DESIGNING THE U.S. CORPORATE TAX SYSTEM FOR THE 21ST CENTURY—SOME REAL-WORLD CONSIDERATIONS*

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"Globalization has made it imprudent for the United States, or any other country, to enact tax rules that do not take into account what other countries are doing."

U.S. Treasury Department (2008)

INTRODUCTION

The organizers of this session have given the presenters *carte blanche* to design the optimal corporate tax system for the United States. Realistically, however, the types of design options are constrained by the fact that the United States economy is integrated in a world economy with significant international capital flows and many varying tax systems.

Other panelists in this session have suggested that the United States should adopt a tax system employed nowhere else in the world—taxing corporations currently on their active foreign income, without benefit of deferral. Such a tax policy, unless offset by significant U.S. tax reductions on foreign earnings, would reduce the ability of U.S.-headquartered companies to compete in foreign markets against foreign-headquartered companies that are subject to more favorable tax rules.

The resulting loss in foreign sales by U.S. companies would cause a contraction in the operations of U.S. multinational companies. Increased acquisitions of U.S. companies by foreign companies could result, because foreign companies could conduct their foreign operations more profitably as they would not be subject to U.S. tax rules. New business entities with the potential for significant foreign earnings would likely establish their headquarters outside the United States in order to avoid being subject to U.S. taxation on their foreign earnings. Portfolio investment from individual investors would favor share ownership of foreign corporations over that of U.S. corporations due to the tax disadvantage U.S. corporations would face in their foreign operations. The ability of U.S. companies to expand into foreign markets would be severely constrained, and the U.S. economy would suffer the consequences.

Background on Cross-Border Investment

Any tax system designed for the 21st century must take into account the tremendous growth of international trade and investment. The stock of cross-border investment among all countries has expanded from less than 6 percent of the world's GDP in 1980 to 28 percent by 2007. Inward foreign direct investment to the United States has expanded from less than three percent of GDP in 1980 to 15 percent of GDP by 2007.

But whereas U.S. companies accounted for as much as 40 percent of world cross-border investment in 1980, they now account for less than 20 percent. Similarly, whereas 40 years ago 18 of the largest 20 companies in the world were headquartered in the United States, today only 6 of the largest 20 nonfinancial companies and 3 of the largest 20 financial companies are headquartered in the United States. In Thomas Friedman's (2007) words, "the world is flat" and, some may add, "getting flatter." (p. 355).

Advances in communications, reductions in transportation costs, and falling tariff barriers have opened the world to expanded trade and investment from all countries. From the U.S. perspective, 95 percent of the world's population lies outside the United States and they hold 75 percent of the world's purchasing power. For any American company, the world market represents tremendous growth opportunities. For example, China's economy has been growing at nearly 10 percent per year, its population exceeds that of the United States by 1 billion and, with many U.S. companies approaching this market with a negligible market share, the potential for expanding sales is enormous.

U.S. INVESTMENT ABROAD

While some fear U.S. investment abroad is commensurate with "shipping jobs overseas,"

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research examining U.S. overseas investment strongly suggests the opposite. A series of studies by Mihir Desai, Fritz Foley, and James Hines find that foreign investment by U.S. companies leads to more domestic investment; increased foreign sales by U.S. foreign affiliates leads to more exports from the United States; and increased foreign compensation paid by U.S. foreign affiliates leads to more domestic compensation.[1] This research, and those of others, finds that the foreign operations of U.S. companies are complementary to U.S. domestic operations, rather than substitutes for domestic operations.

The reason that the growth of U.S. companies' domestic operations is tied to the growth of their foreign operations is largely because these foreign operations permit U.S. companies to expand into foreign markets. Bureau of Economic Analysis data show that 89 percent of the foreign production of U.S. companies is sold to foreign customers, not to U.S. customers.[2] While U.S. multinationals are responsible for about half of all exports from the United States, they also rely frequently on local operations to increase their ability to market effectively to foreign customers. Despite improvements in openness to trade in many countries, tariff barriers and local content requirements, as well as transportation costs for some goods, may limit exports and necessitate local production. Services, which account for 61 percent of foreign affiliate operations, generally cannot be exported and must be supplied locally to customers.

