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Mr. Chairman and Members of this distinguished committee, it is an honor to participate in these hearings on international tax reform. I teach at the University of Michigan, where I am the Richard A. Musgrave Collegiate Professor of Economics in the department of economics and Professor of Law in the law school, and where I serve as Research Director of the business school's Office of Tax Policy Research. I am also a Research Associate of the National Bureau of Economic Research, and the Research Director of the International Tax Policy Forum.

The United States faces serious fiscal challenges in the years ahead. The government needs revenue, and our economy needs sound economic policies that encourage business formation, investment, employment, and other activities that support the economy and thereby generate tax revenue. Business taxation is certain to be on the agenda as part of a broader package of tax measures. The topic of today's hearing is international tax reform, which is appropriate given the current state of fiscal affairs and the position of the U.S. tax system in the world economy.

Put simply, the United States is close to unique among world nations in taxing foreign income in the way that we do. Not only does the United States subject active foreign business income to domestic taxation, but we do so in a manner that strictly limits the ability of taxpayers to claim foreign tax credits and to avoid current U.S. taxation of unrepatriated foreign income. To be sure, there are aspects of the U.S. tax system that limit burdens on foreign income: in

particular, taxpayers are generally entitled to claim credits for foreign income tax payments, and there are many circumstances in which U.S. taxation is deferred until income is repatriated. But most of the world exempts active foreign business income from taxation, and among those countries that tax foreign income, their rules for claiming foreign tax credits and deferring home country taxation of foreign income are far less draconian than those of the United States.

Should we care that U.S. international tax policy differs so markedly from that of other nations, including almost all other major capital exporting countries? There are several reasons why we should care, the primary one being that other countries may be wise in pursuing the policies that they do, in which case we can learn from their reasoning and example. The theory that underlies the policy of capital export neutrality that motivates much of the U.S. worldwide tax system also implies that no nation should ever want to exempt foreign income from taxation. The fact that so many do, and the absence of a groundswell of countries converting their tax systems from exemption systems to worldwide systems that resemble ours, should tell us something.

What would represent an efficient international tax policy? It would be to do what most of the world does, and exempt active foreign business income from U.S. taxation. Exempting foreign income from taxation would promote efficient ownership of productive assets, domestic and foreign, by American businesses. Such a policy would contribute to the vitality of the U.S. economy, the benefits of which would be felt primarily by U.S. workers in the form of greater employment opportunities and higher wages. Efforts to move in the other direction by limiting deferral of home country taxes or limiting the extent to which taxpayers can claim credits for foreign tax payments unfortunately would have the effect of reducing the productivity of U.S.

business operations and thereby reducing the welfare of U.S. residents, again primarily affecting American workers.

At first blush it may appear illogical that the way to contribute to economic activity and economic wellbeing in the United States is to lighten the taxation of foreign income. On further reflection, however, it is clear that the benefits of appropriate taxation of foreign income are simply applications of commonly accepted (and perfectly valid) market principles that guide other economic policies.

Consider, for example, the economic consequences of a policy banning American firms from engaging in any foreign business activity. This is obviously whimsical, a violation of treaties and cherished international norms, not to mention an absurd and self-defeating policy. But it is worth exploring just why this would be such a bad idea for the United States, even putting aside the many real implementation problems that such a policy would encounter. The reason it would be so undesirable is that modern businesses rely on foreign operations for significant fractions of their profitability, and these foreign operations contribute to the profitability of domestic operations of the same companies. If American firms were banned from foreign business activity, then they would shortly find themselves unable to compete effectively against British, Japanese, German, Canadian, and other companies not facing the same restrictions. Furthermore, even if they did not face such competition, the primary effect of such a silly ban would be to reduce their productivity and profitability, to the great detriment of everyone connected with American business.

The issue of banning foreign business activity is relevant because some of the very intuitive arguments advanced in favor of taxing foreign business operations more heavily than we do are also arguments that could be used to support banning foreign business operations

altogether. We certainly do not want to do the latter, and therefore need to ask ourselves why we want to do the former. Of course these policies differ, and in fairness many of the concerns about taxing foreign business operations stem from an understandable desire to avoid subsidizing foreign business activity at the expense of domestic activity. But here is the point: exempting active foreign business income from domestic taxation is not a tax subsidy. This income is subject to taxation by foreign governments, and in order to earn foreign income, American firms must compete against other firms whose governments generally do not subject their foreign income to home-country taxation. These competitors drive down the rates of return to investment available in low-tax foreign locations, making them not the bargain they appear from a simple comparison of tax rates.

