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Do international tax relations impede a shift towards expenditure taxation?

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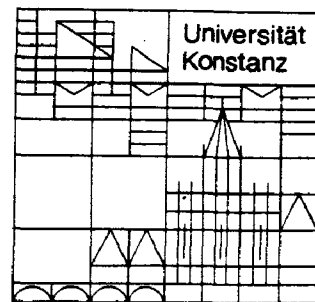
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Diskussionsbeiträge

Juristische
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wissenschaften und Statistik

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**Do International Tax Relations
Impede a Shift
towards Expenditure Taxation?**

**DO INTERNATIONAL TAX RELATIONS IMPEDE A SHIFT
TOWARDS EXPENDITURE TAXATION?**

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Serie II - Nr. 108

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Do International Tax Relations Impede a Shift towards Expenditure Taxation?

Bernd Genser (University of Konstanz)

Zusammenfassung

Die weltweite Steuerreformdiskussion der achtziger Jahre gründet sich auf die theoretische und die empirische Evidenz, daß die bestehenden Einkommensteuersysteme gravierende alloкатive und administrative Mängel aufweisen. Die Hypothese, daß Steuerreformschritte in Richtung auf ein theoretisch überlegenes Ausgabensteuerszenario infolge internationaler Besteuerungsregelungen nicht gesetzt werden konnten, vermag jedoch nicht zu überzeugen. Zum einen läßt sich die Einführung einer Mehrwertsteuer vom Konsumtyp in etwa fünfzig Staaten als ein Schritt in Richtung auf ein ausgabenorientiertes Steuersystem deuten, zum anderen erfordern ausgabensteuerorientierte Neufestlegungen der nationalen Bemessungsgrundlagen von Einkommen- und Körperschaftsteuern nicht notwendigerweise eine Neuverhandlung der bilateralen Doppelbesteuerungsabkommen. Allerdings läßt sich aus der Sicht der ökonomischen Theorie der Steuerpolitik ein Begründungsmuster für die mangelnde politische Unterstützung einer ausgabensteuerorientierten Steuerreform gewinnen. Da insbesondere multinationale Unternehmen über internationale Steuerarbitrage Renten erzielen können, die ihnen in einem globalen Ausgabensteuerregime nicht mehr offenstünden, fällt eine einflußreiche politische Lobby für eine ausgabenorientierte Steuerreform aus.

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**DO INTERNATIONAL TAX RELATIONS IMPEDE A SHIFT TOWARDS
EXPENDITURE TAXATION?**

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**April 1990
Revised draft**

Abstract

The paper questions the view that international tax relations had a decisive impact on the dismissal of expenditure tax scenarios as guidelines for recent national tax reforms in industrialized countries. It is argued that the introduction of consumption-type value-added tax systems must be regarded a step towards expenditure taxation favoured by international agreements and that double taxation treaties should not be regarded as a specific obstacle against a reform of national enterprise taxation with respect to cash flow concepts. Nevertheless a political economy view may explain that international tax avoidance and rent seeking made multinational enterprises reluctant to support an expenditure tax regime.

JEL-Classification Number: 323

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I. Introduction

Theoretical and empirical evidence that national income tax regimes suffered from major shortcomings has resulted in a worldwide discussion of tax reform scenarios in the eighties. Claims that the system of direct taxes needed adaptation to achieve the goals of an equitable distribution of tax burdens and net personal income, of avoiding allocative distortions and welfare losses for the society and of low costs of information, compliance, administration and control is not new and has led to changes in the tax systems in the past. In the last three decades major reform steps have included measures to integrate corporate and personal income taxes, indexation rules to mitigate inflationary distortions or the introduction of assignment rules for household income in order to escape undesirable progressivity effects.

These traditional targets are also present in the recent reform debate. There seems, however, to be one further aspect which might be responsible for the international popularity of tax reform considerations in nearly all major industrialized countries, namely the awareness of the interdependence of national tax systems in our increasingly integrated world economy (see OECD 1987a, Pechman 1988, Summers 1988, Tanzi 1988).

Nevertheless this international view of domestic tax regimes is not novel at all. International factor mobility and resulting income flows have led to international negotiations to tackle the double taxation problem as early as in the last century. In every industrialized country forty or more bilateral double taxation treaties complement domestic tax law. Depending on the goals aimed at these arrangements reflect the structure of the national tax systems at the time when the treaties had been negotiated or amended.

