility is offset by the revenue decline due to reduced taxation of capital income at the individual

¹³ Indeed, the New Zealand Treasury (2008) argues that New Zealand probably has the most mobile labour force of all the countries in the OECD, noting that approximately one quarter of skilled New Zealanders live abroad, with trans-Tasman migration a particularly important phenomenon.

¹⁴ The proposed CBIT would have also applied to unincorporated businesses.

level (and any changes in the taxation of foreign shareholders). Since both interest and dividends are treated uniformly – that is, they are not deductible and are thus taxed at the corporate level – the tax bias favoring debt finance under the typical income tax is eliminated.

The effect of a revenue neutral CBIT on effective marginal tax rates would depend on the net effect of a reduction in the tax burden on equity financed investment (assuming that the statutory rate declines) and the increase in the tax burden on debt financed investment, which would now all be assessed at the business level, raising the source-based tax on debt-financed foreign direct investment. Such relatively harsh treatment of debt would likely reduce the level of debt-financed investment, especially by multinationals – unless multinationals responded by keeping their investment level largely unchanged while reallocating their debt to other countries where full interest deductibility was allowed. The statutory rate reduction obtained under a CBIT would moderately reduce incentives for income shifting, as well as the level of taxation of economic rents. The CBIT is thus more attractive to countries attempting to attract multinationals with investments that generate firm specific rents, than to countries focused on taxing location specific rents earned by both domestic firms and multinationals.

In addition, note that since the CBIT disallows deductions for interest expense, it would raise the same foreign tax creditability issues that plague cash-flow taxes (for example, the Flat Tax and the X-Tax) with the same feature. The combination of an increase in the effective marginal tax rate applied at the business level to debt-financed foreign direct investment (and the transition problems that this would cause for highly leveraged firms) plus the lack of foreign tax creditability would seem to make the CBIT an unattractive option for most small open economies.

Increasing the Individual-Level Share of the Taxation of Capital Income

From the perspective of attracting foreign direct investment that earns either normal returns or firm specific rents, the CBIT has the disadvantage of increasing the share of the

tax burden on capital income that is borne at the corporate rather than the individual level.¹⁵ Altshuler and Grubert (2008) stress that shifting the mix of capital income taxation from the corporation to the individual level, while largely irrelevant in a closed economy (apart from administrative considerations), is desirable as globalisation and capital mobility increase. For example, additional corporate income tax rate reduction could be effected by shifting the point at which the tax burden is imposed from the company level to the individual level in the form of a higher rate or more comprehensive taxation of dividends, capital gains (discussed further below) and interest income at the individual level for domestic investors. Such an approach could keep the combined capital income tax burden on domestic investors roughly constant, especially if the company and personal tax systems are largely integrated,¹⁶ while applying a lower statutory rate to the income (including firm specific economic rents) earned by highly mobile international capital, while reducing incentives for international tax avoidance.

6.3.3 Corporate Rate Reduction with Increases in Labour or Consumption Taxation

Although such base broadening, rate reducing approaches to corporate income tax reform can be used to lower the statutory company tax rate somewhat, that rate would still likely be relatively high after such a reform, and the associated effects on effective marginal tax rates applied to capital income would be relatively small (under the reasonable assumption that any tax preferences eliminated had some impact in terms of reducing the cost of capital for the preferred investments). Accordingly, further reductions in the corporate statutory rate, financed with increases in the taxation of labour income or consumption rather than tax changes that increase the burden on capital income, may be desirable, especially for countries that are focused on attracting foreign direct investment, including investments that generate firm specific economic rents, and concerned about revenue losses due to income shifting by foreign multinationals. Indeed, both New Zealand Inland Revenue (2008) and

¹⁵ Of course, this is an advantage from the perspective of effectively collecting revenue on domestic investment.

¹⁶ See US Department of the Treasury (1992), Hubbard (2005) and Head (2009) for discussions of alternative means of achieving corporate-individual tax integration.

the New Zealand Treasury (2008) suggest that moving toward increased reliance on consumption-based taxes may be desirable – partly on the grounds that corporate income taxes are more harmful than consumption-based taxes to economic growth (see Johansson, *et al.*, this volume); in addition, the Treasury stresses that limited use of payroll taxes in New Zealand implies that the tax burden on capital income is relatively high in comparison to other OECD countries.