The opportunity to earn income in low-tax foreign jurisdictions can be thought of simply as the opportunity to do business in places where a certain kind of cost – in this case, foreign tax cost – is lower. As a general matter, the United States benefits when our companies have low-cost business opportunities. If this were a different kind of business cost – the cost of a raw material, for example – there would be no discussion of the need to impose an offsetting charge on the foreign operations of American companies that use low-cost materials abroad. We should think of the tax system similarly, and be appropriately wary about the desirability of subjecting foreign income to U.S. taxation in order to compensate for low tax rates in some countries.

An instructive way to think about the appropriate taxation of foreign income is to ask whether we would want to impose U.S. excise taxes on a worldwide basis. Suppose, for example, that the U.S. federal government were to levy a $3 tax on each gallon of gasoline sold in the United States and sold abroad by persons resident in the United States. American taxpayers would be entitled to claim foreign tax credits for excise taxes paid to foreign

governments, so that a firm selling gasoline in a country whose excise tax rate exceeds $3 per gallon would owe no additional tax to the United States, whereas a firm selling gasoline in a country with a $1.75 per gallon tax would owe $1.25 per gallon to the United States. One could imagine permitting worldwide averaging, thereby permitting taxpayers to use excess excise tax credits from sales in jurisdictions with excise taxes exceeding $3 per gallon to claim credits to offset taxes due on sales in jurisdictions with excise taxes less than $3 per gallon.

What would be the impact of such a home country tax regime? Firms selling in countries with excise taxes exceeding the U.S. rate would have excess foreign tax credits and therefore no U.S. tax obligations, so the tax regime would not affect them. Firms without excess foreign tax credits would face U.S. excise taxes on foreign sales that vary with local excise tax rates. Odd though such a system would be, it does not necessarily follow that it would spell the end of foreign gasoline sales by American companies in all low-tax jurisdictions, though that is certainly one possibility. American companies would persist in selling gasoline in those foreign markets in which two conditions hold: first, that American firms are profitable, and second, that the same American firms could not be even more profitable by selling their operations to foreign petroleum companies who are not subject to the U.S. tax regime. Since American firms may have significant cost or marketing advantages over their competition in certain foreign locations, it is possible that they would be able to remain in business despite the significant tax penalty associated with U.S. residence. In cases without such advantages, and where low foreign excise tax rates imply significant U.S. tax costs, American firms are likely to disappear.

The economic costs of a residence-based excise tax regime are simple to identify. American firms lose the opportunity to earn profits in foreign markets from which they are driven by U.S. excise taxes, and this, in turn, reduces the rate of return to domestic activities that

make foreign operations otherwise profitable. Since there is every reason to believe that a worldwide excise tax regime would have very significant effects on the participation of American firms in foreign markets, the associated economic costs are potentially enormous. The tax crediting mechanism creates an odd pattern of U.S. excise taxes on foreign operations, with zero and even (in some cases) negative excise taxes on foreign sales in some countries, whereas in other countries the U.S. system imposes positive tax rates that vary with local excises. Even in circumstances in which American firms sell in foreign markets despite the imposition of significant U.S. excise taxes on such sales, the volume of foreign activity will be reduced, and distorted among countries, as a result of such taxes.

What possible justification could be offered for a home-country excise tax regime such as that just described? Many, if not all, of the same arguments commonly advanced in favor of worldwide income taxation would apply with equal force to worldwide excise taxation. From the standpoint of the world as a whole, the benefits of selling an additional gallon of gasoline equals the benefit to consumers, which in turn is measured by the (tax-inclusive) price that consumers pay for the gasoline. Since sellers receive only the tax-exclusive price of gasoline, their incentives do not correspond to global efficiency except in the unlikely event that excise taxes are the same everywhere. In the absence of residence-based worldwide excise taxation, too few gallons of gasoline will be consumed in countries with high excise tax rates, and (relatively) too many in countries with low excise tax rates. Domestic excise taxation might be said to encourage American firms to move their sales offshore. A system of residence-based taxation in effect harmonizes excise taxes around the world from the standpoint of domestic producers.

An analogous argument would apply to domestic welfare, which, by the standard logic, is maximized by a worldwide excise tax regime even less generous than that under consideration.