The existence of the tax treaties has to be considered if the national tax system is to be reformed. If a new tax system

is introduced it might be necessary to adapt tax treaties as well (see Krause-Junk 1989, Musgrave 1989, Vogel 1988). On the other hand the tremendous problem caused by the necessity to renegotiate bilaterally a double digit series of tax treaties might very well be regarded as a major constraint to national tax reform plans and may make the tax policy maker discard tax reform proposals which are not in accord with the prevailing system of international tax relations.

With respect to expenditure taxation one can also find definitive statements in the academic discussion objecting to expenditure tax proposals because of the problems of international tax relations and resulting constraints upon tax reforms (see Mieszkowski 1977, p.48, Goode 1980, pp.65f., Henderson 1984, pp.90f.) In fact income tax reforms have been implemented recently in accordance with the traditional Schanz/Haig/ Simons comprehensive income concept in Europe as well as overseas dismissing expenditure tax alternatives.

The question I want to address in my paper is whether these political decisions could be justified by the existence of international tax relations, which are assumed to be unchangeable in the short run.

The paper is organized as follows. In chapter II the notion of international tax relations is defined and illustrated. Expenditure tax scenarios are explained in chapter III. Chapters IV, V and VI try to explain in which way international tax relations might cause problems with respect to a unilateral step towards an expenditure tax regime. In chapter VII a political economy view of tax reforms in open economies raises the question of whether or not tax relations inhibit a change towards expenditure taxation as a result of legal rigidities, or economic benefits, as perceived by multinational firms. There seem to be arguments that an expenditure tax regime is not particularly advantageous to international firms if one takes into consideration loopholes in international income taxation open to them nowadays.

Chapter VIII gives a short summary of the interrelationship between tax treaties and the outcome of recent tax reforms.

II. The range of international tax arrangements

From a legal perspective international tax law in Germany (see Fischer/Warneke 1988, pp.10ff.) is based on

- (a) international public law
- (b) European Community law
- (c) national foreign tax law (Außensteuerrecht)
- (d) double taxation agreements.

a) Within this legal hierarchy international public law contains general principles, such as national tax sovereignty or the ban on arbitrariness in international taxation. Furthermore the model conventions, worked out by the OECD and by the UN as a guideline for bilateral double taxation treaties are related to international tax law. The "Model Convention for the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital" (OECD 1977) aims at the harmonization of tax treaties between industrialized countries, whereas the UN model should do the same for contracts between developed and developing countries. An international treaty which contains general regulations concerning taxes including tariffs, which may be considered as taxes on traded goods, is the "General Agreement on Tariffs and Trade".

b) The Treaty of Rome provides different rules for indirect taxes and direct taxes (Art 99 and 100), for all member countries of the European Community. Up to now the supranational authority has passed a series of directives, which set tax policy targets to be met by the national governments of the EC member countries.

c) National foreign tax law includes all regulations which are relevant for tax problems when the power to tax is shared with a foreign tax authority. German tax laws determine

unrestricted and restricted tax liability for income, wealth and inheritance taxes as well as unilateral concessions to avoid international double taxation. Special regulations to eliminate distortionary consequences of international tax avoidance are included in separate laws on the taxation of foreign relations, eg. the International Tax Law (Außensteuergesetz).

d) For more than 150 years, double taxation treaties have been recognized as a means of reducing the tax burden for economic transactions, where two national authorities might exercise their power to tax². With the rise of the number of bilateral treaties following the growth of trade several attempts have been undertaken to standardize these treaties. A number of model treaties³ have provided a guideline for new treaties as well as for renegotiations of existing ones.

Under the German constitution double taxation treaties do not have the status of international law, but belong to a group of self-executing agreements, which become German law by approval, without further legal transformation (see Fischer/Warneke 1988, p.12). This status even gives priority to double taxation treaties as compared to domestic legislation.

By 1989 Germany had approved 63 double taxation agreements concerning income and wealth taxes and 5 treaties concerning inheritance taxes (see International Bureau of Fiscal Documentation 1989). Due to Germany's position in the world market the network of bilateral tax relations is quite elaborate but the situation does not differ markedly from other industrialized countries.

² Ross (1988, p.91), mentions a double taxation agreement between France and Belgium signed in 1843 to be the first modern tax convention.

