U.S. FOREIGN TAX POLICY: OPEN BORDERS OR PROTECTIONISM?

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This conference reflects a growing concern on the part of those involved with U.S. public economic policy over the foreign income tax provisions in the federal income tax. This concern stems from the enormous increase in the complexity of those provisions resulting from the Tax Reform Act of 1986 (TRA86) and from the widening perception of the competitive challenges confronting American businesses in the global marketplace. For corporate tax executives and tax practitioners, the complexity of statute and regulation, if not utterly defeating, is at least dismaying. For corporate business managers, the uncertainty about net-of-tax outcomes of their companies' foreign business ventures and the adverse effects of the current tax provisions on the cost of capital committed to these ventures erect significant barriers to effective competition with their opposite numbers of other nationalities. Unhappily, those who appear to be least concerned about the appropriateness of the existing foreign tax provisions with respect to any criterion other than revenue generation are members of Congress, those who write and/or enact those foreign tax provisions.

In the contemporary policy scene, the principal issue posed in confronting the present foreign tax provisions is revenue. In this area of tax policy as elsewhere, the Willie Sutton concern appears to transcend all other considerations in explaining Congressional policy-making. One might conclude that this largely explains why some members of Congress who are ardent free traders, champions of the unimpeded movement of goods and services across national boundaries, nonetheless strongly favor protectionist tax laws aimed at severely limiting the free movement of capital and business enterprise across national borders. It is, after all, politically less risky to lay additional taxes on the foreign, hence remote, business operations of large, visible corporations than to ask real, live human beings -- voters -- to foot the bill for the nice things the member wants to do for them.

This is, however, only part of the answer. It seems likely that many of these policy makers fail to perceive that tax protectionism closely parallels trade protectionism and that, by the same token, free capital and business movement across national boundaries closely parallels free trade.

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 relies on virtually identical assumptions: investment by U.S. multinationals 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 occur in the domestic economy. If these assumptions were correct, a case might indeed be made for both trade and tax protectionism, and it would be the same case for both. The assumptions are, of course, mistaken.

The decision by a company to invest in facilities and 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, for a number of reasons, requires establishing an operating presence in those markets, even if most of the products and services to be sold in that foreign market are to be 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 its investment than 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 profitably sold 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, in short, 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 foreign markets.

Are those effects injurious? As users or consumers of the foreign-products products, Americans clearly are equally well served by a U.S. company or a foreign company producing the products in the advantageous foreign location. As a producer of the products, the U.S. company and its owners are clearly better off in choosing the foreign location. The really critical questions are (1) whether people who are not employed 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 directed abroad?

To assert that employees are injured, one would have to show 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 these 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. Neither of these conditions prevail in the real world. The domestic employment consequences of foreign production, irrespective of the ownership of the foreign producer, are not losses of jobs but changes in jobs.

Trade and foreign investment by U.S. companies often involve dislocations; employees who lose jobs because competing products are produced abroad must incur the costs of relocation, and 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. Good public policy should be guided by recognition of the social gains from efficiency-dictated location choices and should not sacrifice these gains by protecting the employment status quo.

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

This view is clearly at odds with reality. Every business continually confronts a threshhold rate of return in its decisions about whether and how to commit its resources; any business that ignores that constraint soon finds that it can no longer acquire resources and/or is likely to wind up as a takeover target. Reducing the cost of a company's using capital resources in foreign operations is much likelier to increase the company's total investment than to shift its investment from domestic to foreign sites, leaving the aggregate amount of investment unchanged.

In truth, business capital programs are highly responsive to the profitability of capital projects, that is, to the cost of capital. Increasing the cost of capital committed to any particular location doesn't, in itself, reduce the cost of capital elsewhere. Raising the cost of capital confronting U.S. multinationals in their foreign operations doesn't induce these

companies to increase the amount of their domestic investment; instead, it shrinks the aggregate amount of their capital formation. Moreover, raising the cost of capital committed to any given location, other things being equal, will raise the cost of capital confronting the affected companies everywhere, although not necessarily to the same degree in each location. Increasing the tax burden on foreign investment doesn't repatriate U.S. capital from foreign jurisdictions; it penalizes U.S. businesses' capital formation everywhere.

In this analytical context, the foreign tax provisions in the federal income tax are seen to elevate the cost of capital confronting U.S. companies in many foreign jurisdictions, relative to the cost they would otherwise confront. As indicated, this elevates the cost of capital as well in the domestic setting, compared to what it would otherwise be. These results occur whenever the U.S. tax provisions have the effect of increasing the present value of the aggregate tax liabilities on the results of U.S. multinationals' foreign operations compared to the liabilities imposed by the foreign jurisdiction(s). Insofar as they do so, our foreign tax provisions reduce U.S. companies' investment and production abroad compared to the levels that would otherwise result. Just as protectionist trade policies deprive us of the efficiency and welfare gains of unobstructed trade, so, too, do protectionist tax policies.

In essence, our present foreign tax provisions displace the tax laws of other nations in which U.S. companies do business. We impose the same or higher tax costs on the foreign operations of these companies as those that they would incur if the operations were conducted at home. 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 cases, the most efficient use of production resources is impeded and the welfare of our citizens is eroded. [1]

It is the basic set of our foreign tax rules, not some particular provision or provisions, that is responsible for the protectionist cast of our foreign tax policy. To be sure, the thrust of changes in the foreign tax provisions of the federal income tax, particularly since the early 1960s, has enhanced the protectionist character of these provisions. Even if the law today were the same as it had been before the 1962 changes, let alone the 1986 revisions, however, it would nevertheless have a fundamentally protectionist cast. A truly free-trade tax policy would neither increase nor reduce the effective rate of tax imposed by a foreign jurisdiction on the income generated by a U.S. multinational's operations within its borders. This

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[1] For a detailed and rigorous explication of these propositions, please see Norman B. Ture, "Taxing Foreign Source Income," in U.S. Taxation of American Business Abroad, American Enterprise Institute for Public Policy Research (Washington, D.C., 1975), pp. 37-66.

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 when the foreign earnings are repatriated.

As a practical matter, true territoriality cannot be seen as a realistic, near-term goal of federal tax policy. It can, however, serve as guide for far 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, we need to reduce the barriers to effective participation of American businesses in the world marketplace imposed by our present foreign tax provisions.