Domestic welfare, the thinking would go, is maximized by subjecting foreign sales to domestic excise taxation without provision of foreign tax credits. The reason is that, from the standpoint of the United States, the value of selling a marginal gallon of gasoline in a foreign market equals the profit that it generates, whereas the value of selling a marginal gallon of gasoline in the United States equals the profit it generates plus the associated excise tax revenue. Equating these two requires that the United States impose equal excise taxes on foreign and domestic sales.

One simple and entirely reasonable objection to subjecting foreign sales to home country excise taxation is that excise taxes tend to be incorporated in sales prices, so that, for example, increasing a (commonly used today; destination-based) excise tax on gasoline by $0.10 per gallon tends to be associated with roughly $0.10 per gallon higher gasoline prices. Of course, this incidence is unlikely to be exact, and indeed, both theoretical and empirical studies of sales tax incidence find that prices can move by less than, or in some cases more than, changes in excise tax rates. But the efficiency argument is valid on its own terms regardless of the incidence of the tax. That is, the argument is unchanged whether or not gasoline taxes are incorporated fully in consumer prices. Furthermore, and this is the underlying point, the same argument that consumer prices incorporate excise taxes applies to corporate income taxes, and for the same reason: both excise taxes and corporate income taxes increase the cost of doing business, and market forces translate higher costs into higher consumer prices.

The same argument applies with equal force beyond excise taxes to worldwide residence-based taxation of state property and sales taxes. How are taxpayers likely to respond to the introduction such residence-based taxation? The obvious reaction is to shed, or avoid in the first place, ownership of activities in jurisdictions where it would trigger significant tax liabilities. Again, it does not follow that American firms would maintain no foreign operations; it is almost

certain that they would continue at least some operations, despite the tax cost. But the distortion to ownership, investment, and productivity would be enormous.

The older efficiency norms that underlie capital export neutrality and related concepts would evaluate residence-based worldwide excise, property, and sales taxation favorably. Policies that allocate economic activity around the world based on pretax returns maximize world welfare, so the capital export neutrality logic implies that total (host country plus home country) tax rates should be the same everywhere. In the absence of worldwide tax harmonization, this can only be achieved by home country tax regimes that offset any differences between domestic and foreign taxation. Home-country welfare would be maximized by a different regime, in which after-foreign-tax returns are subject to home country taxation at the normal rate.

No country attempts to tax sales or property on a residence basis, doubtless deterred by some of the considerations that are apparent from the preceding analysis. The reason to analyze these taxes is not because they might realistically be adopted by the United States or some other government in the near future, or because they contain desirable features, but instead for the light that they shed on residence-based systems of taxing corporate income earned in other countries. To put the matter directly: why is it that residence-based excise, sales, and property taxation are clearly undesirable policies, while residence-based income taxation has not enjoyed the same unpopularity?

Residence-based taxation of foreign income has the same ownership effects as would residence-based excise, sales, or property taxation, with the same (negative) impact on economic welfare. The economic consequences of income taxation seem subtler than those of, say, excise

taxation, but this is merely an illusion, since a $10 million tax liability associated with American ownership will discourage U.S. ownership of foreign business assets to the same extent whether the $10 million is called an income tax or an excise tax.

It is this distortion to ownership that produces the largest component of the efficiency cost associated with the U.S. regime of worldwide taxation. Compared to other countries, the U.S. system of taxing foreign income discourages foreign asset ownership generally, and in particular discourages the ownership of assets in low-tax foreign countries. Mihir Desai and I have estimated the net tax burden on American firms from the U.S. system of worldwide taxation to be in the neighborhood of $50 billion per year, well exceeding revenue collections, since a significant portion of the net burden comes in the form of the associated efficiency cost.

What would be the consequence of exempting active foreign business income from U.S. taxation? The greater productivity associated with improved incentives for asset ownership would enhance the productivity of factors that are fixed in the United States, specifically including land but primarily labor, and thereby increase the returns that they would earn. Studies, including some of my own recent statistical work with Mihir Desai and Fritz Foley, generally find that 70 percent or more of the corporate income tax burden is borne by labor in the form of lower wages. This is likely to be at least as true of international corporate tax provisions as it is of corporate taxes generally.

