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RETHINKING FOREIGN TAX CREDITABILITY

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International tax policy experts often mistakenly conflate two distinct margins: (1) the overall tax burden on outbound investment, and (2) the marginal reimbursement rate (MRR) for foreign taxes paid, which is 100 percent under a foreign tax credit system, but equals the marginal tax rate for foreign source income under an explicit or implicit deductibility system (such as exemption). From a unilateral national welfare standpoint, whatever the right answer at margin (1), deductibility is clearly optimal, and creditability dangerously over-generous, at margin (2).

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I. INTRODUCTION

Perhaps no feature of modern income tax systems has gained such consistent — and unmerited — approval from commentators as the foreign tax credit, under which tax payments to one's own government with respect to foreign source income are reduced, dollar for dollar, by income taxes paid to foreign governments. This provision's treatment of paying a dollar of tax to someone else as equivalent to paying it to oneself is so "extraordinarily generous" that T.S. Adams, its inventor at the U.S. Treasury Department in 1918, was skeptical that Congress would even consider it, and shocked when it passed easily (Graetz and O'Hear, 1997, p. 1046). Adams might have been even more surprised to witness the foreign tax credit's almost unchallenged intellectual and political entrenchment during the more than ninety years since he proposed it.

The foreign tax credit undoubtedly would be eliminated by the United States if it wholly exempted foreign source income. Short of that uncertain contingency, the foreign tax credit's intellectual prestige could scarcely be greater. Few commentators appear to recognize, however, that clear thinking requires distinguishing between two margins at which a country's international tax rules affect taxpayer incentives and behavior.

The first of these margins involves making outbound investments. Here, credits greatly reduce the expected tax burden that resident taxpayers would face, relative to

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that which would result from charging the full domestic rate but making foreign taxes merely deductible. Yet credits are not the exclusive means for reducing the tax burden that would result from such unmitigated double taxation. Lowering the domestic rate on foreign source income would accomplish this as well, even with mere deductibility for foreign taxes.

A second, distinct margin at which foreign tax credits affect taxpayer incentives and behavior relates to incurring foreign tax liabilities. Foreign taxes can vary even if the amount of foreign investment is fixed, due to taxpayers' ability both to invest in low-tax rather than high-tax jurisdictions, and to engage in foreign tax planning no matter where they actually invest. Thus, the marginal reimbursement rate (MRR) for foreign taxes that the domestic system offers to residents can be important.

If foreign taxes are deductible, the MRR equals the marginal tax rate (MTR). An exemption system, in which the MRR and the otherwise applicable MTR are both zero, is thus an implicit deductibility system. By contrast, foreign tax credits, to the extent fully and immediately applicable, create an MRR of 100 percent.

Deductibility, by equating the MRR for foreign taxes to the otherwise applicable MTR, causes domestic taxpayers to be indifferent at the margin between a dollar of foreign taxes paid and any other one-dollar reduction in net income. This creates exactly the right marginal incentive, from a national welfare standpoint, to engage in foreign tax planning (whether by express planning or simply investing in low-tax, rather than high-tax, countries). By contrast, an MRR of 100 percent — assuming that credits are paid currently — can make resident taxpayers utterly indifferent to how much tax they pay abroad. This incentive structure is clearly undesirable from a unilateral national welfare standpoint, given that foreign tax revenues go to foreigners rather than to the domestic fisc.

Once one understands that deductibility, rather than creditability, optimizes resident taxpayers' incentives (from a unilateral national standpoint) at the foreign tax planning margin — but that this tells us nothing about the outbound investment margin — one's understanding of international tax policy issues significantly changes. While I will save for elsewhere a concrete analysis of the main implications (Shaviro, forthcoming), at a minimum it reinforces the inadequacy (which perhaps should have been clear in any event) of the common "battle of the acronyms" approach to international tax policy. Under this approach, a single efficiency norm supposedly determines what policy goal is optimal. Examples include capital export neutrality (CEN), capital import neutrality (CIN), capital ownership neutrality (CON), national neutrality (NN), national ownership neutrality (NON), and global portfolio neutrality (GPN). With at least two distinct margins to evaluate, however, advocating any of these norms risks unthinking conflation of two distinct sets of issues. As we will see, for example, the much-maligned NN is clearly correct at the foreign tax planning margin, notwithstanding its likely lack of merit at the outbound investment margin.

