

Testimony before the Senate Finance Committee
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Statement of James R. Hines Jr.

Mr. Chairman and Members of this distinguished Committee, my name is James R. Hines Jr. I am Professor of Economics, Public Policy, and Business Economics at the University of Michigan, where I am also Research Director of the Office of Tax Policy Research. I am a Research Associate of the National Bureau of Economic Research, and the Research Director of the International Tax Policy Forum. I am honored to have the opportunity to participate in these hearings on the effect of U.S. tax policy and its impact on the competitiveness of U.S.-owned foreign corporations.

The contribution of the U.S. tax system to the competitiveness of American multinational firms and the performance of the U.S. economy has been the subject of extensive analysis and rethinking in recent years. What we have learned can be summarized in two points. The first is that the ownership and activities of multinational corporations are highly sensitive to taxation, much more so than what was previously believed to be the case. The second is that the competitiveness of the world economy has the potential to change everything we think about the features that characterize tax systems that promote economic efficiency. Together, these two findings carry dramatic implications for the kinds of tax policies that advance the competitiveness of U.S.-owned firms, the well-being of Americans, and the productivity of the world economy.

Much of the current structure of U.S. taxation of foreign income dates to the early 1960s, when the world economy looked very different than it does today. The United States taxes the worldwide incomes of American companies, granting foreign tax credits for foreign income taxes paid, and permits taxpayers to defer U.S. taxation of certain kinds of active foreign income. At the time it was enacted, this structure was thought to promote global economic efficiency. Most observers are considerably less confident now that this kind of tax system, embedded, as it is, in a world economy in which many other countries exempt foreign income from taxation, contributes to the efficiency of resource allocation. The most recent research suggests just the opposite – that the U.S. effort to subject foreign income to taxation at the same (total) rate as domestic income is likely to reduce the productivity of the world economy and the well-being of Americans.

These are difficult concepts, particularly since the tax policy stance that the United States has maintained over the last 40 years, increasingly to our detriment and to the detriment of the world economy, nonetheless has considerable intuitive appeal. It is helpful, therefore, to parse this issue first by evaluating the impact of U.S. taxation on the position of American firms operating abroad, and second by considering the implications for the design of U.S. tax policies.

Taxation and the competitiveness of American firms

Business income earned abroad by American firms is subject to taxation by the United States, whereas business income earned abroad by firms based in other countries is often not subject to taxation by their home governments. Major capital-exporting countries such as Germany, France, Canada, the Netherlands, and Australia effectively exempt most or all of the foreign income earned by their companies. To be sure, some other countries, including Greece,

Italy, Japan, Norway, and the United Kingdom, tax the foreign business incomes of their resident companies, but even these countries do not impose the kind of strict foreign tax regime that the United States does.

These differences influence the competitiveness of American firms in certain foreign markets. Firms from countries that exempt foreign income from taxation have the most to gain from locating their foreign investments in low-tax countries, since such investors benefit in full from any foreign tax savings. Firms from countries (such as the United States) that tax foreign profits while providing foreign tax credits may benefit very little (in some cases not at all) from lower foreign tax rates, since foreign tax savings are offset by reduced foreign tax credits and therefore higher home-country taxation. These relative tax incentives therefore create incentives for investors from countries that exempt foreign income from taxation to concentrate their investments in low-tax countries, leaving investors from countries that tax foreign income while providing foreign tax credits more heavily concentrated in high-tax countries.

There is considerable evidence that the patterns of ownership associated with foreign investment respond to these incentives created by home-country tax regimes. Taxation within the United States offers one such example. Recent research compares the location of investment in the United States by foreign investors whose home governments grant foreign tax credits for federal and state income taxes with the location of investment by those whose home governments do not tax income earned in the United States. Firms that are able to claim credits against their home-country tax liabilities for state income taxes paid in the United States should be much less likely than others to avoid high-tax states. The evidence bears this out: Japanese and British investment in the United States is concentrated in high-tax states, whereas German, French, Dutch, and Australian investment in the United States is concentrated in low-tax states.

The difference is in large part attributable to the ability of Japanese and British firms to claim credits in their home countries for taxes paid to U.S. states.

