INTRODUCTION

The tax bill currently being considered by the House and Senate to repeal the export subsidy is the culmination of a whole series of challenges to the legality of a subsidy that was originally motivated by the imbalances arising from a fixed exchange rate. If any provision has ever demonstrated the difficulty of eliminating a tax benefit once bestowed, this one is a poster child. Despite the finding that the provision (and its predecessors) contravenes World Trade Organization Rules and is now permitting countervailing tariffs, and despite the lack of a sound social welfare justification for subsidizing exports, the provision is still in place, some years after the first changes were made.

The debate surrounding the subsidy also illustrates another issue—the extent to which corporate tax policy in this global economy appears to be made without either understanding, or at least without considering, fundamental principles of tax analysis. Perhaps the most ironic discussion is the proposal to respond to the loss of the export subsidy by moving to a territorial tax where the U.S. would tax no income of its multinationals outside its border. One of the rationales for the original Domestic International Sales Corporation provision adopted in 1971 was to provide a more level footing for exporting, given that the tax system favored operating plants abroad in low tax countries, due to the failure to tax income of foreign incorporated subsidiaries on a current basis. To expand this beneficial treatment to not merely defer but exempt such income (although there is little evidence that much tax is collected on foreign source income) is going in the opposite direction. If the original justification is correct, then taxing this income currently would be the appropriate response. The only circumstance in which a territorial tax base might be the equivalent of an export subsidy is when enforcement of transfer pricing and allocation of deduction rules are lax—a questionable policy for the U.S. government to pursue.

ECONOMIC CONCEPTS

The discussion of international tax policy is littered with misperceptions that indicate one of two things: either

* The views in this paper do not necessarily reflect the views of the Congressional Research Service.
economic analysis has not successfully informed the policy debate, or the pressures of special interests so dominate that economic issues are ignored.

For example, the policy discussion of international taxation is peppered with references to international competitiveness. While competitiveness of an individual firm (in terms of share of market, pricing, etc.) is a concept with economic meaning, what conceivable meaning can international competitiveness have? Since we trade in order to get goods (export in order to import) we cannot have as an export goal a large share of world markets. If we judge our welfare by market share, then the inevitable conclusion is that productivity gains by our trading partners are bad for us, rather than good for us. We cannot be a net exporter of everything. A related problem is focusing on the bi-lateral trade deficit, suggesting that we all slept through our history lessons on triangular trade in colonial times.

It is clear that the fundamental concepts of comparative advantage and the role of the exchange rate as an adjustment mechanism are either little understood or not applied. Why else would politicians and businessmen believe, or claim to believe, that the European style value added tax that is rebatable on exports provides a competitive advantage? (They never seem to view the failure to impose our own retail sales taxes on exports to confer a U.S. competitive advantage.) Similarly the justification of long-run tax features on the basis of job creation reflects a fundamental lack of misunderstanding of how a market economy operates. Even the basic accounting identity that the trade deficit or surplus reflects capital flows seems an alien notion.

One of the never-ending, and yet equally incorrect, notions that are bandied about is the concept of “capital import neutrality.” Its opposite number, “capital export neutrality,” which requires that an investor face the same taxes regardless of location, is clearly correct, whether viewed as neutral, in the sense that taxation (given a fixed capital stock, or fixed revenue base) does not disturb a country’s allocation, or efficient, absent other market failures. If I pay the same tax at home and abroad, then my pre-tax rate of return will be equaled as long as my after-tax return is equaled and capital is allocated efficiently. Moreover, the imposition of taxes will not cause me to reallocate. If I pay a zero tax abroad then I will shift my investment to the foreign country, pushing up returns at home and reducing them abroad until after-tax returns are again equated. Capital important neutrality has nothing to do with neutrality (or efficiency) in the normal sense that economists use the word, and I think that until we can discuss these policies without fundamental confusion on these issues, it is hard to deal with the real issues that arise in the second-best world.