Although labor costs frequently are believed to be an important factor in encouraging foreign production, Bureau of Economic Analysis data show that foreign countries with high per capita income account for nearly 80 percent of the foreign production of U.S. companies (Mataloni, 2008). These countries continue to be the preferred location for new foreign affiliates.

The benefits to the U.S. economy of the presence of U.S. multinational companies are significant. A study by Federal Reserve Board economists found that more than 75 percent of the increase in U.S. labor productivity in the nonfinancial corporate sector over the 1977-2000 period was attributable to U.S. multinationals (Corrado, Lengermann, and Slifman, 2007). U.S. multinationals account for more than 75 percent of all research expenditures by U.S. business (Mataloni, 2008). U.S. multinationals directly employ nearly 22 million workers in the United States and account for more than half of manufacturing employment (Mataloni, 2008). U.S. multinationals pay their U.S. employees significantly more than other domestic businesses, even after controlling for industry, size, and location (Doms and Jensen, 2008).

EFFECTS OF CORPORATE TAXES

The ability of U.S. multinationals to compete effectively in world markets requires that the U.S. tax system not disadvantage corporations headquartered in the United States. There are two aspects in which the U.S. tax system can potentially disadvantage U.S. companies. First, unlike the tax treatment of most multinationals headquartered in competing countries, U.S. multinationals are taxable in the United States on their foreign earnings. Second, corporate tax rates in the United States are the second highest in the Organisation for Economic Co-operation and Development (OECD). In 2008, the combined federal, state, and local corporate tax rate in the United States at 39.3 percent was the second highest in the industrialized countries of the OECD, and 50 percent higher than the OECD average excluding the United States. As a result, U.S. multinationals competing abroad are potentially subject to significantly higher tax rates than their foreign competitors. The tax treatment of foreign earnings is examined in more detail below.

TAXING FOREIGN EARNINGS OF CORPORATIONS

Following tax reforms in 2009 in Japan and the United Kingdom, 25 of the 30 advanced industrialized countries of the OECD now exempt from tax most foreign earnings under so-called "territorial" tax systems. In contrast, the United States and four other OECD countries employ "worldwide" tax systems that tax companies on their foreign earnings (with a credit for foreign taxes), generally at the time dividends are paid by their foreign subsidiaries.

In recent years more countries have adopted territorial tax systems. Part of this trend has been due to an increased recognition of the competitive pressures faced by multinational corporations and the importance of these companies to the overall competiveness of a country's economy. As stated in the proposal of the United Kingdom government calling for adoption of a territorial system, "It is essential that the rules for the taxation of foreign profits keep pace with the changing economy….

The policy objective is to enhance the competitiveness of the UK by providing the widest possible exemption." (United Kingdom HM Revenue and Customs, 2008)

Territorial tax systems are in use in most OECD countries: Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Italy, Japan, Luxembourg, Netherlands, New Zealand, Norway, Portugal, Slovak Republic, Spain, Sweden, Switzerland, Turkey, and the United Kingdom.

Worldwide tax systems are in use in just four other OECD countries in addition to the United States: Ireland, Korea, Mexico, and Poland. Each of these countries provides for deferral of tax on most foreign earnings until they are paid as a dividend to the parent company. The corporate tax rates in these countries range from 12.5 percent in Ireland to 28 percent in Mexico, compared to the 39.3 percent rate for the United States in 2008.[3] The low rate of tax in Ireland means in practice that little or no additional tax is paid by an Irish company on dividends it receives from abroad after application of the foreign tax credit.

The 25 territorial countries account for 97 percent of the outbound foreign direct investment of non-U.S. OECD countries. In other words, when a U.S.-headquartered company competes globally, it is virtually certain that it is competing with a company that is not taxed on its foreign earnings.

HOW SHOULD FOREIGN EARNINGS BE TAXED?

