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# EC92'S IMPLICATIONS FOR U.S. FOREIGN TAX POLICY

Testimony Presented to the

Committee on Ways and Means

U.S. House of Representatives

by

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I am Norman B. Ture, president of the Institute for Research on the Economics of Taxation (IRET). I am grateful to the Committee for giving me the opportunity to testify on the implications of EC92 for American businesses' investment policies. This testimony presents views I have expressed on a number of occasions. These views are not necessarily those of IRET, its Board of Directors, or its contributors.

## Introduction

The European Economic Community's efforts to achieve economic integration focus on removing institutional barriers to the flow of products, services, production inputs, and business enterprises among the member countries. To the extent these efforts succeed, the European economy can realize very substantial benefits from enhanced business efficiency. The very essence of EC92 is to enhance economic well being by removing artificial, government-imposed obstructions to efficient market performance.

These developments hold great promise for American businesses and for the American economy provided that (1) EC92 does not discriminate against businesses owned primarily by non-Europeans, and (2) U.S. public policies do not prevent American businesses from responding effectively to the opportunities EC92 will offer by perpetuating barriers or creating new ones to the movement of American business enterprises and capital across national boundaries. Regarding the first condition, the principal EC92 constraint appears to be that the advantages of integration will be available only to businesses that maintain a real operating presence in the European Community. Most American businesses that are eager to obtain these advantages have little, if any, problem with this requirement. More to the point is whether these businesses will be able to locate and operate business ventures in the European Community without confronting U.S. tax consequences that disadvantage them compared with foreign competitors. The real significance of EC92, I respectfully submit, is that it signals the urgency for an objective, careful, in-depth reappraisal of U.S. foreign tax policy.

EC92 should be seen as recognition by member countries of the obvious facts of life that all of us live in a global economy and that our economic well being depends critically on adjusting our domestic institutional arrangements to that reality. The notion of national origin of products and services has become antique. A great many of the products commonly purchased and used in the United States as in other nations travel back and forth among numerous national jurisdictions in their transformation from raw materials to finished goods. Efforts to determine national content of these products are as fruitless as they are pointless. Provisions of law or regulations that seek to deter American businesses from seeking out the lowest cost locations for producing components or for undertaking assembly operations and to confine such production activity to the United States are not only anti-competitive but unrealistic and costly as well.

Major features of U.S. foreign tax law are some of the principal barriers to efficient participation by American businesses in the world market place. The foreign tax provisions in the federal income tax law reflect a "fortress America" policy orientation. For the past several decades, the guiding objective of our foreign tax policy appears to have been to discourage foreign investment and business operations by American companies, based on the misapprehension that such activity occurs at the expense of investment, production, and employment here at home. The results of this long-standing policy have been to raise the cost of capital confronting American multinational businesses with respect to both their foreign and domestic operations, to disadvantage them in their foreign operations relative to foreign competitors, and to preclude their efficient location choices.

Recent changes in our foreign tax provisions, particularly those made by the Tax Reform Act of 1986, have exacerbated this protectionist complexion. The impetus for these changes appears to have been revenue gains. In fact, their principal consequence has been extraordinary increases in the complexity of the foreign tax provisions rather than additional tax revenues for the U.S. Treasury Department. In the name of greater equity, these provisions have befogged business decision making and introduced a host of artificial constraints on even the most basic considerations about what kinds of activities to undertake in what locations and with what resources.

I respectfully urge this Committee to give the highest priority to a searching and critical reappraisal of the present foreign tax provisions. In undertaking this assessment, the Committee should seek to eliminate those provisions of present law that increase, above the levels that would prevail in free markets, the costs American businesses must incur to invest and to operate in any location.

## The Protectionist Character of U.S. Foreign Income Taxation

Federal income tax provisions pertaining to the tax treatment of income earned abroad by U.S. businesses are essentially protectionist in character. In essence, these provisions impose income tax on the income generated by American businesses in foreign jurisdictions in amounts at least equal to that imposed on an equal amount of income produced in the United States. If a foreign government imposes lower taxes on an American business' income generated in its jurisdiction than the U.S. would levy on the same amount of domestic income, the U.S. collects the difference. In other words, our tax overrides that of a foreign government if it imposes a lower tax on the income of an American business in its jurisdiction than we do.

The rationale offered by some economists for this system is that efficient allocation among all possible jurisdictions of the resources used by an American business requires that these resources produce per unit pre-tax earnings at least equal to those they would earn in the United States. The lower the amount of tax imposed on earnings, the lower the earnings need be to afford after-tax earnings sufficient to induce the resource owners to commit them to use in any particular location. Thus, if the tax imposed by a foreign government is less than that imposed by the United States on any given amount of earnings, it will pay the owners of the production inputs producing those earnings to commit them to use in the foreign jurisdiction even though their contribution to total output is greater here at home.

