Improving International Competitiveness: The Role of Tax Policy

Remarks
of
R. Glenn Hubbard
Chairman, Council of Economic Advisers

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Good evening. It is a pleasure to have the opportunity to discuss with you the role of tax policy in improving the international competitiveness of United States industries. The National Foreign Trade Council has a distinguished history of involvement in efforts to understand and improve the effect of U.S. tax rules on the international competitiveness of U.S. companies. Increasingly, the markets for U.S. companies have become global, and foreign-based competitor companies operate under tax rules that are often more favorable than our own. The existing U.S. tax law governing the activities of multinational companies has been developed in a patchwork fashion, with the result that current law can result in circumstances that harm the competitiveness of U.S. companies. In addition to their economic implications, the international tax rules are among the most complex in the code, with the result that they are both costly and difficult for companies to comply with and challenging for the Internal Revenue Service to administer. I support any effort to review the current U.S. international tax rules with an eye to reducing their complexity and removing impediments to U.S. international competitiveness. In particular, I want to single out the efforts of the U.S. Treasury, which under the leadership of Secretary O'Neill is in the midst of a sustained effort to suggest ways to simplify all aspects of the U.S. tax code.

AT CROSSROADS

During the past year or so, there have been two major events that have highlighted the international aspects of our tax code. The first is the finding by the Appellate Panel of the World Trade Organization (WTO) that the United States' Foreign Sales Corporation/Extraterritorial Income (FSC/ETI) regime does not comply with our international agreements. Subsequently, the WTO arbitration proceeding determined that the EU is entitled to $4 billion in retaliation. Both the finding and the retaliation amount – unprecedented in trade-related damages – have illustrated the importance of this issue.

In light of these events, the President has emphasized that two principles will guide the government's response. First, the United States will honor its international commitments and come into compliance by modifying it tax laws. Second, in doing so, the Administration will work with Congress to enhance if possible, but certainly not diminish, the competitiveness of our tax rules. The President's guidance raises the larger question of tax policy and international competitiveness, which will dominate my remarks tonight.

The second major event is the phenomenon of corporate "inversions." In the aftermath of the decision to invert by several high-profile companies, international tax rules, not normally the fodder for editorials in leading newspapers, were suddenly at center stage. Importantly, inversions are not about production facilities, supply networks, or inventories. The basic goal of an inversion transaction is to change the legal configuration of the corporation while leaving the actual operations untouched. For the same reason, an inversion is not about jobs or target markets. Instead, it is about taxes. Taxes are one part of the business cost structure and businesses regularly seek avenues to streamline their costs and remain competitive.

Broadly, inversions affect tax payments in two ways. By locating the foreign parent in a country that has no or nominal taxes, the worldwide operations of the multinational are subject to taxes on their country-by-country operations: U.S. tax on U.S. profits, German tax on German profits, and so forth. In contrast, the U.S. worldwide tax system subjects profits of U.S. firms in Germany to the German tax and, whenever the U.S. tax rate is higher, additional U.S. taxes. The result is that the tax system places the U.S. firm at a cost disadvantage in competing in Germany. Nearly every major U.S. trading partner follows some version of a territorial tax system.

By inverting to a no-tax country – Bermuda is one preferred choice – the company lowers all future taxes on its foreign operations. Notice two things. First, the same situation would arise in the event of either a merger or a foreign start-up. That is, the fundamental issue is the competitive impacts of the U.S. tax system, not inversions *per se*. Second, none of these corporate structures, inversions in particular, affects U.S. taxes. Firms still must pay U.S. taxes on U.S. profits.

In executing of an inversion transaction, however, it is common for the corporation to shift its financial structure, leaving the U.S. subsidiary "in debt" to the remainder of the global corporation. This is the second tax advantage. Interest payments from the U.S. subsidiary are deductible – lowering or eliminating the U.S. tax – and are usually "received" by either the foreign parent or a branch of the company located in a low-tax nation. Notice again that financial engineering through the use of intra-company debt – known as "income stripping" – is not unique to inversions. It may arise via any of the routes the end with a foreign parent and a U.S. subsidiary. The objective for tax policy should be to address abusive income stripping in any circumstance.

Inversions are not a pure win from a tax perspective. The transformation requires a firm's foreign subsidiary to purchase the American parent. Individual shareholders must effectively pay taxes on the "sale" of their original shares to the new foreign parent. Or depending on how the increase is structured, tax must be paid at the corporate level on the transaction. The fact that U.S. shareholders are voting to pay this tax suggests that the dual benefits of income stripping and a competitive tax system are worth writing the check to the Treasury.

The Administration's approach to inversions was outlined by Assistant Treasury Secretary Pamela Olson in testimony before Congress. In part, this focused on the near-term objective of addressing immediately the gain from income stripping. However, as she noted it is important to not stop there, but rather to reexamine the long-run competitiveness of our tax code, a topic to which I now turn.