The rest of this article proceeds as follows. Section II further spells out the case against foreign tax credits. Section III explores why they receive such strong support, both in practical tax politics and in the tax policy literature, notwithstanding their excessive generosity at the foreign tax planning margin. Section IV offers a brief conclusion.

II. THE CASE AGAINST ALLOWING FOREIGN TAX CREDITS

A. Global Welfare, Unilateral National Welfare, and Cooperative National Welfare

In evaluating foreign tax credits, a crucial first step is deciding whether one should focus on national economic welfare or — as is surprisingly common in the international tax policy literature — global welfare. One's underlying normative perspective always is crucial in tax policy debate, but perhaps never more so than when one is considering foreign taxes. In the domestic setting, the fundamental reason for typically favoring tax neutrality is that tax liabilities, while a cost to those bearing them, are socially a transfer, as the U.S. Treasury gets to spend the money on someone's behalf. This analysis does not apply to foreign taxes, however, unless one counts the benefit to foreign individuals from having their governments obtain revenue.

From a strict ethical standpoint, if one accepts that all human beings' welfare matters equally, the case for focusing on global rather than merely national welfare is compelling. Nations do not commonly act this way, however. Neither do individuals, even with respect to their fellow citizens. For example, tax policy writers (myself included) who examine distributional policy through a utilitarian lens and emphasize the importance of declining marginal utility nonetheless do not typically give away all their money to the poor. Doing so would be commendable, but within limits we accept and expect a degree of narrow self-interest both from ourselves and others.

If self-interested behavior is acceptable in practice for individuals, then surely it is permissible as well for countries. What is more, in the national setting, efforts to impose policies that are more globally altruistic than well-informed voters would favor raise principal-agent issues. As Michael Graetz (2001, p. 279) has observed, U.S. government actors' "… higher obligation to U.S. citizens and legal residents" implies caring about "… where enhanced economic output occurs, whom it benefits, and what national treasury obtains the tax revenues," and thus seeking primarily to promote domestic economic output and wellbeing, rather than that of the entire world.

In any event, the conventional divide in international tax policy debate between global and national welfare analyses is overstated. Proponents of the global standard typically do not take the next step and urge that the United States give trillions of dollars away to poorer countries. Indeed, they appear to believe that a global welfare standard in international tax policy is also best for the United States over the long run. Thus, the U.S. Treasury has argued against "… establish[ing] policies that promote national short-term interests at the expense of global economic welfare," because other countries will reply in kind, and deems this all the more important for a country that "is often looked upon to provide global leadership in the policies it adopts" (U.S. Department of the Treasury, 2000, pp. 25–26).

The real dispute, then, is not so much about global versus national welfare as about how best to pursue national welfare. Globalists argue for a cooperative strategy, based on assuming (often with little in the way of concrete demonstration) that others will either respond in a tit-for-tat fashion or else simply follow the U.S. lead. Critics of that approach respond that unilateral pursuit of national welfare, based on the assumption that others will not respond cooperatively, is at least a significant possibility.

With the question of reciprocity's potential thus in mind, suppose we now consider foreign tax credits, but look purely at the foreign tax planning margin, without regard to the outbound investment margin (since the tax burden at that margin can be similarly adjusted with or without credits). Can a plausible level of reciprocity make a 100 percent MRR, up to the point where the foreign tax credit limit applies, nationally optimal?

With complete reciprocity, the answer is potentially yes. After all, for all countries considered together, foreign tax credits are a zero-sum game. Every time one country loses a dollar, another gets to impose a dollar of tax without its affecting inbound investors' incentives. Thus, if two identical countries, following identical policies, each impose their own source-based tax and credit that imposed by the other, they end up in the same place as if they were not granting foreign tax credits.[1]

Even with differences between countries, full reciprocity conceivably could make foreign tax credits nationally optimal for all. To be sure, without foreign tax credit limits, high-tax countries like the United States would benefit relative to low-tax countries by reason of getting larger reimbursements (although this hardly seems a stable equilibrium). With foreign tax credit limits, however, this balances out, as each country credits no more than the level of taxes that it is itself imposing.

In practice, however, reciprocity generally is not required for other countries' taxes to be creditable. The United States, for example, initially granted foreign tax credits long before anyone else had them, and continues not to condition them on reciprocal creditability.[2] And without such conditioning, even the fact that other countries are likewise mitigating double taxation — for example, through exemption — does not suffice to make the granting of foreign tax credits nationally optimal.