³ League of Nations, Model Convention 1928; Model Convention of Mexico 1943; Model Convention of London 1946; OECD Recommendation Concerning Double Taxation 1955; OECD Draft Double Taxation Convention on Income and Capital 1963, OECD Model Double Taxation Convention on Income and on Capital 1977, UN United Nations Model Taxation Convention between Developed and Developing Countries 1980. See Debatin (1983), 291 ff.

III. Expenditure tax scenarios

In order to analyze the constraints placed by the existing network of international tax relations on a tax reform, dubbed a "switch towards an expenditure tax system", one has to take a closer look at the "expenditure tax scenario". Kaldor's expenditure tax concept (see Kaldor, 1955) was aimed at replacing the personal income tax by a personal consumption tax. This switch is rather easy to grasp in a single tax model economy. But real world scenarios must catch the whole tax system of direct and indirect taxes.

With respect to recent tax reform proposals I will distinguish three types of expenditure scenarios reshaping traditional tax systems:

- (a) partial replacement of traditional tax revenues by a consumption type Value Added Tax
- (b) replacement of the corporate income tax by a cash flow business tax
- (c) replacement of the personal income tax by a graduated personal expenditure tax.

This classification does not exactly meet all the proposals discussed in the relevant literature. Lodin (1978) and Meade (1978) concentrate on direct taxes without considering commodity taxes. On the other hand their recommendation for a progressive expenditure tax regime in accordance with scenarios (b) and (c) also includes a complementary tax on net wealth.

Bradford (1986, pp.312ff.) proposes three different plans to follow a consumption tax strategy for the US. His Plan 1 converts the tax base of existing US individual and corporate income taxes to a cash flow base. Plan 2 introduces a Value Added Tax on an add-on basis, cuts current taxes on individual and corporate income, and provides some payroll tax credits to compensate low income earners for VAT regressivity. Plan 3 is a two-tier cash flow tax consisting of a flat rate business

tax and of a graduated compensation tax on wages, salaries and pension receipts⁴.

Richter and Wiegard (1989) recommend a replacement of the German business tax by a comunal cash flow tax on all business activities.

Kay and King (1986) plead for a shift to a lifetime expenditure tax in the UK including a corporation income tax on a cash flow basis. In their analysis of the British tax system one also finds some implicit recommendations towards an expansion of the value added tax, for example, when they argue that "there are reasons for supposing that the UK would do better to rely rather more on indirect taxes than it does at present" (Kay/King 1986, p.139). Nevertheless they do not take up this argument, when they present their long-run objective of a lifetime expenditure tax and a corporate cash flow tax.

Looking at the variety of reform plans we will regard any shift in accordance with scenarios (a), (b) or (c) as a shift towards expenditure taxation.

IV. International tax relations and value added tax

VAT has been a point of recent discussion with respect to income versus expenditure tax scenarios in Canada, Japan and the US, whereas it had already been implemented in most of the industrialized European countries as well as in many developing countries in Latin America and Africa by the end of the seventies⁵. By 1988 18 out of 24 OECD members had a VAT system to tax private consumption, and another three (Canada, Iceland and Japan) are expected to follow in the near future (Messere/Norregard 1989, pp.25f.). Only Australia, Switzerland

⁴ This Plan 3 version is closely related to the Simple Flat Tax promoted by Hall/Rabushka (1985). In an unpublished 1988 paper Bradford dubbed this Plan 3 X-Tax and proposed an equivalent Earned-Income-Credit version, the EICX-Tax.

⁵ Tait (1988, pp.10ff.) offers a list of 50 countries applying a VAT by 1988.

and the United States seem to refuse a value added tax and to rely on their traditional sales taxes.

A first look at the international figures of consumer taxes (Table 1) shows that the successive change towards VAT has increased the share of general consumption taxes compared to total taxes from 11.7% in 1965 to 16.3% in 1987, whereas within the same period the ratio of total consumption taxes dropped from 34.9% to 28.8%. The same trend is found if one concentrates on European OECD countries or the EC member countries.

A closer look at single countries shows that those countries which had not introduced VAT by 1987 show the lowest share of general consumption taxes (Table 2). Related to national GDP the general consumption tax quota in the US (2.2%), in Australia (2.6%) and in Switzerland (3.1%) was less than half the 1987 average OECD quota of 6.4% (or 7.3% within the EC). This development will most likely continue and become even stronger due to income tax cuts, harmonization measures in the EC and the introduction of VAT in the three other OECD countries.

