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Comments on Guttorm Schjelderup: International capital mobility and the taxation of portfolio investments

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Guttorm Schelderup (GS) has accomplished a clear, and interesting, survey of the problems of taxing portfolio income in a world economy which is increasingly integrated in various ways. His survey is also highly useful for anyone interested in going deeper into this problem area, as GS draws on the most recent papers from the international research frontier and, of course, GS himself is one of the major contributors to the process of pushing this frontier ahead.

The return to portfolio investment comes in many forms, and GS has chosen to organize his survey around these. A first question, however, is whether, and to what extent taxes affect portfolio decisions, that is, the mix between different assets, and—in this case—the choice between alternative locations and tax jurisdictions. GS cites evidence that there are indeed such effects. He does not particularly focus on Sweden, and let me just add the information that when we evaluated the Swedish tax reform in the mid 1990's (see Agell, Englund and Södersten, 1998), we also found that portfolio decisions responded to the relative tax treatment. The volume, or proportion, of savings appeared to be rather insensitive to after-tax returns, but their composition did respond to taxation. We commissioned studies that found that high income earners, with high marginal rates and therefore low after-tax interest costs before the tax reform, adjusted their borrowing after the reform much more and much faster than did other groups. Also, the clear clientele effects that were found before the tax reform, seemed to have disappeared, as a result of the more neutral tax treatment and less favorable conditions for borrowing.

When it comes to tax-driven international financial investments by Swedes, we have much less evidence, and most of it should be perhaps be considered as anecdotal. Swedes are required to report to the National Tax Board when they open a foreign bank account, and usually also to provide a statement that the foreign bank is prepared to

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provide the Swedish tax authorities with the same type of information that Swedish banks provide. However, the number of such accounts registered with the National Tax Board (see Mutén, 2001) is said to be embarrassingly low. Recent estimates indicate that the stock of unreported financial assets abroad is in the order of SEK 350-400 billion. For comparison, we may note that the stock of gross financial wealth is about 2600 billion, that is, Swedes seem to have evaded tax on 13-15 percent of their gross financial wealth by investing abroad.

In the tax reform evaluation project, we mainly pointed to this problem and emphasized that tax legislators are actually facing a difficult dilemma here. Efforts to reduce domestic tax planning may call for a more uniform taxation of labour and capital income, but the more effectively domestic tax planning is combated, the greater are the risks of international tax avoidance and evasion. If capital is induced to stay within the country by considerably lower taxation, which could also reduce the incentives to evade taxes by international investments, the risks of domestic tax planning increase, with mounting difficulties in maintaining the line of demarcation between labour and capital income. Thus, we may have to tax capital in order to tax labour income.

As we all know, the tax treatment of dividends has been, and still is, a controversial political issue in Sweden, and we have seen a couple of sharp policy reversals following changes in government. The section of GS's paper dealing with dividend taxation possibly has more direct policy implications that the rest of the paper, and given the interest among policy-makers in this area, I would like to discuss and perhaps question some of the points he makes here.

On p. 125, GS writes that:

> Many countries offer double taxation relief … by allowing a full or partial tax credit for corporate taxes on distributed profits (one notable exemption is the US). In most countries the tax credit does not apply to investors who hold foreign shares thus introducing a bias in favor of domestic shares as well as impeding the efficiency of global stock markets.

The idea here seems to be that it would be problematic if, say, the Norwegian government would not extend the imputation credits to Norwegian citizens having chosen to invest in Ericson shares, that is, domestic and foreign equity investment undertaken by Norwegian citizens should be treated alike, presumably because this is what residence based taxation requires.

To understand the implications of this, we must somewhat consider how dividend taxes—or rather dividend tax relief—affect stock market prices. Let us first assume that the idea behind the Norwegian double tax reform was to eliminate corporate tax distortions on resource allocation—I think GS refers to this in footnote 31, by saying that the classical system distorts the allocation of resources between the non-corporate and corporate sectors. In technical terms, we may say that the presumption was that the marginal shareholder would be a Norwegian household, receiving imputation credits. The prices of Norwegian shares would then be inflated by these imputation credits, to the effect that the after-tax returns to new equity investments would not earn any excess return, net of tax and imputation credits.
But Swedish– or US—shares are not inflated by any imputation credits. So what is the reason—as GS suggests— for subsidizing Norwegian investment in Swedish or US shares by extending imputation credits? It is not obvious what the long-run equilibrium would be, but there would surely be a tendency for Norwegian equity funds to flow into classical countries.

To take another case, assume that the Norwegian double tax reform did not affect the cost of capital, because Norway, like Sweden, is a small open economy (cf. Boadway and Bruce, 1992). In technical terms, the marginal investor on the Oslo stock exchange would be a foreigner, say a US pension fund. Imputation credits are then simply a subsidy to one particular form of Norwegian savings, that is, corporate equity, and as a result, they must also serve the purpose of promoting domestic ownership of the corporate capital stock. Promoting domestic ownership through the tax system may be a deliberate Norwegian policy, but does it make sense to dilute the ownership effect by also extending the subsidy to foreign equity investment undertaken by Norwegians?

A few sentences later, GS complains about the fact that foreign shareholders do not generally receive imputation credits. I share GS's view here, and I would even tend to consider the main problem for portfolio investment to be precisely that foreign investors are granted less than the full dividend relief offered to resident investors. If a principle of Most Favored Investor (MFI) were to be followed, meaning that all investors in a market—domestic and foreign—were to receive the same imputation credits, the extent of double tax relief *per se* would be of no importance, that is, would not distort the international allocation of portfolio investment. Naturally, the MFI- principle is automatically fulfilled for classical countries, practicing full double taxation.

References

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