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TAX CONVERGENCE AND GLOBALIZATION

Reuven S. Avi-Yonah[1]

This paper addresses three questions: 1. Is there evidence that the tax laws of different countries have converged (i.e., become more similar) over the period 1980-2010? 2. If so, what is the explanation for this convergence? 3. Is this type of convergence a positive or negative development?

1. Are tax laws converging?

   If one compares any two national tax law, the most obvious finding is divergence. Tax law reflects specific national histories, cultures and interests, and not surprisingly they differ. The question to be addressed, however, is not whether underlying differences persist, but rather whether tax laws have converged in the period of globalization (i.e., from around 1980, where most countries began relaxing their restrictions on capital mobility). This paper argues that in certain areas convergence can be detected. Specifically the paper will address three examples: the overall tax mix (which taxes are used by different countries), corporate/shareholder tax integration, and the choice between worldwide and territorial taxation.

   a. The Tax Mix.

      In 1980, one could detect significant divergence in the overall tax mix among OECD member countries, and even more so among all countries. While most OECD countries had both a corporate and an individual income tax since the early 20th century, only the EU countries and a few others relied significantly on taxing consumption.

      The single most important tax policy development in the following thirty years has been the spread of the VAT. In 2010 the US remains the only OECD country not to have a VAT, and the vast majority of developing countries have it as well. Even long-time VAT resisters such as Canada, Australia, Japan and India have adopted it since 1990.

      In most of these instances, the VAT did not replace either the corporate or individual income tax. In some cases it was simply added on (e.g., Canada, Australia and Japan) as the first federal consumption tax. In others, like in most developing countries (and earlier the EU) it replaced tariffs or cascading turnover taxes. However, since at the same time the total tax

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take out of GDP grew in all of these countries, it can be argued that the rise of VAT was much more important than the taxes it replaced. Most countries that introduced VAT in this period also raised the rate over time.

The rise of VAT can thus be analyzed as a shift from primary reliance on taxing income from capital to a primary reliance to taxing consumption, which is equivalent to shifting the tax burden from capital to labor. The same trend can be discerned in more subtle ways as well. Many countries, like the Scandinavian ones, explicitly set lower rates for capital than labor income within the income tax, creating a "dual" income tax system. In other cases income from capital is subject to lower rates (e.g., for dividends and capital gains in the US) or exempt altogether (e.g., in the case of investment earnings of pension funds).

Even where there is no explicit change in law, changes in tax administration tend to the same result. It has been argued, for example, that developed countries have compensated for the erosion of the corporate tax base from tax competition by lowering the permanent establishment threshold, which results in shifting the tax burden from locations of production to locations of distribution and consumption. The apparent stability of revenues from the corporate and individual income taxes in the period under discussion may therefore mask an internal shift within the income tax from capital to consumption, which is added to the rise of VAT as an explicit tax on consumption.

b. Corporate/Shareholder Integration.

In 1980, OECD countries could generally be divided into three categories in terms of their adoption of corporate/shareholder tax integration, i.e., attempting to prevent the double taxation of corporate profits when they were earned at the corporate level and again when they were distributed to shareholders as a dividend. A minority of countries, like the US, maintained the "classical" system of full double taxation. Most countries adopted integration, and the most common form of integration was imputation, under which shareholders receive a credit against their own tax liability for taxes paid by the corporation. This approach was adopted in most of the EU as well as Australia and New Zealand, but was limited to domestic shareholders. Many other countries, especially developing countries, adopted partial or full dividend exemption as their preferred method of integration.

Fast forward to 2010, and a significant degree of convergence emerges. First, most countries that used to have the classical system, like the US, have adopted at least partial integration. Second, most OECD countries

that adopt integration have switched from the imputation mode to the full or partial dividend exemption mode, which has become the norm. Developing countries have likewise maintained this form of integration as the norm.

c. Territoriality and Worldwide Taxation.

In 1980, the world was clearly divided into countries that tax their residents on a worldwide basis and provide a foreign tax credit, like the US, the UK and Japan, and most other countries that tax both residents and nonresidents on a territorial basis (i.e., only on domestic source income) and exempt foreign source income (most of continental Europe and most developing countries). Very few countries taxed foreign investment vehicles or controlled foreign corporations (CFCs) on a current basis. This traditional division is reflected in the choice of credit or exemption methods in the model treaties (OECD model Arts. 23A and 23B).

By 2010, the picture has changed and once again we can perceive significant convergence. There are almost no purely territorial countries left, because most developing countries (especially in Latin America) and the continental EU countries have adopted worldwide taxation of individual residents and many have also adopted CFC and investment vehicle taxation, which is designed to tax residents currently on passive or mobile income earned in low-tax jurisdictions. On the other hand, most worldwide jurisdictions have moved in the direction of territoriality for active business income earned through CFCs, so that such income is not taxed to the parent even when it is repatriated (the UK and Japan are the most recent additions to this trend). As a result, the world is converging toward taxing passive income currently on a worldwide basis, at least in theory (the level of enforcement varies tremendously), while exempting active income. The distinction between worldwide and territorial jurisdictions has lost most of its force.

