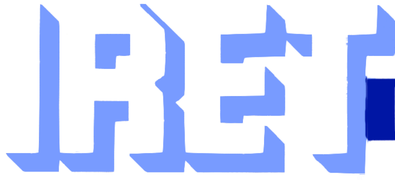

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COMPETITIVENESS AND THE U.S. TAXATION OF CORPORATE INCOME

The current House Ways and Means Committee hearings on the issue of U.S. competitiveness indicate the beginning of serious Congressional concern over the effect on the U.S. position in the world economy of a cumulation of tax and other legislation adopted with strictly domestic political considerations in mind. From the tax standpoint, the failure to consider competitiveness had its culmination in the 1986 tax legislation, when the rules applying to business, and to international operations in particular, were wrung out to produce revenue to fund personal tax cuts, leaving in the aftermath a system that many regard as essentially unadministrable and economically damaging. The hearings announcement makes it clear that a fundamental reexamination of principle is invited. This is all the more welcome for being long overdue.

> ***It is a striking fact that the U.S. approach to the taxation of international business operations is unique in the world in important respects...this uniqueness alone should sound warning bells. What do other nations know that we may have been missing?***

We must begin to come to terms with the overriding fact of cross border economic integration. Today U.S. firms' overseas sales exceed $1 trillion, or four times U.S. exports. Exports and imports account for nearly a fifth of our economy, about double the proportion of only two decades ago. (In some European countries, exports and imports are over 40% of the economy.) An increasing portion of exports and imports consist of materials, work in process, and capital goods, rather than finished products. Major industries now operate across national boundaries in the way they operate across state borders. (Imagine the condition of our economy if each state imposed a tax regime similar to our federal rules!)

It is a striking fact that the U.S. approach to the taxation of international business operations is unique in the world in important respects, particularly regarding its impact on activities taking place

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entirely outside the U.S. In an increasingly integrated world economy, where leading industries must be successful everywhere in order to survive at home, this uniqueness alone should sound warning bells. What do other nations know that we may have been missing?

The guiding principle we have tried to follow (with some exceptions) has been what economists call capital export neutrality. Basically, the idea is that someone doing business abroad should bear the same U.S. tax burden as someone operating domestically. A high degree of extraterritoriality is implicit in such an approach.

The principle that seems to have received more emphasis in other nations is that of capital import neutrality, or the idea that someone doing business abroad ought to be able to operate on the same terms, from a tax standpoint, as those with whom he competes.

The second main argument is...that unless the results of U.S. companies' foreign operations are taxed at least as heavily as domestic business, investment and jobs will run off to foreign locations...This argument has serious flaws.

Although the choice of guiding principle, or more precisely the choice of the right mix of these inherently conflicting principles, is a complex matter, two arguments have sustained the emphasis in the U.S. on capital export neutrality.

The first might be termed a fairness argument — is it fair to tax a domestic business differently or more heavily than one that operates abroad? This issue is most sharply focused in the case of goods manufactured abroad and sold in the domestic market.

The fairness question should be addressed in a real world context. In an integrated global economy, goods and services will be sold across borders and into the country, either by domestic or by foreign firms. If U.S. firms don't do it, foreign firms will. In any case, economic factors with larger weight than taxes will normally affect the transaction. In many instances, major multinational industries do not compete with purely domestic firms. The argument's applicability is further blurred by the fact that production processes are taking place without regard to borders. Parts and work in process move all over the world, and knowledge and material inputs may come from many sources.

In these circumstances the fairness argument represents a partial perspective, reasonable in limited instances where it may apply, but lacking in comprehensiveness. Other industrial nations with much higher levels of cross border economic integration than presently prevail in the U.S. have not hesitated to implement effectively territorial systems in which their domestic firms operating abroad pay whatever taxes, higher or lower, apply in the foreign locale, and are often able, under tax sparing treaties or by law, to bring the earnings home at little or no additional tax cost. These

nations typically have organized labor forces and domestic political pressures similar to the U.S., yet they have apparently concluded that the inward-looking fairness argument is far outweighed by the economic benefits to be gained from eliminating tax impediments to competitiveness.

