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Corporate income tax competition, double taxation treaties, and foreign direct investment

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Abstract

In the presence of international capital mobility, foreign direct investment is influenced by corporate income tax rates and the rules of how taxes paid in the host country are treated at home. In this paper the exemption, credit and deduction methods are considered as tax rules. Tax competition is modeled as a non-cooperative game with respect to both corporate tax rates and the form of double taxation relief. The subgame perfect equilibrium is shown to be independent of the tax rules. Since capital is inefficiently allocated, the feasibility and the content of a cooperative contract between governments are analyzed. It is argued that only the credit method requires neither compensatory payments nor fully harmonized tax rates. This is consistent with the observation that tax credits are very often adopted in double taxation treaties.

Key words: Tax competition; Tax harmonization; Double taxation; Foreign direct investment

JEL classification: F20; H87

1. Introduction

In an interdependent world economy a government's ability to pursue an autonomous tax policy is restricted by the mobility of factors of production and goods. Tax policy is often used to attract business which creates jobs and increases domestic welfare. Therefore, in recent years the topic of tax

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competition came on the political and research agenda. In the literature the question was raised whether capital income taxes can be sustained at all when capital is very mobile: in the words of Roger Gordon (1990), "Can capital income taxes survive in open economies?". The question is reasonable since foreign earnings cannot be monitored and therefore cannot be effectively taxed. Problems of monitoring are particularly relevant when foreign investment takes the form of portfolio investment.[1] In that case taxation of domestically generated capital income is problematic since the same net return as abroad must be offered. Taxation increases the domestic gross rate of return above the world level, which causes inefficiencies. Therefore, taxing mobile factors might not be a tool for raising revenue.

It has been recognized, however, that the taxation of income from foreign direct investment is different since a corporate firm undertakes the investment. The firm is well monitored and is usually interested in documenting the foreign direct investment. On the other hand, taxation of foreign direct investment income is more complicated due to the many possible provisions of double taxation treaties. A good description of these complex provisions is given in Alworth (1988). Since governments are interested in promoting domestic production and in increasing national welfare the strategic use of corporate taxation in open economies has been analyzed in the seminal paper by Hamada (1966), and more recently in Bond and Samuelson (1989), Gordon (1990), and Mintz and Tulkens (1990).

This paper also addresses the strategic use of corporate taxation in an international framework. In contrast to Bond and Samuelson (1989), but in line with Gordon (1990) and Bond (1991), it is assumed that the capital exporting country cannot discriminate against outflowing capital by choosing different tax rates. Foreign investment income is not, however, treated in the same way as income from domestic investment, since double taxation relief for taxes paid in the host country is only partially offsetting. A reason why governments do not discriminate against foreign direct investment by choosing different tax rates could be the following: with discrimination, changes in the capital exporting country's tax rate always induce a reallocation of capital. Although not explicitly modeled in the paper, a change in the location of capital is likely to be costly since (foreign direct) investment is rather a long-run decision with commitment character. With non-discrimination, changes in the tax rate lead only in some cases to reallocations (as will become clearer later).

[1] A good example was the attempt of the German government to introduce a 10% withholding tax on interest income in 1989. Since savers could export their capital to Luxemburg, they were able to evade German taxation.

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