The lesson of American states is applicable to U.S. investment abroad. Since the United States taxes the foreign incomes of American companies and permits a foreign tax credit for income taxes paid to foreign governments, American firms may receive very little benefit from the low tax rates available in some foreign countries, since income earned in such countries produces sizable U.S. tax liabilities. As a result, German, French, or Dutch firms, that do benefit from low tax rates available in some foreign countries, are at times able to outbid their American competitors for foreign acquisitions or other investments based solely on tax advantages.

More detailed provisions of U.S. and foreign taxation of foreign income can produce dramatic examples of the impact of our tax system on the competitiveness of American firms. One such example is provided by “tax sparing.” Most high-income countries other than the United States include “tax sparing” clauses in the treaties that they sign with many developing countries, but the United States has steadfastly declined to do so. “Tax sparing” is the practice by which capital exporting countries amend their taxation of foreign source income to allow firms to retain the advantages of tax reductions provided by host countries. Specifically, “tax sparing” often takes the form of allowing firms to claim foreign tax credits against home-country tax liabilities for taxes that *would* have been paid to foreign governments in the absence of special abatements. Since foreign tax credits are then based on tax obligations calculated without regard to taxes actually paid, any special tax breaks offered by host country governments enhance the after-tax profitability of foreign investors and are not simply offset by higher home-country taxes.

Japan permits its firms to claim “tax sparing” credits for investments in certain developing countries, while the United States does not. Recent research compares patterns of Japanese and American foreign investment over the same time period. Holding other considerations constant, it follows that, to the extent that “tax sparing” is effective, Japanese firms should exhibit greater willingness than American firms to invest in developing countries. In addition, Japanese firms should be more likely than are Americans to receive special tax breaks from countries with whom Japan has “tax sparing” agreements.

The evidence indicates that “tax sparing” is effective in stimulating foreign investment. Japanese firms locate a much higher fraction of their foreign investment in countries with whom Japan has “tax sparing” agreements than do American firms. Furthermore, host governments appear to grant Japanese firms significant tax reductions that are not available to their American counterparts. Holding constant other considerations, “tax sparing” agreements are associated with 140 percent higher foreign investment levels by Japanese firms than by American firms, and 23 percent lower tax rates imposed on Japanese rather than American investors.

The details of the foreign tax credit calculation method offers another insight into the impact of the U.S. tax system on the competitiveness of American firms operating abroad. The foreign tax credit is limited to the amount of U.S. tax that would otherwise be due on foreign income. Taxpayers are permitted to add together different sources of foreign income in calculating their foreign tax credit limits, but only within “baskets” of income types. These “baskets” were introduced with the idea that they would prevent widespread avoidance of U.S. taxes by taxpayers claiming foreign tax credits, but in practice they have contributed greatly to the complexity and inefficiency of the U.S. tax system. Notably, other countries that tax foreign income have not been eager to copy the U.S. “basket” system.

The Tax Reform Act of 1986 required that the income from each foreign corporation owned between 10 and 50 percent by Americans be placed in a separate “basket” for the purpose of calculating the foreign tax credit limit. This provision imposes a potentially quite large tax cost on American firms participating as minority or 50 percent partners in international joint ventures. While some joint venture operations could be restructured to avoid the punishing impact of this provision, others could not, and as a result, American firms were uniquely disadvantaged in competition with firms from other countries to participate in international joint ventures. This disadvantage was particularly pronounced in the case of joint ventures operating in low-tax foreign countries.

American participation in international joint ventures fell sharply after 1986 as a consequence of the separate “basket” rules introduced by the Tax Reform Act of 1986. Figure 1 illustrates this decline in joint venture participation. Partly in response, Congress in 1997 changed (on a phased-out basis over a number of years) the separate “basket” treatment of international joint ventures, removing some (but not all) of the special tax cost associated with international joint venture participation by American companies. Separate “baskets” continue to be used to calculate foreign tax credit limits for such items as passive income, shipping income, and financial services income, and there is ample evidence that this treatment penalizes and thereby discourages American firms from participating in business ventures that are attractive to foreigners and would otherwise be attractive to Americans.