The second main argument is one based on ideas of efficient capital allocation. Here the thought is that unless tax rates are the same, capital investment decisions will be distorted by the tax differentials, and economic inefficiencies will result. (Isn't it interesting that adherents of this argument have not seen fit to support a U.S. subsidy for overseas operations in higher tax countries?) More particularly, the argument is that unless the results of U.S. companies' foreign operations are taxed at least as heavily as domestic business, investment and jobs will run off to foreign locations; other nations, it is argued, will be richer and the United States will be poorer, as a result.

...the argument presupposes that the total amount of saving and investment undertaken by the nation is fixed, so that if we invest more abroad we necessarily invest less at home...If the argument were correct, confiscatory taxation of our foreign operations would produce an investment boom here at home, no matter how unpromising the domestic investment climate.

This argument has serious flaws. Implicit in it is the assumption that our domestic economy is affected only by U.S. investor decisions concerning U.S. capital. Today inward direct investment plays an important role. More importantly, the argument presupposes that the total amount of saving and investment undertaken by the nation is fixed, so that if we invest more abroad we necessarily invest less at home. Neither theory nor experience supports this view. If the argument were correct, confiscatory taxation of our foreign operations would produce an investment boom here at home, no matter how unpromising the domestic investment climate.

Another argument often heard is the "slippery slope." It is thought that should we modify our approach there will be international competition tending to drive down taxes on international business. It is hoped that revenue pressure in other countries will eventually force them to copy our practices and reduce the competitive disparity.

There is little sign of such development. While some nations have adopted limited Subpart F type rules to address situations of gross avoidance of domestic tax, there is nothing remotely like U.S. practice in effect or contemplated. Perhaps the right distance to go down a slippery slope is about as far as others have, and stop there — like they have. The notion that what we do ought to set the pace for everyone else smacks of hubris; others will follow what we do in some respects (as with recent rate cuts), but there is little reason to think they will radically overhaul their systems to mimic something that we ourselves roundly criticize for its complexity and inefficiency.

Instead of clinging to the hope that others will eventually conform to our past practice, we should be asking ourselves why, after more than thirty years, there continues to be a general indifference to adopting our approach.

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If the intellectual case for the heavy U.S. emphasis on capital export neutrality has a parochial quality and seems unconvincing, there are nevertheless considerable political pressures that push in the same direction. Protectionists favor a tax regime that tends to preclude effective U.S. participation in the global economy — witness the Burke-Hartke proposals of the 1970s. Mercantilism in taxation is unlikely, however, to reverse the growing global integration that is a product of the technological revolution. At most, it will simply handicap U.S. competitors, and result in growth in jobs and wealth elsewhere.

Although Burke-Hartke was not adopted, we have nevertheless moved, wittingly or not, a considerable direction towards realization of its objective, which was to impede international operations through elimination of the foreign tax credit and elimination of deferral.

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A desirable tax policy should encourage the development of headquarters-type activities in the United States, including research functions and management expertise. We should seek to maximize high value-added processes and jobs, while not discouraging the migration of low wage, low skill, and low value added work to regions where it may be done on a competitive basis. It is clear that all of this is going to happen anyway — it is just a matter of which countries will best facilitate the process, enabling their multinational firms to be fully competitive, assuring the creation of high quality jobs at home, and thereby benefitting their citizens the most.

Such a process benefits less developed countries as well, by allowing them to commence economic development by furnishing jobs that may go begging in advanced countries, but are

desperately needed locally. This process furnishes a realistic and humane alternative to the failed government-to-government aid policies. The extensive networks of tax sparing treaties that characterize other industrial nations undoubtedly reflect, at least in part, this rationale.

Our approach to taxes stands in ironic contrast to our relatively liberal position on trade.