Implementation of VAT in the OECD countries as a substitute for the former sales and turnover taxes is based on the GATT and its implicit support of the destination

principle⁶. Besides a transparent calculation of equalisation charges for imports and of tax rebates for exports to meet the non-discrimination target, Article IV requires bilateral transparency by entitling contracting countries to retaliate by a countervailing duty on imports if duties or taxes in the exporting country have been refunded in excess of the permitted amount. This arithmetical transparency can only be met by a VAT. The GATT thus seems to have stimulated the acceptance of value added taxes and thereby has brought about a shift towards expenditure taxation.

As regards the 12 EC countries, who have signed the GATT, the change to the VAT system is based on the Treaty of Rome. The demand for a unified system of indirect taxes (Art. 99) has led the EC to require all member countries to follow the VAT line. In a number of VAT directives the unification of the national VAT systems was aimed at, the most important being the 6th directive (1977) on the harmonization of the tax bases. These international arrangements have forced the countries joining the EC to introduce a VAT system, but they also made them use the new tax as a powerful source of government revenue. Apart from France, in all VAT countries the share of general consumption taxes has risen faster than in non VAT-countries within the last ten years.

Although the EC directives are relevant for EC countries only, they have the character of an interpretation of the GATT rules for non EC-countries. GATT does not recommend a VAT but the EC multi-stage system with border tax adjustment is in full accordance with the GATT rules and will have been introduced in 9 out of 12 non-EC OECD-countries as well by end of the decade.

⁶ Article III prohibits tax discrimination of imported goods as compared to domestic ones. The supplementary provision to Article XVI permits refunds of indirect taxes on exported goods as "the remission of such duties and taxes in amounts not in excess of those which have accrued, shall not be deemed as a subsidy". So tax rebates for exports are in accordance with GATT although export subsidies are prohibited.

Thus a look at indirect taxation offers evidence that a shift towards consumption taxes has taken place as a consequence of tax rules included in international agreements. International tax relations have forced this development rather than prohibited it.

V. International tax relations and cash flow company taxes

Taxation of international investment income is usually governed by double taxation treaties. Although the actual methods by which double taxation relief is granted vary considerably from country to country (see Alworth 1988, Debatin 1983), basically the residence principle is applied if income is repatriated to the home country, whereas the source principle is chosen for foreign income accumulation.

In an open economy setting an efficient allocation of capital requires an equalization of gross marginal returns on investment at home and abroad. International taxation, creating a wedge between gross and net returns to the investor will distort capital allocation and reduce global welfare, unless "capital export neutrality" holds, viz. income from marginal investment is taxed at the same rate irrespective in which country investment takes place. It can be shown that an ideal comprehensive income tax system is able to provide capital export neutrality, provided that international personal as well as corporate taxation follows the residence principle, income is defined comprehensively and corporate and income taxes are fully integrated (see Sinn 1985). Nevertheless none of these requirements is met in real income taxation, due to difficulties in calculating comprehensive income, to nonimputation of undistributed profits and to the taxation of foreign affiliates at arms' length⁷.

⁷ Boadway/Bruce (1988) have demonstrated the welfare consequences of a full integration of corporate and personal income on accrual in an open economy setting, which leaves the investment decision distorted by the corporate income tax, unless corporate tax could be levied on a destination basis.

Basically double taxation treaties do adhere to the residence principle by crediting withheld taxes on interests and dividends as well as by exempting source taxes on royalties or independent personal services. On the other hand foreign corporate income from retained earnings and from realized capital gains is subject to tax under the foreign income tax regime and exempt in the home country. Here the arms' length view of foreign affiliates causes a deviation from the residence principle, responsible for distortionary effects within a traditional income tax regime.

Although a pure expenditure tax system should abolish corporate taxes completely (see Kaldor 1955, p.146), because companies do not consume but distribute profits to shareholders only, most recent expenditure tax scenarios adhere to flat rate company taxes either as a withholding tax in an integrated expenditure tax regime or as a measure to capture revenues from foreign capital income⁸. But they recommend a change in the tax base from company income to company cash flow.

Meade (1978, pp.228ff.) has discussed three different kinds of cash flow taxes for corporations:

- the R-base tax, whose tax base is the difference of sales of real goods and services R_1 and purchases of real goods and services R_0
- the (R+F)-base tax, whose tax base is the difference of real and financial inflows (R_1+F_1) and outflows (R_0+F_0).
- the S-base tax, whose tax base is the difference of outflows S_0 and inflows S_1 associated with share transactions and with dividend payments to resident companies and resident shareholders.