MULTINATIONAL CORPORATIONS AND THE UNITED STATES ECONOMY

Multinational corporations are an important part of the United States economy. Approximately one quarter of the 1999 U.S. Gross National Product was produced by U.S. nonbank multinationals. In the manufacturing sector, the contribution is even higher, with U.S. parent firms producing 54 percent of all U.S. gross manufactured products. In the conduct of these operations, U.S. multinational firms provide a large number of jobs to American workers. In 1998, parent firms employed over 21 million people in the United States, compared to a national workforce of 130 million.

The primary motivation for U.S. multinationals to operate abroad is to compete more effectively in foreign, not domestic, markets. Thus their overseas investment activities are largely aimed at providing services that cannot be exported, obtaining access to natural resources abroad, and to selling goods that are costly to export due to transportation costs, tariffs, and local content requirements. As one piece of evidence in this regard, the Department of Commerce notes that, in 1999, two-thirds of sales from U.S.-owned foreign affiliates were local (*i.e.,* to their host country). Only 11 percent of sales from these firms were made back to the United States, and less than 10 percent of U.S. plants abroad exported goods back to the U.S. market. Thus the primary market for foreign operations of U.S. companies is the host country, followed by other foreign countries. Indeed, more than one-half of all foreign affiliates of U.S. multinationals are in the service sector, including distribution, marketing, and servicing U.S. exports.

Sales. By definition, multinationals operate and sell their products in more than one country. However, research indicates that U.S. operations abroad do not serve to displace exports. Indeed, in part because foreign affiliates of U.S. companies rely heavily on exports from the United States, the activities of multinationals generate a net trade surplus. A recent study by the Organization for Economic Cooperation and Development (OECD) complements other academic research in finding that each dollar of outward foreign direct investment is associated with two dollars of additional exports and an increase in the bilateral trade surplus of $1.70.

How important are multinationals in international transactions? In 1999 (the most recent year for which data are available), foreign affiliates of U.S. companies purchased $203 billion of goods from U.S. sources. At the same time, domestic operations of U.s. multinationals exported $267 billion to other foreign customers. Drawing these together, U.S. multinationals contributed roughly $440 billion of merchandise exports in 1999, or about two-thirds of overall U.S. merchandise exports.

U.S. multinationals are also an important part of import behavior. Many are familiar with the notion that imported goods give domestic businesses and consumer's access to a wider variety of goods at lower prices and competition that forces domestic firms to operate more efficiently. However, imports also provide specialized equipment that helps American businesses to compete and improve their productivity. The United States imported $377.1 billion of goods that involved multinationals, 37 percent of the share of U.S. total imports (down from 42 percent a decade earlier). In total, U.S.-owned multinationals exported $64 more than they imported.

Intangible Capital Assets. Physical capital assets often dominate the discussion of multinational investment decisions. However, among the assets of U.S. companies is their scientific expertise. Foreign physical capital investments are one avenue to increase their use of this expertise, thereby raising the rate of return on firm-specific assets such as patents, skills, and technologies. Not surprisingly, raising the rate of return provides enhanced incentives for investment in research and development. In 1999, non-financial U.S. multinationals performed $142 billion of research and development. Such research and development allows the United States to maintain its competitive advantage in business and be unrivaled as the world leader in scientific and technological know-how. In addition, this activity tends to be located in the United States–$123.5 billion, or nearly 90 percent, was done in a domestic operation. Thus, in this area as well, the foreign and domestic operations of multinationals tend to be complements, and not substitutes, for one another.

Employment. A common concern is that the overseas activities of U.S. multinationals come at the expense of domestic employment. There are reasons, however, for the opposite to be true. The need for labor by any firm is related to its overall success. In the case multinational corporations, this is no different. Foreign investments can lead to more domestic employment because the need for employees by a multinational is linked to its entire international, firm-level success at trade in intermediate and final goods. This link generates a complementary, as opposed to competitive, relationship between employment in industrialized and developing countries.

Put differently, international investment by U.S. multinationals generates sales in foreign markets that could not be achieved by producing goods entirely at home and exporting them. U.S multinationals use foreign affiliates in coordination with domestic operations to produce goods that allows them to compete effectively around the world, generating overall success evidenced by employment in the United States and significant exports. As evidence of their success, employment in these export-related activities yields higher-than-average wage rates.

To look from another perspective, suppose that a U.S. multinational chose to forego opening a foreign affiliate and relied exclusively on exports from domestic production. Without the benefit of local marketing and distribution support, it might be less successful in its sales. Or the sheer cost of transport may make it non-competitive. In either event, it would lose out to competitors that either pursued a presence in the country or had lower transportation costs. The end result may be a company with lower profits, slower growth, and fewer employment opportunities.