One wonders at the logic of those who seek by any means to retain low level jobs in the face of our need to upgrade the work force. Perhaps it is because these are the only jobs that can be organized. Such considerations are not only poor policy but unworthy of a nation of great wealth and substantial full employment. Our preoccupation appears to be interest-group driven, and appears to have little influence in other developed countries. None of this is to deny there are problems with marginal workers, but these should be addressed through educational means, not by an out-of-step tax policy that threatens competitiveness.

Unfortunately, from the standpoint of taxes, we have badly handicapped ourselves in adjusting to the trend toward economic integration. Our approach to taxes stands in ironic contrast to our relatively liberal position on trade. Considerable harm is being done for what are relatively meager revenues in terms of the U.S. budget.

Perhaps territoriality should be an ultimate goal. It's attainment, however, would pose many difficult transition issues...there are more limited changes to start with...that would contribute to creating a tax environment more favorable to U.S. business competitiveness.

How might we improve things? Some have proposed replacing the corporate income tax and payroll tax with a uniform business tax that would be border adjustable. However desirable the latter feature may be deemed to be, there are some who fear that such a tax would be adopted as an additional, rather than substitute tax. No increase in tax, no matter how well designed, can possibly improve competitiveness. There are many who fear that adoption of a new source of revenue would be dangerous to sound fiscal management, given our demonstrated record on the federal budget.

Others have recommended adopting a territorial tax system. Perhaps territoriality should be an ultimate goal. Its attainment, however, would pose many difficult transitional issues. As a practical matter, there are more limited changes to start with (even these changes would represent a

considerable departure from current practice) that would contribute to creating a tax environment more favorable to U.S. business competitiveness.

An effective foreign tax credit system coupled with deferral can be as consistent with competitiveness as a territorial system. Our problem is that both the credit and deferral have been substantially eroded.

The foreign tax credit has been rendered less than fully effective in two principal ways. First the Section 861 regulations require the allocation of domestically incurred expense on a unilateral basis, i.e., there is no assurance the expense so allocated will be deductible anywhere.

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For example, a firm that performs research or incurs interest expense in the United States will have some of that expense allocated to foreign source income, in many cases reducing foreign tax credits otherwise available. This is tantamount to the loss of tax benefit for expense incurred to produce income. Foreign nations will not allow such expense to be deducted against their taxes, any more than the U.S. allows deduction of foreign expenses against U.S. income.

While allocation as an abstract concept may be correct, it probably should have been accomplished, if at all, through multilateral treaty negotiation in order to avoid double taxation. To do otherwise places the interests of the fisc ahead of the competitiveness of the taxpayer — something unlikely to enhance revenues in the long run.

Further, the regulations are quite uncertain (allocation of expense is inherently a matter of arbitrary judgment) and have created utter unpredictability as to the ultimate tax costs of foreign transactions. Such uncertainty is itself productive of considerable economic inefficiency. It discourages repatriation of capital that might otherwise support investment in the United States. Section 861 allocation is unique to the United States; no other nation imposes such a burden on its multinational business.

Second, the 1986 Act lowered rates while greatly broadening the base, sharply raising corporate taxes. For example, U.S. capital recovery provisions were lowered to the bottom rank of industrial nations. When the smoke cleared, corporations were paying more tax than ever before, but their foreign tax credits were "excess."

It may be that by a change in labels, a partial back door repeal of the foreign tax credit was accomplished. The effect of the rate cut, unilateral expense allocation, and the drastic changes in

the U.S. tax base have drawn into question the effectiveness of U.S. rules relating to comparison of the domestic and foreign tax bases necessary to assure that the credit is effective in preventing double taxation. In addition, there is a plethora of specific problems not discussed here that arise from cumulative efforts to raise revenues by arbitrarily limiting credits.

Apart from foreign tax credit, another broad problem area is that of the so-called anti - deferral rules. Deferral, or the practice of not taxing overseas subsidiary earnings until remitted to the U.S., has long been thought necessary to assure some degree of competitiveness in a world of primarily territorial, or effectively territorial tax systems. Deferral is limited by the so-called Subpart F rules, which have expanded far beyond their original goal of preventing tax avoidance in the case of foreign base company operations and passive income.