The U.S. tax system differs sharply from the systems used by other countries to tax their multinational firms. The impact of the unwillingness of the United States to grant “tax sparing” for investments in developing countries, or the use of separate “baskets” used to calculate foreign tax credit limits, while interesting in themselves, more importantly serve as illustrations of the

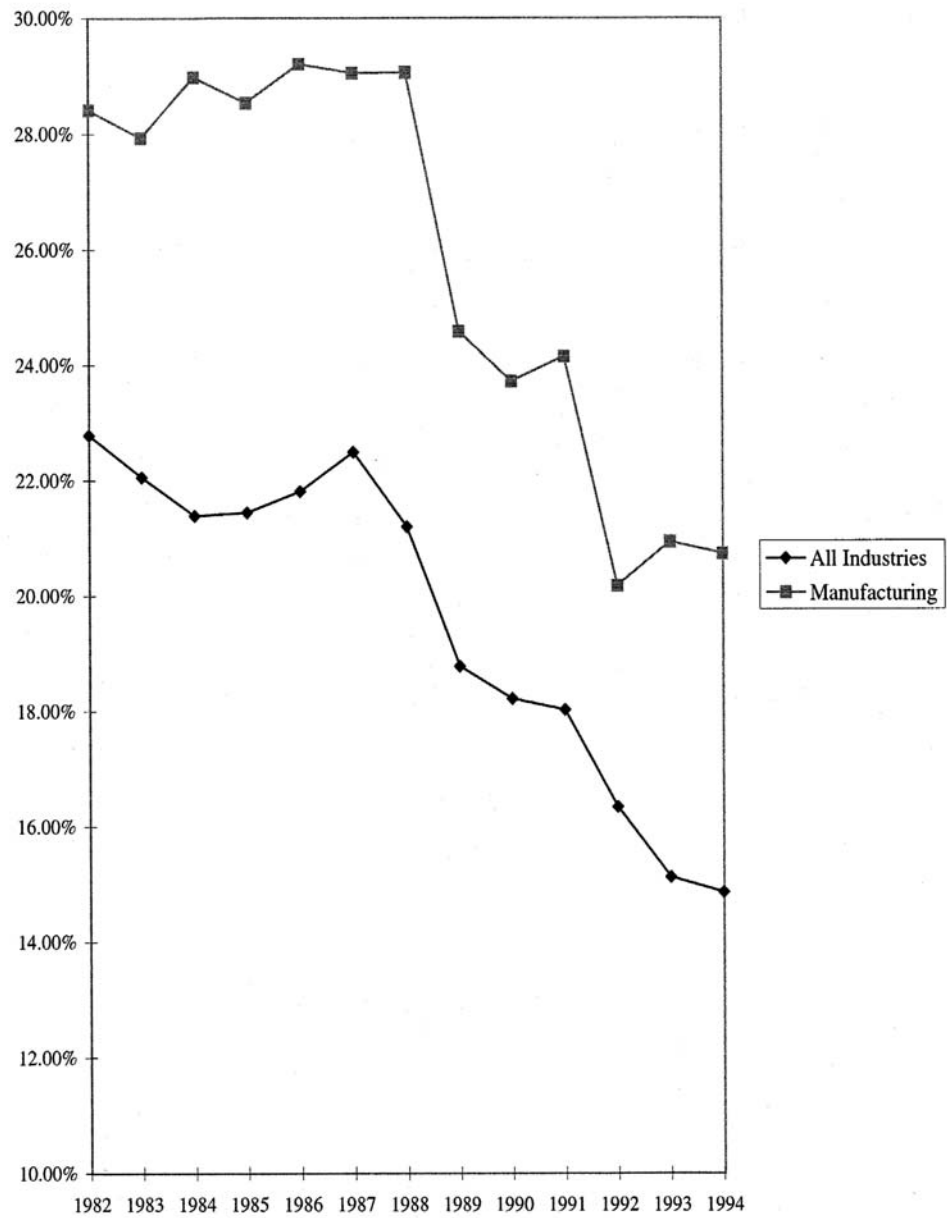


Fig. 1. Joint venture share of foreign affiliate assets, 1982–1994.