Thus, suppose that the United States has a foreign tax credit system, Germany has an exemption system,[3] and Bermuda is a tax haven into which residents of either country can shift foreign taxable income.[4] Foreign tax credits potentially cost the United States after-foreign-tax income by eliminating U.S. companies' incentive to save foreign taxes by shifting taxable income from Germany to Bermuda. If Germany were a foreign tax credit country, this detriment to the United States might be offset by Germany's

[1] Based on a such model, Desai and Dharmapala (2009) conclude that foreign tax credits for outbound portfolio investment can be nationally optimal.

[2] International tax treaties typically include a commitment to mutual creditability of source-based taxes. For passive income, however, they typically provide for exclusively residence-based taxation.

[3] For purposes of this example, to make the United States and Germany equal in the overall tax burdens they impose on foreign source income, differing only in the method used, suppose that the United States grants just enough credits above the limit to match the German exemption system's zero net revenue. This restricts the difference between the two systems to that of their incentive effects with respect to foreign tax liabilities.

[4] The choice of Bermuda for this example may suggest that no real economic cross-border activity shifts out of the United States or Germany. The example works equally well, however, if we posit that the low-tax jurisdiction (such as Ireland or Singapore) can host real activity that shifts there for tax reasons.

eliminating the incentive for German companies to do the same as between the United States and Bermuda. However, a German exemption system eliminates the offset at this margin by keeping German firms cost-conscious with respect to U.S. taxes.

In principle, the U.S. foreign tax credit rules could be revised to limit the benefit to reciprocally credit-granting countries. This seems politically unlikely, however, and would be hard to administer even if otherwise feasible. One problem is that, even as between nominally foreign tax credit-granting countries, actual reciprocity is hard to assess unless one carefully studies the actual system details.[5] A second is that, for purposes of the foreign tax credit limit in reciprocating countries, one would have to determine the countries in which foreign source income arose, multiplying the problems in determining source under current law. Thus, foreign tax credits probably cannot be entirely (or even significantly) reciprocal in practice, and one must consider the unilateral perspective when evaluating their desirability from a national welfare standpoint.

B. Evaluating the Foreign Tax Credit from a Unilateral National Welfare Perspective

From a unilateral national welfare perspective, the question of the optimal MRR for foreign taxes almost settles itself. Again, the reason taxes are classified in the domestic setting as socially a transfer, rather than a cost, is that the payment of a tax merely causes money to change hands, as between domestic residents. However, if one disregards the benefit to people in other countries from having tax payments made to their governments, foreign tax payments are no longer any different from any other business expenses, as judged from a domestic perspective. Hence, foreign taxes should simply be deductible in computing foreign source income for purposes of a domestic tax on such income.[6] This causes the MRR for such taxes to equal the otherwise applicable MTR, and makes U.S. taxpayers indifferent between (a) paying $1 of foreign taxes, (b) incurring any other $1 business expense, and (c) foregoing $1 of gross income.

Absent reciprocity, in the sense of foreign countries raising their MRRs for U.S. taxes in response to our increasing the MRR we apply to their taxes, it is difficult to see what could change this result from a unilateral national welfare standpoint. Suppose, for example, as Roin (2001) has posited, that the corporate tax is aptly viewed as a benefit tax, reimbursing the home government for the extra cost of providing services by reason of the taxpayer's economic activity in the jurisdiction. In that scenario, the

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5 For example, countries can use a restrictive definition of foreign source income to make their foreign tax credit limits more restricting than they might otherwise appear (Shaviro, 2007). In addition, if they allow deferral for foreign source income, the extent to which they counter foreign tax planning depends on whether they have rules like those in subpart F of the U.S. rules that create deemed dividends for transactions that suggest its presence, such as the use of foreign base companies in countries where little economic activity occurs (Shaviro, 2009).

6 For simplicity, I disregard the possibility that proper income tax accounting would require that particular foreign taxes be capitalized, such as on the ground that they created durable assets or expectations of future income. This consideration might even make unconditional deductibility too generous.

government might actually prefer (all else equal) that its companies invest abroad rather than at home, so as to spare it any costs associated with their domestic activities' use of government-provided domestic infrastructure. However, while (as Roin notes) this might affect the optimal domestic tax treatment of outbound investment, it would not undermine the case for deductibility unless foreign taxes paid actually served as a measure of the costs saved domestically,[7] which seems quite unlikely.