The fallacy in this argument is that the higher pre-tax return on the use of the resources here rather than in the lower tax jurisdiction reflects a higher cost imposed by the government on the use of those resources here compared to the foreign jurisdiction. In the face of that higher cost, fewer of those resources are used here, in combination with other production inputs, than would otherwise be the case. The smaller is the amount of such inputs used in combination with other production resources, the higher is their pre-tax returns. Indeed, sufficiently fewer of these resources are used here to afford pre-tax returns sufficiently great to cover the higher U.S. tax in order to assure that the after-tax reward for their use will be at least as great as in the lower-tax foreign jurisdiction. The obvious consequence is that we use less of the resources here at home than we would if our taxes were lighter; by the same token, we enjoy less of the output of these resources.

At the same time, our foreign tax provisions make sure that these resources can't be used more profitably in foreign jurisdictions. By insisting that taxes, foreign or U.S., must be imposed on the income produced by these resources used by American businesses in foreign jurisdictions at a rate no lower

than the U.S. rate, we follow a dog-in-the-manger or beggar-my-neighbor foreign tax policy. This is tax protectionism, precisely the same as trade protectionism.

Trade protectionism bases its case on the assumptions that (1) production abroad of products and services to be sold in the United States erodes our domestic employment, output, and income, and (2) production at home of products and services to be sold elsewhere expands domestic employment, output, and income. Tax protectionism rests on virtually identical assumptions: investment by American businesses in foreign ventures is at the expense of domestic investment, and the production by U.S. controlled foreign corporations is at the expense of production that would otherwise be undertaken in the domestic economy. Neither of these assumptions is correct, conceptually or factually.

The decision by a company to invest in facilities and to undertake business operations in a foreign location is impelled principally by two sets of considerations. One of these is the perception that penetration of foreign markets requires establishing an operating presence in those markets, even if most of the products and services to be sold in that market are produced in the United States. The second set of considerations are cost differentials, the determination that one or more production costs, including taxes, is sufficiently less in the foreign location than in the United States to afford the company higher profit margins and a greater return on investment that can be obtained here at home. The foreign production, therefore, is sold in both the U.S. and foreign markets at lower unit prices than those at which it could be sold with equal profitability if made here or in greater quantity at the prices that would be required for domestic production.

Note that these conditions and these results apply equally to a U.S.-owned and a foreign-owned company operating in the foreign location. No meaningful distinction can be drawn between the effects in the domestic economy of foreign investment and operations by U.S. multinationals and those of foreign-owned companies, whether the output of those operations flows into the U.S. domestic market or into foreign markets.

Are these effects injurious? As users or consumers of the foreign-produced products, Americans are clearly equally well served by a U.S. company or a foreign company producing the products in an advantageous foreign location. As producers of the products, the U.S. company and its owners are clearly better off in choosing the foreign location. The critical questions are (1) whether people who are not employed in the domestic economy by the company because the production occurs abroad are injured by the choice of the foreign site, and (2) whether the economy as a whole loses capital, its direct contribution to output, and its

contribution to expanding productivity because investment is undertaken abroad?

To show that employees are injured, one would have to prove that they are completely specialized to the production of the products and services that are produced in the foreign location instead of here, so that if they are not employed producing those products, they can't be employed at all. One would also have to show that the U.S. company's foreign producer has a complete monopoly on the product so that no foreign-owned producer could take advantage of the economies available in the foreign location, produce the same products or close substitutes, and sell them in the domestic American market or foreign markets at lower prices than those at which the domestically-produced products would have to be sold. These conditions do not exist in the real world. The domestic employment consequences of foreign production, irrespective of who owns the foreign producer, are not losses of jobs but changes in jobs.

Participation in the world economy, by foreign investments of U.S. companies as well as by trade, often involves economic dislocations. Employees who lose jobs because competing products are produced abroad at lower costs must incur the costs of relocation. These private costs should not be treated lightly. To attempt to avert or moderate these costs by restricting imports or by insisting on domestic production of products aimed at domestic or foreign markets imposes much larger social costs. Public policy should be guided by the recognition of the social gains from efficiency-dictated location choices and should not sacrifice these gains by seeking to protect the employment status quo.

The notion that foreign investment is at the expense of domestic investment rests on the mistaken view that the aggregate amount of investment in any period of time is fixed. In this view, companies are bound to undertake the investment somewhere, irrespective of the rates of return on the investment. In this scheme of things, every dollar of capital added abroad is a dollar less capital added at home.

This view is at odds with reality. Every business continually confronts a threshold rate of return in its decisions about whether, how, and where to commit its resources. Any business that ignores that constraint soon finds that it can no longer acquire resources and may well wind up as a takeover target. A lower cost of capital in foreign jurisdictions is much likelier to increase a business's total investment than to shift its investment from domestic to foreign sites.

By the same token, increasing the cost of capital used in foreign locations doesn't, itself, reduce the cost of capital here at home. U.S. tax provisions that raise the cost of capital

confronting U.S. multinationals in their foreign operations don't induce these companies to increase the amount of their domestic investment; instead, they shrink the aggregate amount of capital formation.