2. Globalization and convergence

Why has this convergence taken place? In the above three examples, it can be argued that the reason is globalization, or specifically the relaxation of barriers to the free mobility of capital.

If capital is more mobile that labor, one would expect a shift in the tax base from capital to labor. This is in fact what is happening with the rise of VAT, because consumption taxes tend to fall on labor. Consumers are less mobile than producers. The shift to dual income taxes and the shift in the corporate

tax from production to consumption locations reflect the same concern about taxing a vanishing base.

Globalization also explains the shift toward corporate/shareholder integration. As long as most shareholders are domestic, countries were free to adopt or reject integration for domestic companies with domestic shareholders. However, once portfolio investment became globalized, countries had to deal with their own residents becoming shareholders in foreign corporations and foreign residents becoming shareholders in their corporations. In both cases, the classical system became an obstacle to cross-border investment because it was subject to two levels of tax while domestic investment was only subject to one level. This created pressure to relieve the situation by adopting integration. For example, while the Bush administration proposed in 2003 to limit integration to US shareholders in US companies, Congress eventually adopted partial integration for US shareholders in both foreign and domestic corporations.

The same pressures also explain the move away from imputation. Imputation forces the source country (where the corporation is located) to either grant credits to foreign shareholders, or to discriminate against them by only granting credits to domestic shareholders. The latter course was the norm in 1980, but was ruled out in Europe for EU residents as being discriminatory, and in other locations proved merely to increase the cost of capital for domestic corporations. Dividend exemption was instead extended to investments in both domestic and foreign corporations, without requiring countries to send checks to foreign shareholders (Australia tried to do that for a brief period, but it proved too expensive).

Finally, the move toward taxing passive income on a worldwide basis and active income on a territorial basis can also be explained by globalization. When exchange restrictions were relaxed, purely territorial countries were forced for the first time to tax the overseas income of their rich residents or face a complete erosion of the tax base. The move toward territorial corporate taxation can be explained by tax competition for increasingly mobile corporate headquarters: The UK, for example, adopted dividend exemption for active income for fear that its multinationals might move to other locations in the EU that have generous participation exemptions.[2]

3. Is Convergence a Positive Phenomenon?

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[2] Another common example is that corporate tax rates appear to have converged in the period after 1986, with a general downward tendency. However, some scholars have suggested that from a longer time perspective no convergence of rates can be seen. See Omri Marian, The Discursive Failure in Comparative Tax Law, Am. J. Comp. L. (2010).

There are reasons to decry tax convergence, if one believes that cultural diversity is important and that countries should be free to adopt their tax laws without undue pressure from outside forces like globalization. However, one should remember that convergence is a relatively narrow phenomenon that is limited to certain aspects of the tax system, primarily its corporate and international provisions. In those areas, I believe convergence is a positive phenomenon because it reduces the scope of tax arbitrage.

Tax arbitrage refers to the ability of taxpayers to exploit differences in tax regimes of various countries to achieve double non-taxation. It is a highly controversial phenomenon, but increasingly countries have tended to adopt anti-arbitrage provisions. The reason is that tax arbitrage undercuts the corporate tax of both countries, and at the extreme can lead to non-taxation of cross-border income flows. Such non-taxation can in turn threaten the viability of the corporate tax.

An example can help clarify how convergence undercuts tax arbitrage opportunities. Under the old imputation system that was prevalent in Europe and Oceania before 2000, US corporations with subsidiaries in imputation countries would enter into dividend stripping transactions in which a domestic source country investor in, e.g., Italy would acquire the right to receive the dividends from the subsidiary for a certain period of time. From an Italian perspective this was a "usufruct" transaction and the local investor was entitled to the imputation credit on the dividends. From a US perspective, however, the transaction was regarded as a secured loan from the investor to the US parent. The dividends were seen as flowing to the US parent, where they were not taxed because they carried foreign tax credits, and the US parent obtained a deduction for deemed interest paid to the Italian investor (who of course had no corresponding interest income). This transaction cannot be done today after the switch to dividend exemption by the imputation countries.

Of course, there are still many opportunities for tax arbitrage, because tax laws cannot and should not be completely harmonized. Still, convergence has meant that these opportunities are rarer and carry higher transaction costs, and for that I believe we should be grateful.

4. Conclusion.

The above is merely a short survey of some examples of convergence. Other examples can be given, some of which might also be attributed to globalization. For example, it seems that countries tend to move toward a less formalistic and more substantive mode of interpreting tax law, which may be the result of the spread of US-style tax planning around the globe.

It should always be remembered, however, that these examples are merely the surface, and that considerable diversity persists below it. To take an extreme case, almost every country in the world claims to follow the OECD transfer pricing guidelines (Brazil being the only prominent exception), but in practice there is huge variation in the ways the guidelines are implemented. And overall, the world is too diverse to have harmonized tax laws. But in some areas convergence does occur, and to the extent that it can actually bolster the ability of countries to protect their revenue base, it is a blessing.