My conclusion that, in a unilateral national welfare analysis, the optimal MRR for foreign taxes paid equals the domestically imposed MTR for foreign source income, should not be considered either surprising or novel. Indeed, it has been well known since at least 1963, when Peggy Richman (Musgrave) (1963) set forth the unilateral national welfare standard of national neutrality (NN), according to which, absent strategic interactions with other countries, one should tax the foreign source income of all residents at the full national rate, with foreign taxes merely being deductible.

National neutrality, though commonly treated as a single unitary standard, in fact makes two distinct claims. First, it asserts that countries should tax the worldwide income of their residents, so that investing abroad, rather than at home, will not result in a loss of tax revenue — as it would, under an exemption system, if outbound investment came at the expense of net domestic investment. Second, NN holds that foreign taxes should merely be deductible, in measuring foreign source income, since they are just like any other expense, from a national welfare standpoint, given that the money goes to a foreign treasury rather than the domestic one.

The first of NN's two claims has been significantly weakened or even refuted, as applied to corporate income taxation, based on evidence and arguments contradicting its assumption that outbound investment comes at the expense of net domestic investment (Desai and Hines, 2003, 2004). Lying behind this empirical issue are two important points that traditional international tax policy thinking has generally ignored. First, a country that is pursuing NN can determine the overall incentives only of its own residents, who are interacting in world capital markets with other investors. Thus, even a net investment outflow by residents has no effect on net domestic investment if it triggers a matching net inflow — as may happen, for example, if appealing location-specific investment opportunities are subject to congestion. Second, the main actors in cross-border investment are corporations, which are taxed at the entity level. Corporate residence, unlike that of individuals, may in the future increasingly verge on being elective for newly created corporations, potentially making residence-based tax rules close to meaningless. In addition, since corporations can raise new equity on world capital markets, they are not subject to the same type of budget constraint as that faced by individuals. For an individual with $X of savings that are available to invest, send-

[7] Roin (2001, p. 588) argues that "[t]he problem with allowing taxpayers only a deduction for foreign taxpayers is that it suggests that the U.S. government is entitled to apply its normal tax rates to the income that remains after the deduction has been taken." My analysis, however, expressly separates the issues of outbound tax rate and MRR. Roin sees the benefit tax view as supporting exemption, which I describe as an implicit deductibility system.

ing a dollar abroad may mean foregoing its use to invest at home. But well-established corporations can finance all demonstrably meritorious projects by issuing equity. This permits their prospective domestic and foreign projects, while surely substitutes for each other in some cases (e.g., in deciding where to locate fixed production capacity), to be unrelated in other cases, and complements in yet others. Thus, it perhaps should not be surprising that recent empirical studies predominantly find that outbound investment by resident corporations tends not to reduce even their net domestic investment, much less that of the taxing country as a whole.

While NN's claim about taxing residents' worldwide income has thus been (at a minimum) seriously undermined, it remains uncontroverted with regard to the unilateral national welfare implications of a resident's paying a dollar of foreign taxes. Thus, recall that an exemption system, while rejecting NN's first claim, follows its counsel with respect to the choice between paying a dollar of foreign taxes or otherwise losing a dollar of net after-tax income. Only a lack of clear thinking about the distinction between the outbound investment and MRR margins has prevented this point from being so widely recognized as to need no elaboration here.

III. WHY IS THE DESIRABILITY OF OFFERING FOREIGN TAX CREDITS SO WIDELY ACCEPTED?

Given the strength of the case against allowing foreign tax credits, why is their desirability so widely accepted? One reason is simple confusion and incoherence, which unfortunately are all too widespread even among foreign tax experts. Rather than crisply distinguishing between the foreign tax planning margin and the outbound investment margin, experts often assume — unthinkingly rather than consciously — that foreign source income, unless exempt, must at least nominally bear the full domestic rate. This leaves only foreign tax creditability, along with other normatively ad hoc adjustments such as deferral, to address the severe discouragement of cross-border investment that otherwise might result from the interaction of residence-based and source-based tax systems.