The different tax bases are related by the fundamental cash flow identity

⁸ Further arguments are taxation of rents, avoidance of windfall capital gains or discouragement of expenditure tax evasion within companies. See Aaron 1989, pp.3ff. or Boadway/Bruce 1988, p.27.

$$R_1 + F_1 + S_1 + T_1 = R_0 + F_0 + S_0 + T_0$$

where T_0 and T_1 are taxes paid and repaid to the fiscus respectively. Thus the (R+F)-base and the S-base only differ by the tax term

$$(R_1 - R_0) + (F_1 - F_0) = (S_0 - S_1) + (T_0 - T_1)$$

and may be regarded as being equivalent apart from a tax inclusive versus tax exclusive calculation of tax rates.

The efficiency gains of a global switch to cash flow corporation taxes can be fully captured in an international setting, if the residence principle is universally applied. Then capital export neutrality will prevail, if the credit system absorbs differences in national corporation tax rates. But efficient capital allocation can also be reached in a world, where only one country introduces a cash flow system whereas other countries keep their income tax, provided that the application of the residence principle ensures that income taxes in the source are credited against domestic cash flow taxes (see Sinn 1987, pp.35ff.).

Double taxation relief that is granted in existing treaties for different types of company income under the prevailing income tax regime, will also be granted for different types of company cash flows under the expenditure tax regime. In general repatriation of income by means of royalties or transfer prices of goods paid to the domestic parent are tax-exempt in the source country and taxed in the destination country, where these flows increase the tax base. Dividends and interest payments by the foreign subsidiary are included in the F-base and taxed according to the cash flow concept chosen. Withheld foreign taxes on these flows should be credited against domestic company taxes.

Income taxation according to the residence principle is not applicable to retained earnings and realized capital gains, where double taxation relief is provided by exemption in the residence country. With respect to these income flows source taxation under an income tax regime may differ

considerably from source taxation under 'an expenditure tax regime, even if tax rates are close. But a deviation from neutrality due to exemption cannot be regarded as a specific expenditure tax problem. It is relevant for income tax systems as well and it will remain if both countries switch to an expenditure tax regime.

The question of whether or not the allocative distortion introduced by the arms' length principle should be tolerated as a trade-off between efficiency in international capital markets and national independence of tax administration must be answered again in an expenditure tax world. Meade (1978, pp.412f.) seems to prefer an arms' length rule by restricting the deductibility of real investments to domestic ones. Foreign investment returns would therefore be subject to company taxation in advance, whereas repatriation of returns will be tax-exempt by crediting foreign source taxes. This regulation would require no amendment of existing tax treaties but could be implemented within the scope of domestic company tax law.

VI. International tax relations and a personal expenditure tax

A change from the existing personal income tax regime towards an expenditure tax basically results in exempting personal saving from the existing income tax base, irrespective of the specific form of a personal expenditure tax scenario.

Contrary to company taxation, the personal expenditure tax should exhibit some progressivity. In an open economy setting a graduated expenditure tax makes sense only in combination with the residence principle. Domestic as well as foreign personal expenditures of any resident form the tax base to which the tax schedule is applied in such a way as to meet horizontal as well as vertical equity targets. A pure residence principle would require that foreign cash flow income to residents is taxed by granting a tax credit on

income taxes withheld abroad thus compensating domestic tax liability that arises when these cash flows are not invested in qualified domestic assets but consumed. If according to existing double taxation agreements relief is granted by exclusive source taxation, this might be regarded as an administrative compromise and national equity targets revealed in the graduation of the tax schedule can be partly met by the progressivity proviso clause.

Further problems arise, if expenditure taxation is introduced in one country whereas the other keeps its income tax regime. Here again foreign income taxes on dividends and interests can be credited and other income flows are exempted in the source country. In this case the residence principle absorbs any difference in tax bases between the two countries. But on the other hand there are foreign income taxes on capital income, wages, pensions, and realized capital gains, which are taxed abroad with tax bases and tax rates differing from the domestic expenditure regime. Since for these income flows the credit system is not agreed upon in existing tax treaties, there only exists an economic incentive to escape detrimental taxation by repatriation and accumulation of foreign income in domestic savings to qualify for expenditure tax exemption.