Such an approach could be implemented simply by decreasing income tax rates and increasing tax rates applied to consumption, for example, under a value-added tax. Such a tax substitution, however, is often deemed to be undesirable on distributional grounds. In this case, an alternative approach is to reduce the taxation of capital income relative to the taxation of labour income. Such an approach clearly deviates from traditional arguments for comprehensive income taxation of all capital and labour income at the same rate. However, as discussed above, the application of a lower rate to capital income than that applied to labour income may be desirable for a wide variety of reasons, especially in an environment characterised by increasing international capital mobility, international tax competition, and international tax avoidance. That is, in general there is no particular reason to believe that the optimal balance between labour and capital income taxation necessarily prescribes equal tax rates for both types of income, and the arguments for relatively lower rates on capital income typically found in the optimal income taxation literature are augmented by international taxation considerations (Sørensen, 2005; Auerbach, 2008a).

However, applying lower income tax rates to capital income naturally creates incentives for the conversion of labour income into capital income. As discussed above, lower rates for capital income may simply be accompanied by a variety of administrative measures designed to limit the conversion of labour income to more lightly taxed capital income. An alternative and more systematic approach, which attempts to limit the conversion of labour income into capital income through the use of special imputation rules, is the “dual income tax” (DIT) pioneered in the late 1980s and early 1990s by the Nordic countries, and adopted more recently in numerous other settings (Genser and Reutter, 2007).

Since the dual income tax is addressed at length by Sørensen (this volume), the following discussion will be brief. Under a “pure” dual income tax,¹⁷ all capital income is taxed at a single proportional rate at either the business or individual levels (equal to the minimum non-zero tax rate applied to labour income), while labour income is taxed at progressive rates under the individual income tax. Dividends are excluded from the individual capital income tax base, while capital gains are taxed at the individual level on a realisation basis but with shareholders allowed to write up their basis by net retained earnings. Capital income taxes are collected via withholding at source, which in the simplest version of the tax (which does not allow capital loss offsets against labour income or apply personal exemptions or standard deductions against capital income) represents a final tax. In principle, full tax withholding could be extended to foreigners, but in practice this is very limited, for the same reasons as noted above in the discussion of the CBIT. Profits of proprietorships and closely-held companies are split into a capital income component, typically calculated by applying a presumptive rate of return to the firm’s capital, which is taxed at the proportional rate on capital income, and a labour income component, which equals the residual profit and is taxed at progressive rates under the personal income tax.

The structure of the dual income tax is clearly designed to strike a balance between the standard small open economy argument for low tax rates on capital income, including firm specific rents, supplemented by concerns regarding the implications of international tax avoidance, and the opposing arguments for taxing capital income at relatively high rates to capture location specific economic rents earned by both multinationals and relatively immobile domestic firms, while maintaining a backstop to the personal income tax.

The primary problem with the dual income tax approach – its “Achilles heel” according to Sørensen (2005) – is that despite the imputation method used to split capital income described above, in practice considerable income shifting by the owners of closely-held companies still occurs.¹⁸ In addition, as mentioned above, in response to intense tax

¹⁷ This definition follows Cnossen (2000); see also Sørensen (1994) and Nielsen and Sørensen (1997). Of course, in practice, actual dual income taxes differ to varying degrees from this ideal version.

¹⁸ Devereux and Sørensen (2006) note that Norway has attempted to remedy this problem (for “active” shareholders in a closely-held company) by replacing the income splitting approach with a shareholder tax that

competition with respect to the taxation of interest income, in practice DIT countries impose at most partial withholding taxes at source on interest payments. Note, however, that to the extent interest income is taxed at source under a DIT, its treatment of debt is relatively harsh (compared to the typical treatment of full deductibility and limited if any withholding), discouraging multinationals from allocating debt to any country that has adopted a DIT.