In practice, however, foreign tax credits, rather than simply being viewed as a necessary evil to limit discouragement of outbound investment, often are viewed as normatively desirable, based on two predominant rationales. The first, which chiefly explains their public political appeal, is that they prevent "unfair" double taxation. The second rationale, which predominates in defenses of the foreign tax credit by policymakers, academics, and other experts, is that they advance global economic efficiency. However, neither rationale is persuasive.

A. Aversion to "Double Taxation"

Foreign tax credits are politically popular because they address what is "… perceived as the manifest injustice of double taxation" (Graetz and O'Hear, 1997, p. 1047). Given foreign source-based taxation of profits earned abroad, which is widely considered both justifiable and a fixed feature of the worldwide political landscape, policymakers (and perhaps even voters) evidently agree that, absent a move to exemption, the United States faces a virtual moral compulsion to grant foreign tax credits, in order to avoid double taxation's "essential unfairness" (Graetz and O'Hear, 1997, p. 1109).

The asserted unfairness of "double taxation" is a common theme in U.S. tax policy debate. For example, President George W. Bush emphasized it in arguing for the adoption of corporate integration via dividend exemption.[8] Advocates of repealing the estate tax likewise emphasize the claim that it causes unfair double taxation, because "… money is taxed once when it is earned and again when it is passed on to the next generation" (Graetz and Shapiro, 2005, p. 7). And consumption tax proponents, going all the way back to Mill (1848), argue against the income tax that it unfairly double taxes savers, by reaching them duplicatively first when they earn money and then again when they save it.

What really matters, however, is not how many times one is taxed, but relative tax burdens as between the items that are being compared. For example, it surely is better to be taxed twenty times at 1 percent each time than once at 40 percent. Or suppose we are comparing the taxation of people who do A to that of people who do B. If we observe that A is taxed at 30 percent, whereas B is taxed at 40 percent, this will affect incentives and, potentially, distribution. It should not matter, however, whether, as a formal administrative manner, B was taxed on two occasions or only one. Converting a double tax on B (say, 30 percent every January 1 and an additional 10 percent on January 2) into a single, but still 40 percent overall tax, would not significantly change B's overall treatment.

Accordingly, attention is better focused on overall tax neutrality, or more generally the relative tax burdens on the activities that are being compared, than on whether something or other formally faces "double taxation." Thus, the more compelling (if less politically salient) argument for corporate integration is that it addresses disfavoring corporate equity and dividend payouts. The better-framed argument against the estate tax is that it treats bequeathed wealth less favorably than that spent by the earner, whether or not the tax is formally duplicative of prior income taxation. The case against the income tax is that it disfavors future consumption relative to current consumption — again, whether or not the very same thing is being taxed twice.

In the international realm, overlapping residence-based and source-based taxation clearly raises efficiency issues, as they may reduce cross-border investment relative to what one might expect in a nontax world. The problem, however, is one of relative global tax rates, not of how many times a tax is levied. Thus, the important thing, if one

[8] In a prominent speech in support of his dividend exemption proposal, Bush (2003) argued that it would result in our "… treating investors fairly and equally in our tax laws. As it is now, many investments are taxed not once, but twice. First, the IRS taxes a company on its profit. Then it taxes the investors who receive the profits as dividends … Double taxation is bad for our economy. Double taxation is wrong … It's fair to tax a company's profits. It's not fair to double-tax by taxing the shareholder on the same profits."

disfavors a higher global tax rate for cross-border investment, is to reduce it appropriately, whether or not this involves lowering the deemed number of taxes levied from two to one.

To make this more concrete, suppose the United States has a worldwide system and generally taxes corporate income at 35 percent, while China has a 20 percent rate for income earned in China. Unmitigated double taxation of U.S. companies' Chinese earnings would result in the application of a 48 percent combined rate.[9] Suppose one believes this is too high, given the lower one-country rates, and that the United States should act unilaterally to mitigate the problem. Offering foreign tax credits is only one possibility. A second, non-mutually exclusive approach is to offer other special tax benefits of some kind for outbound investment, such as deferral under current U.S. law. This, however, may distort other behavioral margins and encourage socially wasteful tax planning to maximize the advantage taken of these benefits.