This implicit use of tax crediting by substitution does not avoid the efficiency loss due to the different treatment of income flows in the source and the residence country, but on the other hand it may help to outweigh the most important discriminating element of foreign source taxation within an income tax regime.

The application of the expenditure tax regime to non-residents would require taxing them on a cash flow basis, exempting accrued income such as pension rights or unrealized capital gains, and if desirable also savings in tax-exempt assets. The non-resident's tax base thus would include

consumption expenditures in the source country as well as repatriated cash flows.

One item of the expenditure tax base which is likely to create difficulties is consumption financed by foreign assets. If the two countries apply an expenditure tax, then dissaving of foreigners will be regarded as a taxable activity, which due to a residual item clause in the treaties is tax exempt in the source country and taxable in the residence country. Since dissaving is not subject to tax under an income tax regime, the residence country does not have to provide any credit mechanism. On the other hand there will be a strong incentive for residents to evade domestic expenditure taxation by consuming abroad, especially in income tax countries where the tax authority has no obligation to check dissavings. This loophole nevertheless may be closed by applying the prepayment method for foreign saving, restricting tax exempt saving to domestic registered assets.

One problem, which has been a major point of discussion in Lodin (1978, pp.108ff.) and Meade (1978, pp.419ff.) is migration. A shift towards an expenditure tax regime offers an incentive to residents to emigrate in order to consume tax-exempt assets in an income tax country. On the other hand there also exists a disincentive to emigrate from an income tax country, if accumulated wealth out of already taxed income might be subject to the expenditure tax as well. In my view both problems do not conflict with tax treaties. Emigration means withdrawal from qualified accounts, which like consumption expenditures leads to expenditure tax liability. Lodin's "emigration tax" is just another form of expenditure tax prepayment, which has been suggested for consumer durables to avoid the problem of imputing consumption flows over the years of utilization. Progressivity peaks due to prepayment might be avoided by some kind of averaging according to domestic regulations.

Immigrants on the other hand should be made to register their assets in qualified accounts, by granting them a fair tax credit which again is to be regarded as a prepayment of taxes to the foreign fiscus and which can be used up if future consumption is financed through dissaving. There is an incentive to register for immigrants in order to avoid double taxation which would occur if liquidation of assets for consumption purposes would give rise to expenditure taxation once they are residents.

A switch towards an expenditure tax system will require some minor amendments to existing double taxation agreements, but will neither require an international harmonization of tax regimes nor cause increased costs for administration and control. But again the question must be posed, whether deviation from the residence principle, which according to existing double taxation treaties is tolerated for the current income tax regimes, might be tolerated as a minor administration/efficiency trade-off for the expenditure tax regime as well.

VII. A political economy view of tax reforms in open economies

In considering the impediments which international tax relations may set against a switch towards an expenditure tax regime, I cannot see a serious obstacle. Although the residence principle is not applied generally in tax treaties, both cash flow company taxation as well as cash flow personal expenditure taxation can be implemented within the existing framework of international tax relations if there is only a unilateral shift to such a new system.

The theoretical argument in favour of the switch towards expenditure taxation is a welfare gain caused by avoiding tax distortions. Efficiency can be improved by eliminating allocative distortions in domestic savings and investments as well as distortions in international investments.

Nevertheless income tax reform proposals towards expenditure taxation have nowhere gained an electoral majority in the political process. Furthermore cash flow company taxation has not even received decisive support from multinational enterprises, although such a switch should prove especially attractive to enterprises investing in international markets.

But there seems to be a rather simple explanation why multinationals do not lobby for a tax reform based on cash flow concepts despite of the increasing international mobility of capital. Multinationals benefit from the existing network of tax treaties in a way, which does not make them appreciate an expenditure tax regime as an attractive alternative⁹.

To escape the welfare loss of discriminatory international double taxation tax treaties contain rules which limit the national power of the two countries involved to levy taxes. But international factor mobility does not only offer an international enterprise the benefits of a bilateral treaty, but allows to make use of the whole global network of existing treaties and the regulations contained therein. Thus rents may be gained by exploiting the differences between various bilateral treaties.

Basically three types of strategies might be followed by multinational companies to make use of tax preferences in addition to a simple bilateral double taxation relief: zero taxation, treaty shopping and rule shopping.