In summary, by largely separating the taxation of capital income from the progressive income taxation of labour income, the dual income tax approach provides a mechanism for dealing with the many tensions faced by tax policy makers in a small open economy described above. It thus represents a reasonable approach to balancing the offsetting tensions that characterise today's fiscal landscape, and deserves serious consideration by governments who are attempting to design company tax policy in the face of increasing international capital mobility, international tax competition, and international tax avoidance.

6.3.4 Consumption-Based Business Taxes and Consumption Tax Reforms

As discussed above, one response to the forces of increasing globalisation has been to reduce business level taxes as much as possible in order to attract foreign direct investment (including investments earning firm specific rents) and minimise business income shifting opportunities, and concentrate the taxation of capital income at the individual level.¹⁹ Implementation of a dual income tax would reduce the taxation of capital income at the individual level as well. A natural question, especially in light of the desire to stimulate domestic saving in New Zealand to reduce persistent current account deficits and reliance on potentially unstable mobile foreign capital, is whether it would be desirable to eliminate the taxation of the normal returns to capital by adopting a more radical and certainly more controversial reform – implementing direct taxation on the basis of consumption rather than income.

results in taxation of returns in excess of a normal rate of return (termed the rate-of-return allowance) at individual rates.

¹⁹ The same reasoning played a role in the development of the recent Norwegian reform, noted above, that provides a rate-of-return allowance at the personal level to shareholders rather than at the business level as under the conventional “allowance for corporate equity” (ACE) tax discussed below (Sørensen, 2005).

Many consumption-based direct taxes have been proposed in recent years.²⁰ In general terms, under a consumption-based approach, a business level tax would apply an effective tax rate of zero to the normal returns earned by marginal investments while taxing above normal returns or economic rents at the statutory tax. Under most plans, this would be achieved by subjecting businesses to a cash-flow tax that would allow immediate expensing of all investment purchases and either disallow deductions for interest expense or tax loans on a cash-flow basis (with loan proceeds taxed and both interest and principal repayments deductible). However, under the alternative “Allowance for Corporate Equity” (ACE) approach,” firms would continue to get deductions for depreciation and interest expense, and would be allowed an additional deduction for equity financed investment – equal to the product of the book value of equity capital and a fixed rate of return – analogous to the deductions for interest expense allowed for debt-financed investment under the income tax. Capital income at the individual level would either be exempt or subject to consumption-based cash-flow taxation as well – in the latter case with deductions for saving and taxation of all withdrawals (that is, the same treatment provided to much retirement savings under many tax systems that are nominally described as income taxes).

There is of course a huge literature on the relative advantages of income and consumption taxation, developed largely in the context of closed economies.²¹ In brief, proponents of consumption-based taxes argue that they are preferable to income taxes because they are (1) relatively efficient, primarily because they eliminate the income tax distortion of consumption-saving decisions as well as a wide variety of investment distortions; (2) fairer than the income tax because they do not discriminate against

²⁰ These include the Flat Tax proposed by Hall and Rabushka (1995) and its X-Tax variant as designed by Bradford (1986, 2003), the “cash-flow income tax” proposed by Aaron and Galper (1985) and its close relative the “Unlimited Savings Allowance” or USA Tax (see Weidenbaum, 1995), the “hybrid consumption tax” proposed by McLure and Zodrow (1996a, b), the “allowance for corporate equity” or ACE tax adopted temporarily in Croatia (Institute for Fiscal Studies, 1991; Rose and Wiswesser, 1998; Keen and King, 2002), and a tax on net corporate distributions, adopted in Estonia.

²¹ For recent discussions see Auerbach (2008a), Banks and Diamond (2008), and Zodrow (2007), as well as the articles in Zodrow and Mieszkowski (2002), Aaron, Burman and Steuerle (2007), and Diamond and Zodrow (2008).

individuals who save and earn capital income while still utilising multiple rates to achieve progressivity; and (3) simpler in terms of administration and compliance.

From the perspective of a small open economy, a consumption-based tax has the advantage of applying an effective marginal tax rate of zero to the normal returns earned by both foreign and domestic investment while taxing location specific economic rents at the statutory rate – which under most plans would be set equal to the maximum individual tax rate on labour income. In addition, alignment of the business level tax rate and the top individual rate implies that a consumption tax acts as an effective backstop to individual level taxation of labour income. The business tax under a consumption tax also satisfies at least partially the political need for such a tax.