A third alternative is simply to lower the U.S. tax rate that applies to foreign source income. Exemption, which results from making the outbound rate zero percent, is an example of this approach, but is merely one point along a continuum. Leaving aside administrative issues, a deductibility system with, say, a 1 percent rate, appears quite similar to exemption. It also may place a lower overall U.S. tax burden on outbound investment than does a foreign tax credit system. Accordingly, little about its merits (or demerits) is illuminated by observing that, unlike both a foreign tax credit system and exemption, it involves formal "double taxation."

Whatever the overall domestic tax burden on outbound investment that results from a particular foreign tax credit system (given domestic versus foreign tax rate relationships and the structure of any foreign tax credit limits), one should always be able to replicate this burden under a deductibility system with a suitably adjusted domestic tax rate for foreign source income.[10] Likewise, one ought to be able to replicate existing revenues with deductibility plus a lower rate. For convenience, I will therefore refer to the burden-neutral or the revenue-neutral (as the case may be) deductibility rate for a particular foreign tax credit system.

Obviously, the underlying equivalence in U.S. tax burdens on outbound investment is only in the aggregate. As between two burden-neutral alternatives, the deductibility system will impose a higher U.S. tax burden on U.S. investment in high-tax countries, and a lower one on such investment in low-tax countries, reflecting that (unlike creditability) it does not adjust U.S. tax burdens in such a way as to eliminate the incentive to engage in foreign tax planning. Arguably, this difference is best evaluated on its own terms, without resort to confusing and formalistic labels such as "double taxation."

[9] This assumes U.S. deductibility of the Chinese tax, so that U.S. taxpayers retain 80 percent of their pre-tax Chinese earnings after paying the Chinese source-based tax, and 65 percent of that amount (52 percent of the pre-tax whole) after paying the U.S. residence-based tax.

[10] Absent foreign tax credit limits, the burden-neutral tax rate for foreign source income might, under particular circumstances, be zero or even negative.

There is, however, a separate line of argument for creditability, resting on efficiency grounds rather than intuitive moral aversion to double taxation as such. Indeed, this argument was dominant in the international tax policy literature for many decades and, though recently challenged, it still has numerous adherents. Under it, foreign tax credits (if unlimited), by reason of their eliminating foreign taxes' impact on one's after-tax bottom line, have a virtue, in efficiency terms, that no deductibility system can share. They cause a domestic taxpayer to face the same worldwide net tax rate (i.e., the domestic rate) no matter where it invests, thereby eliminating tax rate differentials as an input to its investment choices. I address this efficiency argument for foreign tax credits next.

B. Foreign Tax Credits as a Tool for Advancing Worldwide Efficiency

From the 1960s until recently, just as NN offered the predominant benchmark among international tax policy experts for unilateral national welfare analysis, so the standard of capital export neutrality (CEN) held the high ground in thinking about global welfare, or that in which foreign individuals' welfare counts equally to that of domestic individuals (rather than being disregarded). This equivalent standing reflected that the two standards are effectively identical, except in how they treat foreign taxes. Again, under NN, only domestic taxes are socially a transfer, since the benefit to foreign individuals from their governments' acquiring tax revenues is disregarded. Under CEN, *all* taxes are viewed as transfers rather than costs, and the question of which government collects them is treated as irrelevant.

CEN thus dictates presenting domestic taxpayers with the same tax rate no matter where they invest, so that tax rate differences will not influence (i.e., distort) their investment choices. This is exactly what NN does, except that CEN equates foreign taxes with domestic taxes, rather than with other costs of producing income. Thus, CEN focuses on the overall worldwide tax rate, rather than the domestic tax rate.

CEN's worldwide tax neutrality requirement would be satisfied without any need for foreign tax credits if all countries either (1) only levied residence-based taxes that treated foreign and domestic investment the same, or (2) only levied source-based taxes, all of which fortuitously had the same rate. With varying-rate source-based taxes being levied around the world, full worldwide taxation plus unlimited foreign tax credits is the only practical device at hand for achieving CEN with respect to one's residents.

For the first four decades after Richman (Musgrave) (1963) first wrote about CEN, its only serious rival in the international tax policy literature was capital import neutrality (CIN). Under CIN, all of the parties around the world that might invest in a given location should face the same tax rate, and differences in locations' tax rates are immaterial. CIN is most easily satisfied by exclusively source-based taxation. Thus, it effectively calls for exemption of foreign source income, in contrast to CEN's prescription of worldwide taxation with unlimited foreign tax credits. However, a widespread expert consensus long held that CEN was the more compelling principle, from the standpoint of designing international tax rules to advance global economic welfare (Shaviro, 2009).