What would be the domestic consequences of reducing the taxation of foreign income and thereby rationalizing the demand for foreign assets by American firms? There is a flurry of recent statistical evidence suggesting that the associated rise in outbound foreign direct investment would not reduce the size of the domestic capital stock, but instead increase it. This evidence includes a study of my own with Mihir Desai and Fritz Foley, examining the aggregate

behavior of U.S. multinational firms over a number of years, but also includes aggregate evidence for Australia, industry-level studies of German and Canadian firms, and firm-level evidence for the United States, the United Kingdom, and Germany. In a very recent firm-level study of my own with Mihir Desai and Fritz Foley, we find that for American firms between 1982 and 2004, 10 percent greater foreign capital investment is associated with 2.6 percent greater domestic investment, and 10 percent greater foreign employment is associated with 3.7 percent greater domestic employment. Foreign investment also has positive estimated effects on domestic exports and research and development spending, indicating that foreign expansions stimulate demand for tangible and intangible domestic output.

Hence there are good reasons to think that exempting active foreign business income from U.S. taxation would stimulate greater economic activity in the United States. It follows that the opposite is also true: reforms that would curtail the ability of U.S. taxpayers to defer home country taxation of foreign profits or the ability to claim foreign tax credits would reduce the productivity of U.S. business operations and thereby reduce economic activity in the United States.

One of the striking aspects of viewing international income taxation through the lens of its impact on asset ownership is that this perspective offers important implications for the treatment of domestic expenses by firms with foreign income. Businesses engaging in worldwide production typically incur significant costs that are difficult to attribute directly to income produced in certain locations. Important examples of such expenses include those for interest payments and general administrative overhead. There is a very important question of how these expenses should be treated for tax purposes. Practices differ in countries around the world, and indeed, U.S. practice has varied over time, but the current U.S. tax treatment is

squarely on the side of allocating domestic expenses between foreign and domestic income based on simple indicators of economic activity. Thus, for example, an American multinational firm with 100 of domestic interest expense is not permitted to claim as many foreign tax credits as is an otherwise-equivalent American firm without the interest expense, reflecting the theory that a portion of the borrowing on which interest is due went to finance foreign investment.

Expense allocation of the variety embodied in current U.S. tax law has a decided intuitive appeal. It carries the general implication that domestic expenses that are incurred in the production of foreign income that is exempt from U.S. taxation (as is the case, for example, of income earned in countries with very high tax rates, for which foreign tax credits are available) are effectively not permitted domestic tax deductions (via an equivalent reduction in foreign tax credit limits). While there is much to be improved in the details of the current U.S. rules governing expense allocation, the general structure of expense allocation is largely consistent with the rest of the U.S. system of attempting to tax foreign income in a manner that vaguely embodies the principle of capital export neutrality.

Taking as a premise that capital export neutrality is an unsatisfactory basis for taxing foreign income, and that the United States would instead prefer to exempt foreign income from taxation based on capital ownership considerations, then what kind of expense allocation regime properly accompanies the exemption of foreign-source dividends from domestic taxation? The answer is that domestic expenses must not be allocated at all, but instead traced to their uses, as most countries other than the United States currently treat interest expense. To put the same matter differently, tax systems should permit taxpayers to allocate general expenses that cannot be directly attributed to identifiable uses in such a way that they are fully deductible in the country in which they are incurred.

In order to understand the logic behind permitting the full deductibility of domestic expenses, it is helpful to start by noting that any other system of expense allocation will have the effect of distorting ownership by changing the cost of foreign investment. Consider the case of a firm with both foreign and domestic income, and 150 of expenses incurred domestically in the course of activities that help the firm generally, and thereby arguably contribute both to domestic and foreign income production. One sensible-looking rule would be to allocate the 150 of expenses according to income production, so that if the firm earns half of its income abroad and half at home, with the foreign half exempt from domestic taxation, then the firm would be entitled to deduct only 75 of its expenses against its domestic taxable income. (We could envision a world in which foreign governments might permit the firm to deduct the other 75 of its expenses against income earned in their country, though this is of course not the world we inhabit. The discussion that follows assumes that governments do not permit deductions for general expenses incurred in other countries, as is indeed the universal practice.) For a firm with a given level of borrowing, greater foreign investment would then be associated with reduced domestic interest deductions, and therefore greater domestic taxes. Hence the home country would in fact impose a tax on foreign income, in the sense of discouraging foreign investment and triggering additional domestic tax collections for every additional dollar of foreign investment. The only sense in which this tax differs from a more conventional tax on foreign income is that it does not vary with the rate of foreign profitability.

