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R. GLENN HUBBARD

This paper addresses some important issues in the policy debate over capital taxation in Europe. The title belies two problems of historical significance in Europe – the quick responsiveness of capital to tax changes ('capital flight') and non-cooperative behaviour in setting tax rates on real investments ('tax competition'). Much of the discussion extends previous work by Giovannini on the need for stricter application of the 'worldwide principle' or ('residence principle') of taxation.[1] A focus on eliminating impediments to the worldwide principle is a useful one, as it shifts the focus of policy debates away from 'harmonization' *per se*.

The Giovannini–Hines paper is not an exercise in optimal taxation, it constitutes a specific policy proposal. I shall frame my remarks accordingly, though, at points, I shall question the merits of specific aspects of the plan as against obvious alternatives.

The basic idea is as follows. Let us suppose that we want a corporate-level tax. Suppose also that we want to mitigate distortions (e.g. avoid 'tax competition'), but, at the same time, raise revenue. Three issues arise in designing such a tax in the context of present institutions for taxing multinational corporations: (i) problems of deferral; (ii) the lack of integration of corporate and individual taxes; and (iii) defining the appropriate tax base. After reviewing briefly parts of the background discussion in the paper germane to the policy proposal, I shall discuss these issues.

1 *The context: distortions in European capital taxation*

Giovannini and Hines begin by noting that capital tax revenues as a percentage of gross domestic product are lower in the EC than in the US. Such comparisons are inevitably difficult, owing to measurement issues

(e.g. difference in measuring proprietors' income or taxes on interest income). A reasonable goal here is to determine whether 'enforcement costs' or 'behavioural responses' explain this 'pattern'.[2] Giovannini and Hines note the wide scope for varying definitions of 'annual income' (including differences in the measurement of inventories, advertising, patents, goodwill and depreciation deductions). I return to this problem below.

At the most basic level, European countries do try to limit 'double taxation' of multinationals' foreign-source income. Relief is limited, however, owing to limitations on foreign tax credits, and to differences in the concept of 'foreign source income' from the concept used in the computation of 'corporate tax' (i.e. stemming from deferral). Moreover, in most countries, integration of 'corporate' and 'individual' taxes is very imperfect. That is, there would be significant tax distortions even if the worldwide principle were perfectly applied at the 'corporation' level.

We are left, then, with three central problems, those of (i) measuring income flows within a multinational firm (e.g. transfer pricing complications); (ii) coordinating tax systems for taxing foreign-source income when definitions of income vary; and (iii) avoiding at least some of the problems in measuring income in the current system. The Giovannini–Hines plan (hereafter GHP) addresses some of these concerns, and provides for international corporate taxation under the residence principle and with no deferral.

The mechanics of the GHP are as follows. There is a uniform ceiling corporate tax rate for all European countries. Taxes are due on a territorial basis (i.e. to the government of the country in which the income is earned). A separate system of country-specific rebates applies to owners of corporate shares. The definition of 'taxable corporate income' is for each country the outcome of mutual agreement.

Avoidance of double taxation is ensconced in the GHP. Foreign-source income within Europe is exempt from direct corporate taxation by the country of corporate residence; foreign-source income outside of Europe is taxed at the full European rate, but a credit is allowed for taxes paid. Withholding taxes are proscribed. Importantly, GHP provides for tax integration. Corporate income is attributed to individual shareholders without deferral. Individuals then receive rebates from their home governments (equal to the excess of taxes paid by the firms they own over the product of their home corporate tax rate and their corporate income). A clearinghouse system reallocates corporate income from source countries to countries of shareholder residence.

Corporate income tax systems have been under attack in academic and public policy circles. Why consider such a system here? Giovannini and

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Hines review 'ability to pay' and 'benefits received' rationales for corporate taxation. The former is unconvincing in this context. Taxing foreigners on a source-based basis in all likelihood redistributes rents. The latter presumes a benefit to incorporation. Even here, convincing arguments are difficult to find. For example, large-scale enterprises have emerged in the US under partnership governance in recent years. Realistic motivations for a corporate-level tax are more likely to centre on the need for revenue (e.g. to the extent that revenue is more difficult to collect at the individual level).

Perhaps the most significant problem with corporate income taxes is that associated with measuring income (recall the significant differences internationally in this respect noted by the authors). One corporate-level tax alternative which circumvents many of these problems is a 'cash flow' tax.[3] A corporate cash-flow tax falls ultimately on rents associated with monopoly power, ideas, entrepreneurial skill, etc. The tax avoids both investment and financing distortions. In addition, at the margin, there is no need for crediting foreign taxes paid (since the government is effectively a partner in firms' equity). Raising revenue is, of course, an important consideration. Studies for both the UK (by Mayer, 1982) and the US (by Aaron and Galper, 1985) have estimated that the cash flow tax could raise similar revenue as that under an income tax at lower rates.

Giovannini and Hines argue that, under a cash flow tax, there is a temptation towards high rates (presumably to confiscate rents). This seems disingenuous. Time-inconsistency problems are common to a host of fiscal reforms. The point would have equal force applied to a true income tax. Drawbacks of switching to cash flow taxes have more to with difficulties in designing transitional arrangements. Some transitional arrangements will also be required in the implementation of the GHP.

2 *The Giovannini–Hines plan as a reform*

The GHP is a well-reasoned attempt to reform the system of capital taxation in Europe. The critical question, of course, is to what extent it mitigates the significant distortions in the present system. My two reservations here are as follows. First, we are given no evidence on how large the distortions under the present system actually are. Such an omission is noteworthy in a 'practical corporate tax' proposal. Second, it is not clear that the GHP addresses the significant underlying problems of measuring income required in any corporate-income-tax systems.

I would like to see the authors expand their analysis of the proposal to consider questions like the following.

What are the efficiency gains from the new system?

Suppose such gains are large. How would the gainers compensate the losers (presumably significant for political viability)?

The GHP takes away the ability of countries to tax directly corporate income earned within their borders by firms owned by non-Europeans. Are their implications for 'outsiders' (in particular, US firms) with respect to corporate takeovers, etc.?

There are limits on the ability to subsidize domestic investment. What happens in response to a shift in investment incentives in the US?

Since Europe is not the world, there presumably must be adjustments in European rates in response to major shifts in capital tax systems in the US. How would renegotiation of the European ceiling rate occur?

These questions notwithstanding, Giovannini and Hines have done an excellent job in presenting the issues and suggestions for reform. The paper should draw attention both from academic researchers assessing the efficiency costs of alternative systems and from policy-makers balancing the need for reform with national political concerns.

NOTES

1 See Giovannini (1989).
2 Of interest here as well is Giovannini's (1988) previous research suggesting that, historically, there may have been large behavioural responses to capital levies associated with wartime finance in Europe.
3 Alternative corporate cash flow bases are reviewed in King (1986).

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8 Reflections
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