And this in turn, given the peculiar decades-long consensus that one can reasonably discuss international tax policymaking at the national level purely in global efficiency terms, supported a general consensus among experts in favor of offering foreign tax credits, within the setting of a worldwide residence-based system.

While CEN's longstanding intellectual acceptance rivaled that of NN — with the difference that CEN was actually considered an appropriate national policy guide — it has recently lost ground for the same reasons. Recall that NN foundered empirically on the increasing consensus that outbound investment by resident companies probably does not reduce net domestic investment, reflecting two accepted facts that traditional international tax policy analysis had underappreciated. The first is that a country's tax rules only determine the overall relative incentives of its own residents, who are interacting in world capital markets with other investors, while the second is that the main actors in cross-border investment are corporations, which are taxed at the entity level (Desai and Hines, 2003, 2004).

Suppose that a country's decision to follow CEN, by taxing residents' worldwide income with unlimited foreign tax credits, has no effect on net domestic or foreign investment. Resident multinationals, for example, end up owning less assets in low-tax countries than they would have if they could benefit from the low taxes, but no asset's location (as distinct from who owns it) changes, relative to the counterfactual in which the country exempted foreign source income. This scenario, in addition to refuting NN, would rebut any claim that the country's pursuit of CEN has increased global economic efficiency.

To make this clear, recall that CEN aims to direct taxpayers' incentives towards pre-tax rather than after-tax profitability, on the view that all countries' taxes are merely transfers from a social standpoint, and with the aim of increasing global economic productivity. In this regard, CEN is effectively a subset of worldwide locational neutrality (Shaviro, 1992), which would exist if *all* investors' locational choices did not affect their net worldwide tax liabilities with respect to a given amount of income. The mechanism by which CEN, in common with broader worldwide locational neutrality, could increase global economic productivity (relative to the world of varying-rate source-based taxes) is by inducing a shift of net investment from low-tax countries to high-tax countries where the pretax profit is higher. If this does not happen when a given country pursues CEN, because the policy only reaches a subset of global investors and thus simply induces ownership shifts, then the global efficiency payoff has failed to materialize.

The decline of CEN as a guide to national tax policy — even if one accepts its focus on global rather than national welfare — weakens the case both for imposing worldwide residence-based taxation and for creating a 100 percent MRR via foreign tax credits. Shifting to an exemption system would address both margins, but the case for each change can be made independently of the other. Thus, suppose one favors retaining some U.S. taxation of outbound investment by U.S. multinationals, perhaps to impede their mischaracterizing income as foreign source. Without the CEN benchmark, this aim does not imply preferring foreign tax credits to a burden-equivalent system with lower rates and deductibility.

In sum, the affirmative case for creditability based on CEN, no less than that based on aversion to double taxation, proves unpersuasive when examined closely. Thus, the case against foreign tax credits, founded on the bad incentives that they create as viewed from a national welfare standpoint, remains unrebutted.

IV. CONCLUSION

Among means of reducing the domestic tax burden on foreign source income that would otherwise result from worldwide taxation of resident taxpayers, foreign tax credits are decidedly problematic. They provide a 100 percent MRR for foreign taxes paid, notwithstanding that the optimal such rate, from a unilateral national welfare standpoint, equals the otherwise applicable MTR for foreign source income. In practice, exemption systems, since they are implicit deductibility systems for foreign taxes paid, get this right, whereas worldwide/foreign tax credit systems do not.

Might it nonetheless be reasonable, as a matter of unilateral self-interest, for a country to offer foreign tax credits? Assuming a decision not to enact exemption — the assessment of which would require analyzing the outbound investment margin, as distinct from just the foreign tax planning margin — this depends on the pluses and minuses of realistically available alternatives. No definite conclusions will emerge immediately in a world of politically and administratively constrained choices that only an extreme optimist would view as anywhere close to *second*-best. However, even if one rejects the realism or desirability of converting our existing foreign tax credit system into, say, a revenue-neutral deductibility system, the defects of foreign tax creditability should be kept firmly in mind. As I plan to show in other work, these defects may importantly influence both big-picture choices, such as that between the worldwide and exemption systems, and more interstitial reform debates within the context of a continuing worldwide system.

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