At the same time, however, several factors suggest that implementing a consumption-based tax may not be appropriate for a small open economy attempting to attract investment in the world economy. A consumption-based tax naturally also taxes firm specific economic rents at the statutory rate, and thus may discourage relatively mobile investments that generate such rents, especially if the statutory rate is kept high in order to collect significant revenues from both domestic and international investments that earn location specific economic rents and to make up for the loss of revenue that occurs with the tax exemption of normal returns to investment. Similarly, a relatively high statutory tax rate under the business component of a consumption tax will create incentives for tax avoidance in the form of income shifting by multinationals, resulting in a potentially significant negative effect on tax revenues. It should also be noted, however, that under certain forms of consumption-based taxation interest deductions are not allowed, in which case businesses would face a large incentive to allocate debt to income tax jurisdictions where interest was deductible, thus mitigating the effect of a relatively high cash-flow tax rate.

Several other issues associated with implementing a consumption tax are problematical. Since normal returns are not subject to the business tax, some (probably relatively small) amount of revenues that might be obtained via the treasury transfer effect would be foregone. Moreover, it seems clear, that the US, and perhaps other countries that grant foreign tax credits, would not allow creditability for a cash flow business tax, despite

arguments that creditability would be appropriate (McLure and Zodrow, 1988).²² Consumption-based taxes are not immune to tax avoidance manipulations, especially in a world where one's trading partners continue to use the income tax (Bankman and Schler, 2007). Finally, the transition problems associated with implementing a consumption tax – including the need to renegotiate existing treaties with income tax countries – would be formidable (Gravelle, 2002), although a variety of factors act to mitigate some of these problems (Zodrow, 2002).

This discussion suggests that, although consumption-based direct taxation has many advantages, there are also a number of reasons why caution would be advisable, and why the desirability of such reform in a given country would depend on its specific circumstances. Moreover, if a country is seriously contemplating a move towards consumption-based direct taxation, the discussion above also suggests that serious consideration should be given to the ACE approach to such a tax. Because the ACE approach is closer to an income tax in structure than any of the cash-flow tax options – it basically adds a generous investment incentive to an income tax in the form of the additional deduction for corporate equity, while continuing to allow deductions for depreciation and interest expense – it would involve fewer transitional issues and would not be perceived as a radical departure from income tax, as would any of the cash-flow based consumption tax options. Moreover, for essentially the same reasons, the US has not questioned the credibility of the ACE tax, for example, when it was enacted briefly in Croatia (Rose and Wiswesser, 1998; Zodrow, 2003). The investment stimulus and efficiency gains associated with adopting an ACE would of course be enhanced if the equity deduction were not granted to existing capital; indeed, Griffith *et al.* (2008) propose such an approach, and show that the potential problem of firms liquidating and reforming to take advantage of the new equity deduction is limited as long as asset sales are treated as fully taxable.

²² Note, however, the US has agreed to allow creditability for a portion of the Italian IRAP (Imposta Regionale sulle Attività Produttive), a type of origin-based value-added tax that is quite similar to a cash-flow business tax with no deductions for labour compensation; roughly speaking, the creditable portion is the value-added tax base less compensation and interest payments (Adelchi, 2002).

The ACE approach does not have the apparent simplicity advantages of allowing expensing rather than deductions for economic depreciation. However, the practical benefits of allowing expensing for tax purposes are limited, given that firms will still have to determine depreciation deductions for financial accounting purposes. A related point is that the ACE approach also avoids some problems peculiar to allowing expensing under the cash-flow approach, including increasing the gains to various tax avoidance schemes and creating new avoidance opportunities (especially in the international arena), and increasing the likelihood of negative business tax bases and the problems they engender (McLure and Zodrow, 1996b). Moreover, in a variant of his X-Tax, Bradford (2003) argues that an approach similar to that under an ACE tax is in fact a highly desirable way to implement a consumption tax, as it reduces transition problems and eliminates the potential distortions of investment timing decisions that arise under strict cash flow accounting when future tax rate changes are anticipated. The ACE approach – like the cash-flow options but in contrast to the income tax – has the advantage that inflation adjustment of depreciation allowances is unnecessary as any understatement of such allowances is exactly offset in present value terms by a higher value for the equity deduction. Indeed, this argument applies to all mismeasurement of depreciation allowances since, as with the expensing option under the cash-flow approaches, the present value of the deductions allowed – for depreciation and the equity deduction – equals the purchase price of the asset.