1. Zero taxation

Instead of repatriating capital income from a firm in country A to the shareholder in country B income may be

⁹ The existence of tax loopholes in the income tax regime may also be the reason why domestic enterprises hardly lobby for an expenditure tax regime as well, but prefer to apply for traditional tax preferences usually more favourable depreciation rules etc.

collected temporarily in a base company in country C. By placing base companies in suitable tax havens (e.g. the Bahamas or the Channel Islands) as "exempt companies" tax liabilities in the countries A and B can be avoided (see OECD 1987b, 60ff., Grundy 1985, ff.). Base companies are also frequently found in the Netherlands, where dividends of foreign subsidiaries are not taxed, if the company qualifies for a "participation exemption", or in Belgium, where tax preferences apply, if a company acts as a "coordination centre" (see Giovannini 1989, 358ff.). Usually the shareholder will benefit from a tax deferral, as income flowing from the base company to the shareholder will only be subject to tax in some future period. But there may also exist an opportunity for a second sheltering which leads to a permanent tax exemption.

2. Treaty shopping

Instead of using a tax haven a shareholder in country B may also benefit from a double taxation treaty between country A and C (see Becker 1985, pp.171ff., Piltz 1987, pp.36ff.). To become entitled to this form of double taxation relief a conduit company may be placed in country C and the income flow from A to B is channelled via country C. The conduit company in country C serves as a stepping stone to take advantage of the tax preferences of the bilateral treaty (see OECD 1987b, pp.88ff.). The stepping stone approach may be extended by using a series of treaties sequentially to arrive at the most favourable tax treatment ("stepping stone conduit").

3. Rule shopping

Rule shopping makes use of the different treatment of transnational income flows in double taxation treaties (see Piltz 1987, pp.49f.). Within a multinational firm income flows show a high degree of fungibility. In any suitable stepping stone country the conduit company can be used to transform a

certain flow of income into another one, eg. royalties into interests, in order to reduce the overall tax burden.

International tax relations thus create economic rents which can be exploited by multinational firms through tax minimization strategies. These rents do not only include reduced tax burdens, but they also offer multinationals a comparative advantage with respect to national competitors who cannot escape taxation through double taxation treaties.

Multinational companies will have an incentive to lobby for the continuance of national income tax systems and international tax relations as the source of their rents. Furthermore other enterprises becoming aware of these rents will invest resources in rent-seeking activities which create opportunity costs and reduce global welfare, but offer a chance to participate in rent sharing.

I must admit that this explanation of a resistance of the multinationals to switch to an expenditure tax system is not based on quantitative empirical data. Nevertheless a variety of case studies (see Grundy 1985, Piltz 1987) support the view that prevailing tax systems are "highly ineffective in reaching foreign-source investment income" (Bird/McLure 1988, p.31). Alworth (1988) has provided a comprehensive survey of figures to illustrate tax options for multinationals, although statistical evidence on the actual amount of tax losses to national fiscs is still lacking. This is a new field to apply the political economy approach and to test its explanatory power.

VIII. Conclusion

One of the obstacles to change from the existing income tax regime to an expenditure tax regime can be seen in the existence of a highly complex network of bilateral double taxation treaties, negotiated and implemented in countries with traditional income tax systems. Nevertheless the

hypothesis that the legal constraints of international tax relations have had a decisive influence on the dismissal of expenditure tax alternatives in recent tax reforms in industrialized countries should be rejected. A closer look at the proposals shows that international tax relations have pushed ahead the introduction of consumer type VAT systems and their fiscal importance, and this is a step towards expenditure taxation. A change from the existing personal and corporate income taxes towards cash flow taxes on companies and households recommended by theoretical analysis need not fail due to incompatibilities with the existing structure of bilateral double taxation agreements.

Nevertheless another impediment to an expenditure tax reform may be attributed to international tax relations. Existing regulations and treaties provide an incentive for rent seeking by multinational firms through tax arbitrage and to exploit rents. Thus one important target group of an expenditure tax reform, multinational firms, does not necessarily appreciate tax relief in an efficient expenditure tax regime compared to present benefits from tax loopholes in our income tax world.

Majority assistance for expenditure taxation seems to require that consumers are convinced of the beneficial effects of such a reform. Thus the view should be rejected that expenditure taxation would primarily relieve the entrepreneur and the rentier by exempting their savings and economists have to demonstrate more clearly that today's taxation of international income is a poor concept, which is neither efficient nor equitable.

IX. References

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