The foreign tax provisions in the federal income tax raise the cost of capital confronting American-owned companies in many foreign jurisdictions, relative to the cost they would otherwise confront. This occurs whenever the U.S. tax provisions have the effect of increasing the present value of the aggregate tax liabilities on the results of these companies' foreign operations compared to the liabilities imposed by the foreign jurisdictions. The result is a lower amount and a less efficient allocation of investment by U.S. companies abroad compared to levels and uses that would otherwise prevail. Just as protectionist trade policies deprive us of the efficiency and welfare gains of unobstructed trade, so, too, do protectionist tax policies.

Our foreign tax provisions impose the same or higher tax costs on the foreign operations of U.S. companies as those they would incur if they conducted their foreign operations at home and, in many cases, higher tax costs than are imposed by the governments in the foreign locations. Trade protectionism, in a perfectly analogous fashion, seeks to impose on imported goods and services the same or higher prices as those of the same or comparable domestically-produced products and services. In both case, the most efficient use of production resources is impeded, and the well being of our citizens is eroded.

A truly non-protectionist tax policy would neither increase nor reduce the effective rate of tax imposed by a foreign government on the income generated by a U.S. multinational's operations in its jurisdiction. This criterion clearly calls for a true territorial approach under which U.S. tax law would not reach the results of U.S. companies' foreign operations, either at the time those results are realized or on the occasion of the repatriation of the foreign earnings.

As a practical matter, true territoriality is not a near-term goal of federal tax policy. It should serve, however, as a guide for more modest statutory revisions aimed at moderating the protectionist character of our tax system. If national policy is to recognize the exigencies of economic globalism, signaled by EC92, we need to reduce the barriers imposed by our present foreign tax provisions to effective participation by American businesses in the world market place.

<u>Some Suggested Revisions</u>

As the Committee is aware, the very nearly universal business complaint about the TRA86 revisions of the foreign tax provisions is the enormous complexity they added to the law.

This added complexity greatly increases compliance costs. In doing so, it increases the tax costs of investment and operations in foreign jurisdictions.

One highly constructive effort the Committee might well undertake is simplification of the foreign tax provision changes made by the TRA86. In a great many cases, these changes were made ostensibly to close off so-called tax avoidance opportunities, hence to increase U.S. tax revenues from foreign operations of American businesses or to accelerate the receipt of these revenues. It may well be that these changes have failed to generate incremental tax revenues sufficient to offset the revenue losses from the increase in deductible compliance costs. If the Committee were to find this to be the case, repeal or further amendment of the TRA86 changes in the interest of simplification would not only enhance the net tax revenue flow to the Treasury; it would, even more importantly, reduce the tax cost of the foreign operations of American businesses and improve their competitive position in the world market.

Obvious candidates for the proposed review by the Committee are the provisions of present law that differentiate foreign tax credit treatment on the basis of the character of the income or the jurisdiction in which the income is realized. The numerous distinctions in the tax law with respect to kinds or sources of income and expense have no justification in economic logic. In particular, the distinction between so-called passive income and "other" income has no economic meaning. Source and allocation rules similarly defy economic logic and impose artificial constraints on business decision making.

Perhaps the most challenging set of provisions in the present law is Subpart F. It is difficult to understand the reasoning underlying rules that hold that if a controlled foreign corporation responds to the lower taxes imposed by a foreign government, it may not defer payment of the additional U.S. income tax on its "Subpart F" income until that income is repatriated. By accelerating the U.S. tax payment, the effective rate of tax on Subpart F income is increased. This income, of course, consists of returns on the capital used by the controlled foreign corporation and affiliates. Increasing the effective tax rate on these returns increases the cost of capital committed to the business activities that produce them.

Subpart F is at odds with good tax policy both with respect to its singling out certain types of income for distinctive tax treatment and for subjecting that income to tax before its effective receipt by the U.S. person. The principles of territoriality that I suggested as guides to limited reform of our foreign tax provisions strongly urge a critical rethinking of Subpart F.

At the very least, the Committee should reexamine Subpart F in the context of the opportunities and challenges posed by EC92. At the very time that EC92 would treat all business activity in the EEC as occurring in a single market, our Subpart F rules continue to insist on identifying the member countries as separate economic jurisdictions. Under EC92, European companies presumably will be able to incorporate and do business as Europe-wide corporations. They will, accordingly, be free to choose the locations for their various activities on the basis of real cost considerations, unaffected by tax differentials. In contrast, U.S. companies' location and consolidation decisions will have to continue to be guided by concerns about Subpart F's treatment of undistributed earnings. Even barring repeal, at the very least Subpart F should be amended to treat the European Community as a single country for purposes of its application.

I am sure that many other witnesses, particularly those from the business community, have offered the same or similar suggestions. I hope the Committee will give careful consideration to these proposals.

## Conclusion

Our foreign tax provisions have moved over the last several decades in a direction that is increasingly at odds with what has been happening in the real world. I hope that our public policy makers are sincere in their widely professed desire to allow American businesses to be more effectively competitive in the world market. If so, policy makers must recognize that the free flow of investment and business operations across national borders is essential to the realization of that objective. To this end, our tax laws need to be revised to reduce the penalties they now impose on investing and operating abroad.