The current U.S. practice of worldwide taxation with deferral permits foreign subsidiaries of a U.S. company to operate in a competitive fashion in a given foreign location provided the U.S. company reinvests its foreign earnings abroad. In the absence of deferral, however, a U.S. company operating in a given foreign location would have a higher tax burden than its competition. The ability of a U.S. company to succeed and grow in the foreign market would be severely handicapped if deferral were repealed.

The argument of some that U.S. companies should be taxed currently on their foreign earnings stems from a view that foreign investments by U.S. companies are substitutes for domestic investments. This view is encompassed in the doctrine of *capital export neutrality* which calls for equal tax treatment between domestic and foreign investment in order to maximize the efficient allocation of capital investment. As noted by Desai (2009), this view depicts capital investment as being driven by "arbitrage" of tax differentials rather than firm-specific advantages in ownership and management.

But as described earlier, the data do not support the general notion that domestic and foreign investments are substitutes for each other. Increases by U.S. multinationals in their foreign investment have been shown to lead to greater domestic investment. Investment abroad can increase the market for U.S. goods and services, thereby increasing the demand for domestic investment.

An alternative notion of efficiency, *capital ownership neutrality*, put forth by Desai and Hines (2003) has been described as not having the tax system interfere with who will own operations in a given foreign location. This concept is much closer to the competitive arguments put forth by business: For example, if a U.S. company and a foreign multinational are bidding to undertake a new operation in China, the U.S. corporate tax system should not influence the outcome of this competition. Instead, the company with the greatest market efficiency should win the bid. Territorial systems satisfy this concept of neutrality. In the absence of deferral, however, worldwide tax systems would impose a higher tax burden on one competitor and could drive the outcome of this competition.

If deferral were repealed for U.S. companies, the loss in competitiveness over time would cause the foreign earnings of U.S. companies to contract, with the potential loss of domestic activities associated with the foreign operations being lost as well. The United States would also be a poor location for the start-up of new companies founded on innovative ideas. Ultimately, U.S. companies or their foreign operations might be more profitably held by foreign corporations—a result that would be purely driven by tax law. Indeed, there is evidence that even today U.S. tax rules favor conversion of U.S. companies to foreign ownership as part of merger and acquisition activity between the United States and foreign companies (Huizinga and Voget, 2009).

CONCLUSION

As U.S. companies face increased competition in foreign markets, the United States no longer can set its tax policies independently from the rest of the world. With the U.S. corporate tax rate significantly higher than the average in the OECD, the worldwide tax system employed by the United States means that U.S. multinationals would owe significantly more tax than their foreign competitors in the absence of current deferral rules.

Efforts to increase the tax paid on the foreign earnings of U.S. multinationals, either by limiting deferral or other indirect methods, would reduce the competitiveness of U.S. companies in foreign markets. As research indicates that the foreign operations of U.S. companies contribute to the growth of U.S. companies at home, such proposed changes would have significant disruptive effects on the U.S. economy.

At the same time, with the United States facing significant deficits in the decades ahead, higher tax revenues will likely be sought by Congress as part of the solution. The challenge is to ensure that any increases in taxation be implemented in a manner that would pose least harm to the U.S. economy.

In this regard, consideration should be given to greater use of consumption taxation, such as a value added tax (VAT), which would not reduce the attractiveness of the United States as a location for production relative to corporate income taxes. A recent proposal by Michael Graetz (2008) suggests one method for introducing a VAT while reducing reliance on both corporate and individual income taxes and maintaining the overall progressivity of the tax system.

Notes

1. See, for example, Desai, Foley, and Hines (2009).
2. Bureau of Economic Analysis (U.S. Department of Commerce, 2006) computations based on data available at http://www.bea.gov/international/pdf/usdia_2006p/GroupIII_F1-F15.pdf (Table III.F3) showing $3.7 trillion in foreign sales and $0.4 trillion in sales to the United States.
3. OECD Tax Database, Table 11.3. Rates are combined federal, state and local statutory corporate tax rates.

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