Source: U.S. Department of Commerce, Bureau of Economic Analysis. Note: The figure depicts the ratio of joint venture assets to assets of all U.S.-owned foreign affiliates.

effects of the U.S. tax system. Those who study the available quantitative information on the effect of the U.S. tax system do not doubt that it has an important influence on the behavior of taxpayers and the positioning of American firms in the global economy. The question that we face is how this insight should be used to enlighten American tax policy.

Analysis of taxing foreign income

Until relatively recently, there was a commonplace belief that the U.S. policy of taxing foreign income while granting foreign tax credits was if anything too generous from the standpoint of advancing American interests, and could be justified only as a gesture that advances well-being around the world. This belief persisted in spite of the differing practices of so many other countries, and the evident impact of American tax policy on the foreign business activity of U.S.-owned firms. In recent years those who think about these questions have come to some very different conclusions, but in order to understand the latest thinking on these issues, it is helpful to appreciate what we used to believe, and where it has gone wrong.

An older framework for evaluating policy

Capital export neutrality (CEN) is the doctrine that the return to capital should be taxed at the same total rate regardless of the location in which it is earned. If a home country tax system satisfies CEN, then a firm seeking to maximize after-tax returns has an incentive to locate investments in a way that maximizes pre-tax returns. This allocation of investment corresponds to global economic efficiency under certain circumstances. The CEN concept is frequently invoked as a normative justification for the design of tax systems similar to that used by the United States, since the taxation of worldwide income with provision of unlimited foreign tax

credits satisfies CEN. This is not exactly the system that the United States uses, since taxpayers are permitted to defer home country taxation of certain unrepatriated foreign income, and foreign tax credits are subject to various limits. Nonetheless, CEN is often used as a normative benchmark against which to evaluate contemplated changes to the U.S. system of taxing foreign income, since tax systems that satisfy CEN are thought to enhance world welfare.

The standard analysis further implies that governments acting on their own, without regard to world welfare, should tax the foreign incomes of their resident companies while permitting only a deduction for foreign taxes paid. Such taxation satisfies what is known as national neutrality (NN), discouraging foreign investment by imposing a form of double taxation, but doing so in the interest of the home country that disregards the value of tax revenue collected by foreign governments. From the standpoint of the home country, foreign taxes are simply costs of doing business abroad, and therefore warrant the same treatment as other costs. The home country's desired allocation of capital is one in which its firms equate marginal after-tax foreign returns with marginal pretax domestic returns, a condition that is satisfied by full taxation of foreign income after deduction of foreign taxes. This line of thinking suggests that the American policy of taxing foreign income while granting foreign tax credits fails to advance American interests because it treats foreign income too generously. In this view there is a tension between tax policies that advance national welfare (NN) by taxing after-tax foreign income, and those that advance global welfare (CEN) by taxing foreign income while permitting taxpayers to claim foreign tax credits. The practice of much of the world, including Germany, France, Canada, and the Netherlands, that effectively exempts foreign income from taxation, is, by this reasoning, difficult to understand, since it is inconsistent with either national or global interests.

The third of the standard efficiency principles is capital import neutrality (CIN), the doctrine that the return to capital should be taxed at the same total rate regardless of the residence of the investor. Pure source-based taxation at rates that differ between locations can be consistent with CIN, since different investors are taxed (at the corporate level) at identical rates on the same income. In order for such a system to satisfy CIN, however, it is also necessary that individual income tax rates be harmonized, since CIN requires that the combined tax burden on saving and investment in each location not differ between investors. While CEN is commonly thought to characterize tax systems that promote efficient production, CIN is thought to characterize tax systems that promote efficient saving. Another difference is that CIN is a feature of all tax systems analyzed jointly, whereas individual country policies can embody CEN or NN. As a practical matter, since many national policies influence the return to savers, CIN is often dismissed as a policy objective compared to CEN and NN.

It is important to clarify that there are important assumptions built into the standard normative framework that delivers CEN and NN as global and national welfare criteria, and in particular, it is critical that foreign firms are assumed not to respond to changes induced by home-country taxation. Realistically, however, investment by domestic firms at home and abroad may very well influence investment by foreign firms, a scenario that is inconsistent with the logic underlying CEN and NN. If greater investment abroad by home-country firms triggers greater investment by foreign firms in the home country, then it no longer follows that the home country maximizes its welfare by taxing foreign income while permitting only a deduction for foreign taxes paid. From the standpoint of global welfare, if home and foreign firms compete for the ownership of capital around the world, and the productivity of an investment depends on

its ownership, then it is no longer the case that the taxation of foreign income together with the provision of foreign tax credits necessarily contributes to productive efficiency.