The determination of the imputed rate of return on equity would of course be difficult under the ACE tax, and its neutrality properties would not obtain unless that rate were determined accurately. (The same issue arises in the determination of the carry-forward interest rate for negative cash-flows under the various cash flow options.) Griffith *et al.* (2008) conclude that the appropriate rate would be the risk free rate plus an “average” risk premium to reflect the possibility that any losses might not be recovered in full. Since the appropriate risk premium will differ across firms, but administrative realities imply that a single rate will be used, some distortions of investment decisions will arise. In addition, because the statutory tax rate under an ACE tax would likely be relatively high, it cannot avoid the problems of taxing firm specific economic rents, creating incentives for income shifting by multinationals, and perhaps losing some revenue by forgoing the treasury transfer effect. But no tax is perfect, and the ACE tax achieves all the benefits of

consumption-based taxation outlined above. In particular, it might be an attractive business tax reform option in a country – like New Zealand – that can be characterised as a relatively small open economy, has a significant fraction of investments that earn location specific economic rents, and wishes to increase domestic saving by eliminating income taxation of the normal return to saving.

Finally, the argument made by Altshuler and Grubert (2008) discussed above – that concerns regarding globalisation and international capital mobility suggest that the taxation of capital income should be concentrated at the individual rather than the corporate level – can be applied in this case as well, with the same advantages and disadvantages. Specifically, if some taxation of capital income were deemed desirable, consumption-based taxation could be applied at the business level, coupled with individual level taxation of capital income. Such an approach results in a hybrid system that has the advantages of consumption-based taxation at the business level, while retaining some taxation of capital income, to satisfy distributional concerns or to reflect a policy response to arguments implying that the optimal tax rate on capital income, while lower than that applied to labour income, is nevertheless not zero (Auerbach, 2008a, b; Zodrow, 2007). Indeed, the “Growth and Investment Tax” proposed by the President’s Advisory Panel on Federal Tax Reform (2005) in the US consisted of a consumption-based business level tax that allowed immediate expensing of all business-related purchases (while ignoring loans), coupled with taxation of dividends and capital gains at a flat rate of 15 percent. Similarly, the reform proposed for the UK by Griffith *et al.* (2008) consisted of an ACE tax at the business level, similarly coupled with individual level capital income taxation.

6.4 Conclusion

This paper argues that any moderately small open economy operates in an environment characterised by increasing international capital mobility, international tax competition, and international tax avoidance. Although one can construct theoretical arguments with policy prescriptions that range from zero taxation of capital income to full taxation of capital income and a rate equal to the top individual rate applied to labour income, in practice neither of these extreme solutions is likely to be desirable. Instead, policies on the taxation of capital income will depend on specific circumstances – with the primary factors being the

extent to which the supply of international capital is highly elastic, the relative importance of firm specific and location specific economic rents, and the extent to which income shifting, including by multinational corporations and between the personal and company tax bases, is a problem that cannot be resolved with regulations designed to limit such shifting. In general, the traditional arguments for base broadening and rate reduction are strengthened by international considerations, which also imply that taxation of capital income at rates lower than those applied to labour income is likely to be desirable, with the dual income tax being one potential way to achieve such differentiation. Finally, although there are many advantages to direct taxation on the basis of consumption, there are also many problems associated with implementing such a reform. On balance, in the current environment, if a consumption-based approach is deemed desirable, the ACE approach is the most feasible of the many available consumption-based business tax options. Moreover, it could in principle be accompanied by individual level income taxation of dividends and capital gains, if a full implementation of a consumption tax were deemed undesirable.

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