Summary. U.S. multinationals provide significant contributions to the U.S. economy through a strong reliance on U.S.-provided goods in both domestic and foreign operations. These activities generate additional domestic jobs at above average wages and domestic investments in equipment, technology, and research and development. As a result, the United States has a significant interest in insuring that its tax rules do not bias against the competitiveness of U.S. multinationals.

TAX POLICY AND U.S. INTERNATIONAL COMPETITIVENESS

The increasing globalization of economic competition has centered attention on the impact of U.S. tax rules. Foreign markets represent an increasing fraction of the growth opportunities for U.S. businesses. At the same time, competition from multinationals headquartered outside of the United States is becoming greater. An example of this phenomenon is the sharp decline over the past 40 years in the United States share of the world's largest multinational corporations.

Why Tax Policy Matters

If U.S. businesses are to succeed in the global economy, the U.S. tax system must not generate a bias against their ability to compete effectively against foreign-based companies – especially in foreign markets. Viewed from the narrow perspective of income taxation, however, there is concern that the United States has become a less attractive location for the headquarters of a multinational corporation. This concern arises from several major respects in which U.S. tax law differs from that of most of our trading partners.

First, about half of the OECD countries have a territorial tax system (either by statute or treaty), under which a parent company is not subject to tax on the active income earned by a foreign subsidiary. By contrast, the United States taxes income earned through a foreign corporation, either when the income is repatriated or deemed to be repatriated under the rules of the tax code. It would be useful for the United States to examine closely the merits of a more territorial approach, a move that would be consistent with most commonly discussed fundamental tax reforms.

Second, even among countries that tax income on a worldwide basis, the active business income of a foreign subsidiary is generally not subject to tax before it is remitted to the parent. In some circumstances, for example income arising from "base country sales or service" sources, the active business income is deemed to be repatriated and taxed immediately. Indeed, one reading of tax history is that the FSC regime originally developed at least in part in response to the pressures generated by the absence of deferral on these income sources. Remarks during dinner are hardly the place for an extended discussion of the details of the mechanics of these tax rules and potential routes to modification. But clearly this is an important issue.

Third, the United States places greater restrictions on the use of foreign tax credits than do other countries with worldwide tax systems. For example, there are multiple "baskets" of tax credits which serve to limit the flexibility of firms in obtaining credits against foreign taxes paid. In some circumstances, allocation rules for interest and other expenses also preclude full offset of foreign tax payments, raising the chances of double-taxation of international income.

Fourth, the United States (along with Switzerland and the Netherlands) is one of only a handful of industrialized countries to fail to provide some form of integration of the corporate and individual income tax systems. The absence of integration results in double taxation of corporate income, making it more difficult for U.S. companies to compete against foreign imports at home, or in foreign markets through exports from the United States, or through foreign direct investment.

Principles of Neutrality

A strict concern for the competitiveness of a U.S. multinational operating in a foreign country would dictate an approach to taxation that results in the same tax as a foreign- based multinational operating in that country. This competitiveness principle is also known as Capital Import Neutrality (CIN), as it results in the same rate of return for all capital flowing into a country. An alternative notion of efficiency is that a U.S. investor should be taxed equally whether the investment is made at home or abroad. This latter notion is referred to as Capital Export Neutrality (CEN).

The debate regarding the principles of competitiveness and capital export neutrality dates back at least to the early 1960s and the proposal of the Kennedy Administration to tax immediately all foreign source income earned by subsidiaries of U.S. companies (except in developing countries). Despite forty years of debate, however,

CEN and CIN have not proven to be very useful principles in practice. The theories supporting the principles have been overly simplified and have not advanced much in the intervening time. In many instances, analysis fails to account for the existence of a corporate tax, the ability of portfolio investors to buy foreign corporate shares, and the utter complexity with which actual tax systems involve mixtures of residence-based and source-based taxation.

The conventional economic analysis supporting CEN assumes that all foreign investment is in the form of direct equity and that there are no international flows of portfolio equity or debt investments. Under these assumptions, any decrease in foreign investment by U.S. companies would result in increased corporate investment in the United States. However, capital can flow out of the United States because portfolio investors can reinvest their shareholdings, selling interests in U.S. firms in favor of interests in foreign firms. Such investment can also flow into the U.S. noncorporate sector. Currently, portfolio investment accounts for about two-thirds of U.S. investments abroad and about two-thirds of foreign investment in the United States, casting doubt on relying on a theory that excludes portfolio investment.