Modern thinking on the desirability of taxing foreign income

Modern analysis of international tax systems tend to focus much more on tax-induced ownership changes than do the older views on the subject. Tax systems satisfy what is known as capital ownership neutrality (CON) if they do not distort ownership patterns. It is easiest to understand the welfare properties of CON by considering the extreme case in which the total stock of physical capital in each country is unaffected by international tax rules. In this setting, the function of foreign direct investment is simply to reassign asset ownership among domestic and foreign investors. If the productivity of capital depends on the identities of its owners (and there is considerable reason to think that it does), then the efficient allocation of capital is one that maximizes output given the stocks of capital in each country. It follows that tax systems promote efficiency if they encourage the most productive ownership of assets within the set of feasible investors.

Consider the case in which all countries exempt foreign income from taxation. Then the tax treatment of foreign investment income is the same for all investors, and competition between potential buyers allocates assets to their most productive owners. Note that what matters for asset ownership is comparative advantage rather than absolute advantage: if French firms are always the most productive owners of capital, but they do not have the resources necessary to own everything, then efficiency requires that French firms own the capital for which their rate of return difference with the rest of the world is the greatest. The United States would reduce world welfare by taxing foreign income while permitting taxpayers to claim foreign tax

credits, since such a system encourages American firms to purchase assets in high-tax countries and foreign firms to purchase assets in low-tax countries. These tax incentives distort the allocation of ownership away from one that is strictly associated with underlying productivity differences.

CON is satisfied if all countries exempt foreign income from taxation, but the exemption of foreign income from taxation is not necessary for CON to be satisfied in this particular case. If all countries tax foreign income (possibly at different rates), while permitting taxpayers to claim foreign tax credits, then ownership would be determined by productivity differences and not tax differences, thereby meeting the requirements for CON. In this case the total tax burden on foreign and domestic investment varies between taxpayers with different home countries, but every investor has an incentive to allocate investments in a way that maximizes pretax returns. More generally, CON requires that income is taxed at rates that, if they differ among investors, do so in fixed proportions. Thus, CON would be satisfied if investors from certain European countries face home and foreign tax rates that are uniformly 1.2 times the tax rates faced by all other investors.

In order for the allocation of capital ownership to be efficient it must be the case that it is impossible to increase output by trading capital ownership among investors. This efficiency condition requires not necessarily that capital be equally productive in the hands of each investor, but that the potential gain of reallocating ownership to a higher-productivity owner be exactly equal to the cost of such a reallocation by offsetting ownership changes elsewhere. Since taxpayers allocate their investments to maximize after-tax returns, the marginal dollar spent on new investments by any given investor must yield the same (expected, risk-adjusted) after-tax return everywhere. It follows that, if net (host country plus home country) tax rates differ

between investments located in different countries, marginal investments in high-tax locations must generate higher pre-tax returns than do marginal investments in low-tax locations. Selling an asset in a low-tax location and purchasing an investment in a high-tax location increases output by the firm engaging in the transaction, but (generally) reduces output by the firm on the other side of this transaction. If both parties face the same tax rates, or face taxes that differ in fixed proportions from each other, then CON is satisfied, ownership reallocation would have no effect on total productivity, and the outcome is therefore efficient. If some countries tax foreign income while others do not, then it is impossible to restore CON without bringing them all into alignment, though individual countries have the potential to improve global welfare by moving their taxation of foreign income into conformity with an average global norm.

The welfare implications of CON are less decisive in settings in which the location of plant, equipment, and other productive factors is mobile between countries in response to tax rate differences. Tax systems then determine the location of production as well as patterns of ownership and control, so the net effect of taxation on global welfare depends on the sum of these effects. There is considerable statistical evidence that international tax rate differences influence the location of property, plant and equipment investment, which conforms to anecdotal accounts of tax-motivated investment in low-tax locations such as Singapore and Ireland. Hence pure source-based taxation at rates that differ between countries may encourage excessive investment in low-tax countries, even though it would satisfy CON. If one country were then to tax foreign income while providing foreign tax credits, it would have the effect of reducing the welfare cost of real capital misallocation, but do so at the cost of distorting the ownership and operation of industry. Whether the cost of having too many factories in the Bahamas is larger or smaller than the cost of discouraging value-enhancing corporate acquisitions is ultimately an

empirical question, though the importance of ownership suggests that the attendant welfare impact of distorting ownership allocation can be very large.