The rationale for the United States attempting to preclude its multinationals from minimizing foreign tax is elusive.

Many types of active business income are now caught, or arguably fall within, the passive definitions, and therefore suffer accelerated taxation. This is becoming a worse problem with the technological revolution, because an increasing proportion of value added in world trade is accounted for by intangibles, income from which may fall within passive definitions even though it represents active business income. To that extent, the purpose of allowing competitiveness with effectively territorial systems elsewhere is defeated.

To the extent Subpart F applies to wholly foreign transactions, precluding avoidance of foreign taxes, we may be shifting tax revenues from the U.S. fisc into foreign coffers. Current U.S. taxation of the Subpart F earnings may induce shifting the site of foreign operations to higher-tax jurisdictions so that the foreign income eventually comes back to the U.S. carrying substantial foreign tax credits. The use of foreign base sales and service companies by foreign multinationals is common practice — often for business purposes as well as for tax savings. Concerns over the levels of income in the base companies are typically addressed by advanced pricing rulings or in the course of tax audits.

The rationale for the United States attempting to preclude its multinationals from minimizing foreign tax is elusive. Perhaps it can be viewed as some sort of foreign aid out of the pockets of U.S. business, transferring revenues to foreign treasuries where they would not have otherwise collected them. It is too bad other countries don't reciprocate by trying to force their companies unnecessarily to pay U.S. taxes.

Of course, in many cases our rules do not actually cause the payment of foreign tax or even of U.S. tax; companies simply avoid engaging in transactions they would otherwise carry out for good

business reasons, and which their competitors carry out every day. Or the transactions may be carried out in other ways, albeit at higher cost.

The underlying rationale for these strange distinctions unique to U.S. law seems to be that unless various transactions that allow the multinational enterprise effective use of its own capital are treated as the equivalent of dividends, deferral will too much resemble outright exemption, in derogation of the capital export neutrality concept. If one concludes, however, that that standard is of dubious value in today's competitive environment, then such rules may be seen as no more than useless abstractions that impose needless costs on the U.S. firm which its competitors never face. The fact that such provisions often do not produce revenue makes them especially futile.

To summarize, an attempt to comprehend changed circumstances in the world economy and their implications for our tax treatment of corporations is an urgent undertaking. It must be recognized that an integrated global economy and the vital interest in assuring that U.S. multinationals remain viable will impose considerable restraints in the future on what has in the past been found convenient as a matter of domestic politics.

Henceforth, the first question that should be asked about any tax proposal is "how does this compare with what other nations do?"

Great changes have taken place in the world, but our approach to taxation seems to be running on the fumes of the last intellectual fill-up, which took place in about 1962. Henceforth, the first question that should be asked about any tax proposal is "how does this compare with what other nations do?" Members and staff should ask not "how can we get some revenue with the least adverse public reaction," but "how can we raise revenues in ways that are least burdensome, that minimize the inevitable economic losses that result from taxation?"

I believe that something like this is the attitude taken toward taxation of corporate income in those foreign nations that have turned in astonishing records of economic development, and which have shown far more sophistication than we have about the importance of, and conditions for, successful competition in the global economy. Suffice it to say that their tax systems have a very different appearance than the unwieldy hypercomplex system under which we labor. Perhaps instead of offering them advice, we should be seeking it.

Competitiveness is also affected by the domestic aspects of the corporate income tax. New business enterprises start off domestically long before they expand abroad. Capital cost recovery and research provisions which compare poorly with other nations are not adequately compensated by a somewhat lower than average rate. Internal rules that hamper capital formation and new business enterprise relative to rules prevailing in other jurisdictions will tend to cause economic development to shift away from the U.S.

The basic corporate income tax issue is its burdensomeness relative to the revenues derived from it. Is it a sensible way to raise taxes?