A second weakness of the typical economic analysis underpinning CEN is the presumption of "perfect" competition. Perfect competition is a useful analytical benchmark for economists. However, strictly interpreted, it requires that firms produce the same products, cannot take advantage of scale economies, and do not ever earn above-market profits. In practice, multinationals produce differentiated products, and compete in industries where there are some economies of scale – which is one explanation why foreign plants are affiliated with a parent firm at all. A reevaluation of tax principles in a more realistic setting casts doubt on the traditional analysis, including my own research with Michael Devereux. We reexamined the theory of international tax policy, noting that foreign investment is different from portfolio investment. In particular, foreign investment offers the possibility of exploiting intangible factors such as brands or patents and company-specific cost advantages. This research calls into question the basic findings that support CEN. Interestingly, in this setting it is often the case that average tax rates – not just marginal tax rates – have a large influence on investment decisions.

One implication of the accumulation of research is that there is no simple general abstract principle that applies to all international tax policy issues. The best policy in each case depends on the facts of the matter and how the tax system really works. A U.S.-controlled operation abroad must compete in several ways for capital and customers. They might have to compete with foreign-based companies for a foreign market. They might have to compete with U.S. exporters or domestic import-competing companies. Each of these competing businesses can be controlled either by U.S.-based or foreign-based parents. It is a challenge for policy to determine the best path to a competitive tax system.

A direct application of the simple CEN notion can actually make efficiency worse, even from the perspective of its objectives. A well-known economic theorem shows that when there are multiple departures from economic efficiency, correcting only one of them may not be an improvement. Unilateral imposition of capital export neutrality by the United States may fail to advance either worldwide efficiency or U.S. national well-being.

A direct application of the alternative notion of neutrality, CIN can be equivalent to a territorial tax system. As noted above, it is unlikely that any single, pure theory of international tax rules will provide direct and universal policy guidance. However, it is interesting to note that this recent research tends to support the tax strategies of competitive nations. Nevertheless, concerns have been raised over the possibility that using CIN to guide tax policy will result in a narrower tax base and a shift in the structure of production for multinational firms. In this light, it is interesting to note that recent analyses of variants of territorial tax systems by Harry Grubert and Rosanne Altshuler depart from traditional conceptions of the implications of a territorial tax system, arguing that revenue may rise when moving to a territorial system and there may be little impact on plant location decisions by multinationals.

Implications for U.S. Multinationals

As noted earlier, from a tax perspective the United States is now less favorably viewed as an industrial country in which a multinational corporation should locate. Over time, any such bias from U.S. tax rules could lead to a reduction in the share of multinational income earned by companies headquartered in the United States. Incentives supporting a decline in the importance of U.S. multinationals should be a concern, not out of any narrow concern over particular companies, but because of the potential loss in economic opportunities such a decline would bring about for American workers and their families. Professor Laura Tyson, one of my predecessors as Chair of the Council of Economic Advisers, has pointed out a number of political, strategic, and economic reasons why maintaining a high share of U.S. control over global assets remains in the national interest. These reasons include the fact that U.S. multinationals locate over 70 percent of their employment and capital assets in the United States. Also, they have higher pay and investment per employee in the United States than in either developed or developing countries. Finally, as noted earlier, U.S. multinationals conduct a very large percentage of their research and development domestically.

Department of Commerce data support the view that the vast majority of the revenue, investment, and employment of U.S-based multinationals is located in the United States. This has not changed over time. In 1999, U.S. parents accounted for about three-fourths of the multinationals' sales, capital expenditures and employment. These shares have been relatively stable for the last decade. Therefore where a firm chooses to place its headquarters will have a large influence on how much that country benefits from its domestic and international operations.

The decline in the market share of multinationals headquartered in the United States has important implications for the well-being of the U.S. economy. To the extent that tax rules are the source of this shift, higher-paying manufacturing jobs and management functions may move along with these headquarters. Research and development may be shifted abroad, in addition to jobs in high-paying service industries, such as finance, associated with headquarters' activities. Future investments made by these companies outside of the United States are unlikely to be made through the U.S. subsidiary since tax on these operations can be permanently removed from the U.S. corporate income tax system by instead making them through the foreign parent. As I pointed out earlier, portfolio investment offers still another, if less visible, route by which foreign-owned multinationals can expand at the expense of U.S. multinationals. If U.S. multinationals cannot profitably expand abroad due to unfavorable U.S. tax rules, foreign-owned multinationals will attract the investment dollars of U.S. investors. Individuals purchasing shares of foreign companies – either through mutual funds or directly through shares listed on U.S. and foreign exchanges – can generally ensure that their investments escape the U.S. corporate income tax on foreign subsidiary earnings.

CONCLUSIONS

Multinational corporations are an integral part of the U.S. economy, and their foreign activities are part of their d0.0001 Tw 12 0 0929.5346.2 00 T1 067d0.0001 Tw 12 stic1.9ccesoreiAc