The welfare properties of CON emphasize the allocation of ownership of a given volume of business activity between locations whose tax attributes differ. The taxation of foreign income also has the potential to influence rates of national saving and the sizes of domestic firms, though this effect is not explicitly incorporated in the analysis. National saving is affected by a large range of public policies including monetary policy, intergenerational redistribution programs such as social security, the taxation of personal income, estate taxation, and other policies that influence the discount rates used by savers. Business activity is likewise influenced by a host of fiscal, monetary, and regulatory policies. Given these various factors that influence national saving and corporate investment, it is appropriate to analyze the optimal taxation of foreign v. domestic income separately from the question of how much governments should encourage capital accumulation and total investment of home-based firms.

The same circumstances that make CON desirable from the standpoint of world welfare also imply that countries acting on their own, without regard to world welfare, have incentives to exempt foreign income from taxation no matter what other countries do. The reason is that additional outbound foreign investment does not reduce domestic tax revenue, since any reduction in home-country investment by domestic firms is offset by greater investment by foreign firms. With unchanging domestic tax revenue, home-country welfare increases in the after-tax profitability of domestic companies, which is maximized if foreign profits are exempt from taxation. Tax systems that exempt foreign income from taxation can therefore be said to satisfy “national ownership neutrality” (NON). Hence it is possible to understand why so many

countries exempt foreign income from taxation, and it follows that, if every country did so, capital ownership would be allocated efficiently and global output thereby maximized.

National welfare is maximized by exempting foreign income from taxation in cases in which additional foreign investment does not reduce domestic tax revenue raised from domestic economic activity. This condition is satisfied if, to the extent that marginal foreign investment reduces domestic investment by domestic firms, it triggers an equally productive amount of new inbound investment from foreign firms. In more general cases, the welfare-maximizing tax treatment of foreign investment depends on the extent to which foreign investment substitutes for domestic investment lost due to new outbound FDI, and the relative productivities of foreign-owned and domestic-owned capital in the home country. If foreign investment and domestic investment are equally productive in the home country, but inbound foreign investment replaces only 75 percent of domestic investment lost due to outbound FDI, then the analysis implies that the optimal home-country policy is to tax 34 percent of the after-tax foreign income earned by home-country firms.

Implications for American tax policy

There is extensive evidence that tax systems influence the magnitude and composition of international economic activity, and there is good reason to believe that improved tax design has the potential to enhance the performance of national economies. The welfare principles that underlie the U.S. taxation of foreign income rely on the premise that direct investment abroad by American firms reduces the level of investment in the United States, since foreign competitors are assumed not to react to new investments by Americans. It follows from this premise that the opportunity cost of investment abroad includes foregone domestic economic activity and tax

revenue, so national welfare is maximized by taxing the foreign incomes of American companies, whereas global welfare is maximized by providing foreign tax credits. If, instead, direct investment abroad by American companies triggers additional investment in the United States by foreign companies, which is likely in a globally competitive market, then entirely different prescriptions follow. National welfare is then maximized by exempting foreign income from taxation (NON), and global welfare is maximized by conformity in the systems of taxing foreign income among capital-exporting countries (CON).

It is tempting to think of international tax differences as influencing the location of economic activity rather than determining the ownership of assets around the world. In fact tax systems do both, but given the central importance of ownership to the nature of multinational firms, there is good reason to be particularly concerned about the potential for economic inefficiency due to distortions to ownership patterns. Tax systems that satisfy CON ensure that the identities of capital owners are unaffected by tax rate differences, thereby permitting the market to allocate ownership rights to where they are most productive. Proposed and pending international tax reforms in the United States have the potential to affect national and global welfare. In order to evaluate these tax reforms properly, it is necessary to consider their implications for patterns of capital ownership throughout the world.