The fact that a simpleminded expense allocation rule acts just like a tax on foreign investment might at first suggest that those who design policy should seek alternative expense allocation systems that do not create these incentives. Unfortunately, there is no clever solution available to this problem: any system that allocates expenses based on a taxpayer's behavior will

have the effect of influencing that behavior, in the same way that a more conventional tax would. An alternative system of tracing expenses, in which taxpayers determine and report the uses to which deductible expenses are put, does not have this feature but creates ample opportunities for tax avoidance. Hence policies designed to avoid taxing foreign income necessarily must forego allocating expenses incurred domestically.

This implication of foreign income exemption seems to run afoul of obvious objections from the standpoint of tax arbitrage. Why should the United States permit taxpayers to borrow in the United States, using the proceeds to invest abroad, and thereby earn income that is exempt from U.S. tax while claiming deductions against other U.S. taxable income for the cost of their borrowing? Even the observation that this is exactly what many other countries do has the feel of not fully addressing this issue. The answer lies in the fact that greater foreign investment triggers added domestic investment, so from the standpoint of the U.S. tax system, the borrowing does not simply generate uncompensated interest deductions, but instead a domestic tax base that is equivalent to (quite possibly greater than) the tax base that would be forthcoming if the borrowing proceeds were invested domestically by the same entity that does the borrowing.

The same point can be considered from the standpoint of the taxpayer. An American multinational firm with domestic and foreign operations should be indifferent, at the margin, between investing an additional dollar at home or abroad; if not, the firm is not maximizing profits. Hence when the firm borrows an additional dollar to invest abroad, it might as well invest at home, since the two produce equivalent after-tax returns – and it is clear that if a purely domestic firm borrows to undertake a domestic investment, it is entitled to deductions for its interest expenses.

Part of the confusion that surrounds the treatment of interest expenses (and other general expenses that firms incur and that are difficult to assign to particular lines of business) is that, from a tax standpoint, the marginal source of investment finance matters greatly. That said, the marginal source of investment finance is extremely difficult to pinpoint. Debt finance is generally preferred to equity finance on the basis of tax considerations, since in a classical corporate income tax system such as that practiced by the United States, interest expenses are tax deductible whereas dividend payments to shareholders are not. Hence debt finance might be thought of as a worst case scenario from the standpoint of raising corporate tax revenue; with appropriate income measurement, marginal debt-financed domestic investments generate no tax revenue, and with inappropriate income measurement, these investments might generate positive or negative tax revenue.

If the goal of a tax system is properly to raise revenue while offering appropriate economic incentives, and these are understood to include efficient incentives for capital ownership, then the simple exemption of foreign income from taxation is insufficient without accompanying expense allocation rules. Exempting foreign income from taxation gives taxpayers incentives to allocate their resources to maximize after-local-tax profits only if there is no unwinding of these incentives through expense allocation that depends on where income is earned or where other expenses are incurred. Using a system of expense tracing that in practice often entails full deductibility of domestic expenses need not be viewed as a daring step. The same logic that underlies the efficiency rationale behind exempting foreign income in the first place also implies that expenses should be deductible where incurred.

There are sure to be both revenue concerns and other concerns associated with a reform that exempts foreign income from taxation and permits tracing for domestic expenses. Removal

of U.S. taxation of active foreign business income would increase the importance of effective enforcement of the transfer pricing rules and other rules designed to protect the U.S. tax base. It would, however, be a mistake to maintain the current regime of taxing foreign income simply out of concern over base erosion of this type, given that there are many ways of addressing these issues. For example, elimination of U.S. taxation of active foreign business income might be accompanied by allocating significant additional resources to the Internal Revenue Service for use in international enforcement. Given the alternatives before us, it would be a serious mistake to think that enforcement concerns alone dictate the maintenance of an inefficient system of taxing worldwide income.

The question to ask going forward is what is the alternative to exempting foreign income from taxation? The alternative is one in which American businesses continue to face inefficient incentives for asset ownership, incentives that their competitors from most of the rest of the world do not face. The inefficiencies for which these incentives are responsible continue to erode American living standards, not acutely, but gradually and relentlessly, thereby contributing to an economic situation in the United States that is not as promising as it might otherwise be. If worldwide taxation of active business income is a good idea, then is it not also just as good an idea to subject the foreign operations of American firms to U.S. excise taxation, sales taxation, and property taxation? And if not, what does that tell us about worldwide income taxation?