**TAX POLICY ISSUES**

In that second-best world, there are issues that probably need our serious attention both as scholars and in the formulation of tax policy. The first issue is whether to eliminate export subsidies, and the clear answer to that question, from an efficiency standpoint, is yes. However, there are two export subsidies, both costing about $5 billion. The first is the explicit benefit for extraterritorial income that is the center of the dispute. The second is the title passage rule that allows an allocation of half of export profits in the country of sale which benefits firms in excess credit positions. According to Grubert and Mutti (2001), about 25 percent of income falls into this category.

I would particularly like to focus on two other issues. The first is whether to move towards a territorial tax where there is no U.S. tax on foreign source income or to move in the opposite direction where all income is taxed currently. Partial moves in
both directions have been proposed. The House version of the corporate tax bill contains a number of provisions that make deferral more feasible for some types of income—including the exempting of foreign base company sales and service income—although some of these provisions are probably intended as export subsidies. The bill also includes some provisions that affect the foreign tax credit (including reducing the number of baskets and liberalizing the interest allocation rules) that are revenue losers. Senator Kerry, however, has proposed current taxation of active income of firms manufacturing offshore for further export, and more narrow proposals focused on runaway plants (i.e., income from activities abroad for export to the United States) have been proposed. The Kerry proposal to limit the current taxation only to operations that involve exports would be more complicated than full current taxation, probably without much real economic difference. Proposals that focus only on production for export back to the U.S. (runaway plants) would also be more complicated.

The second, and related, tax policy issue, regardless of the system in use, is the perennial problem of the allocation of income and deductions which can be affected by prices of goods transferred between the parent and its subsidiary as well as the allocation of deductions. Obviously, the two are related, and both are related as well to the tax shelters arising from multinational transactions including corporate inversions and earnings stripping.

FLAWS WITH CURRENT SYSTEM

Before discussing these issues, however, it must be pointed out that the current system is far from consistent with capital export neutrality, even though the U.S. nominally taxes on a worldwide basis. Our rules, inherited from legal and accounting concepts developed early in the twentieth century, have created a hybrid system that may be worse than either full worldwide taxation or a territorial system. It collects very little revenue on foreign source income ($5.2 billion in 1996 according to Grubert and Mutti (2001). Moreover, several important features of the current system that violate capital export neutrality or even permit the avoidance of tax on domestic U.S. income include deferral of tax on active foreign source income until it is repatriated, cross crediting of the foreign tax across income types and countries, and a failure to disallow deductions for overhead costs (such as interest) that may be used to support deferred income for companies in an excess limit position (accounting for 75 percent of income according to Grubert and Mutti (2001). Because the tax is triggered by repatriation, there is an argument that firms are discouraged from reinvesting in the United States (although that depends on whether one subscribes to the “new view” or “old view” as discussed in Grubert and Mutti (2001). At the same time, allocation rules for the foreign tax credit allocate only for head office and not for foreign costs, such as interest. Allocation rules, as noted above, also create an export subsidy for firms in an excess credit position (accounting for 25 percent of income according to Grubert and Mutti (2001). The foreign tax credit rules may also provide incentives to develop patents abroad because royalties are sheltered from the U.S. tax for firms in excess credit positions.

THE CASE FOR WORLDWIDE CURRENT TAXATION

The case for current taxation of income of foreign subsidiaries is completely straightforward and arises from the concept of capital export neutrality. By taxing all income under the U.S. tax, the incentive to invest abroad will be eliminated. But more than that, a worldwide system that taxes income whether or not repatriated would also seem to have benefits in
that the incentives to shift income to tax havens would be reduced—that activity undermines the U.S. revenue base without changing real investment. And the extent of income shifting seems to be significant. Sullivan (2004) reports that four tax havens (Luxembourg, the Netherlands, Ireland, and Bermuda) have 5.3 percent of plant and equipment, but 30 percent of profits. The top 11 tax havens had 12.6 percent of plant and equipment, along with almost half the profits.

ARGUMENTS FOR TERRITORIAL TAXES (OR DIVIDEND EXEMPTION)

Since capital import neutrality is not really a useful framework to assess a tax system, the analysis of the argument for territorial taxes (or a more limited provision for exempting dividends from tax while retaining the anti-abuse rules for passive income) really rests on a second-best argument. The second-best arguments have to do with three issues: (a) we cannot effectively achieve capital export neutrality because of the actions of other countries or because of the option of portfolio investment, (b) the simplification that arises from territorial taxation is worth the distortion, or (c) current distortions in our system might actually be reduced and revenue raised by a dividend relief system.