The tax antedates the personal income tax; it was originally adopted as a relatively painless, very low-rate tax on what were seen as large pools of income and wealth. Basically, no more economic sophistication was brought to the issue than to the establishment of those fortresses on the Rhine which collected tolls from river traffic in the Middle Ages.

Deadweight losses from reduction in investment and other causes may impose costs on the economy far in excess of revenues raised. Some estimates are around $150 billion per year, on a tax that recently raised about $105 billion.

At today's rates and base, with complex rules elaborated to cover in detail a multiplicity of activities, the tax has become extremely burdensome. Last year the National Association of Manufacturers released a study, based on work done by Arthur D. Little & Co. for the Internal Revenue Service, that estimated a compliance cost of over 60 cents per dollar of revenue.

Unfortunately, that is only the tip of the iceberg. Deadweight losses from reduction in investment and other causes may impose costs on the economy far in excess of revenues raised. Some academic estimates are around $150 billion per year, on a tax that recently raised about $105 billion.

The U.S. corporate income tax is one of the more damaging things we do to ourselves. It is something we have blundered into as a result of years of pursuing the politically expedient, rather than what is known to be sound policy.

No one knows where the burden of the tax falls. Clearly it is not borne by "rich corporations," which are themselves nothing more than legal fictions, pieces of paper filed in state offices. Only people can be affected. There are three possible choices; customers (through higher prices), employees (through reduced employment or lower wage growth), or shareholders (through lower returns to invested capital).

Present economic theory gives no clear answer. However, in a time of substantial import competition (about 70% of U.S. production faces such competition), opportunities to pass the tax forward to customers are severely limited. The tax probably functions to a substantial degree as a

regressive tax on labor through its effects in lowering capital investment that would make labor more productive and thereby result in higher growth in labor's real incomes. Moreover, most share capitalis today indirectly owned by workers through pension and benefit plans, so the tax again comes back to labor.

Whatever the actual incidence, one cannot say much for the equity or efficiency of a tax where no one knows who bears it, and where the burden is probably different in every case depending upon circumstances.

Most members of Congress sincerely want to do the right thing — they do not want to cause actual harm even where political pressures are great. Lacking sound advice, however, they will tend to follow the easiest path...Tax policy professionals generally have failed to make clear to legislators the real costs of what we have been doing.

The real vice, however, is that the tax pulls income from the economy at exactly the point at which it would otherwise be invested. Corporations account for only about 8% of total taxable income, yet they typically account for more than half of the net saving in the U.S. For most corporations, every dollar paid in taxes is a dollar not invested in research or new productive equipment. In a weak saving economy, concentrating tax effort on corporations imposes an enormous cost in lost economic growth. To focus that effort, as was done in the 1986 act, on sensitive leading-edge multinationals that are locked in a competitive struggle for survival is the height of folly — folly of a kind that no other nation is committing.

If all these matters are well known, it is equally true that they are generally ignored. The features that make the tax so undesirable economically are the ones that make it politically appealing.

The U.S. corporate income tax is one of the more damaging things we do to ourselves. It is something we have blundered into as a result of years of pursuing the politically expedient, rather than what is known to be sound policy. We are fortunate that other countries have to some extent made the same mistake, although they have not pushed nearly as far as we have.

Most members of Congress sincerely want to do the right thing — they do not want to cause actual harm even where political pressures are great. Lacking sound advice, however, they will tend to follow the easiest path. In the tax area they heavily depend on advice from professionals. Part of the problem is that the lawyers among us have gotten caught up in elaborate conceptualisms to the extent that they have lost sight of fundamental goals. Economists could have done better, too. Tax policy professionals generally have failed to make clear to legislators the real costs of what we have been doing.

While we may be politically constrained from a major overhaul at this point, we should at least try to put public discussion and political debate on a more rational footing, and be more cognizant of the likely effects of what we do than we have been to date. A full recognition of the economic costs we impose upon ourselves may lead to more rational decision making in the future.

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Note: Nothing here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before the Congress.