Consider first that many other countries do not tax worldwide income and, therefore, our goal of capital export neutrality with respect to stemming the investment to low-tax countries cannot be obtained. If the U.S. were a small country and investments were homogeneous, then the deployment of capital around the world could not be affected by our system. Other countries would determine the allocation of capital. Since we are a large country with heterogeneous investments, our rules do matter. The issue is further complicated by the availability of portfolio investment, which allows U.S. investors to invest directly in foreign firms with lower taxes. With widespread portfolio investments and homogeneous investment opportunities, territorial taxation would always be achieved at the corporate level by investing in firms of countries that practice territorial rules.

Of course, under those conditions, the U.S. treatment becomes irrelevant. But if investments are heterogeneous, there will remain some investment by U.S. firms in the rest of the world. Is there some advantage to sacrificing investment neutrality to maintain a larger presence of U.S. firms abroad? One might argue, however, that it is the burden of advocates of territorial taxation to show that this trade-off is desirable.

The other two arguments, very ably made by Grubert and Mutti (2001), are that moving to a territorial tax (by exempting dividends) would simplify tax administration and compliance, increase economic efficiency, and actually raise revenue—a finding consistent with the Joint Committee on Taxation’s estimate under an assumption of strict allocation of overhead costs (McKinnon, 2004). The gains in tax compliance arise in part from avoiding the need to do complicated tax planning with respect to repatriation in order to minimize taxes. The revenue gains are associated with an allocation rule that would disallow expenses associated with exempt income. And the efficiency gains arise in part from eliminating the value of the export subsidy (title passage rule) and distortions with patent development and computer sales (due to the protection of income from U.S. tax resulting from excess foreign tax credits).

CHALLENGES AND CRITICISMS OF A WORLDWIDE APPROACH

Ending deferral would not eliminate all issues of allocation of income and transfer pricing. In particular, there are many issues associated with the foreign tax credit
limit which would need to be considered for firms in excess credit positions. If current overall credit limits are retained, this problem may be less serious; Grubert and Mutti (2001) report only 25 percent of income in excess credit, and many firms might be less likely to be in an excess credit position with current taxation of tax–haven income.

In addition, there is the issue of cross crediting, which interferes with capital export neutrality. By using excess tax credits generated in one activity or country to offset U.S. taxes due in another country, certain investments continue to be favored. Note, for example, that we have not always had an overall foreign tax credit limit that allows excess credits in high tax countries to offset U.S. tax in low tax countries. The price of the per country limit is to place additional incentives for artificially reallocating profits according to tax considerations—and that may be a considerable burden.

A criticism of the worldwide approach is the same as a justification for the territorial approach—due to other countries’ activities and portfolio investment, the presence of U.S. firms may decline, although it is not clear whether that decline is a problem. Another criticism is that the worldwide system may create greater incentives for corporate inversions—reorganizing to make the parent company a foreign firm. It is possible to deal with corporate inversions, through toll taxes or tracing provisions, although these changes complicate the law.

CHALLENGES AND CRITICISMS OF THE TERRITORIAL APPROACH

Aside from the investment distortions inherent in the territorial approach, the territorial approach will intensify pressure to allocate income to foreign, low–tax jurisdictions, so that the stakes will become higher in the transfer pricing and allocation–of–income game. Anti–abuse rules would still need to be in place as well.

In addition, many of the gains, in both revenue and efficiency—suggested by Grubert and Mutti (2001) could be achieved by reforms to the current system short of exemptions (such as allocation of income for deferral purposes and elimination of the title passage rule).

SUMMARY

This analysis suggests some important issues to consider in reforming international tax rules in accordance with economic principles. It would seem that a more convincing case could be made for worldwide taxation, as an alternative to either the present system or to a territorial (or exemption of dividends) approach. In the political arena, however, it is very hard to focus on the real issues as long as the public debate is mired in the myths of international competitiveness, capital import neutrality, and misunderstandings of the mechanisms of exchange rate adjustments.

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