Tax Policy and International Competitiveness

By
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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. 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. Indeed, the current U.S. international tax rules should be reviewed with an eye to reducing their complexity and removing impediments to U.S. international competitiveness.

At a Crossroads

During the past few years, 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 European Union 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.

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 newspa-

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pers, 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 Bush Administration and the Congress continue to work together on near-term objectives. However, the more important tasks lie in reexamining the long-run competitiveness of our tax code.

The Longer-Run Issue

The U.S. economy is increasingly linked to the world economy through trade and investment. U.S.-based multinationals and their foreign investment help bring the benefits of global markets back to the United States by providing jobs and income. The profitability and long-term viability of U.S.-based multinationals is influenced by U.S. tax policy.

Like all firms, multinationals are faced with a number of business decisions, including how much to invest and where. Because multinationals by definition operate in a number of countries, they also have to decide in which country to locate their headquarters which in turn affects which countries reap the majority of benefits from the multinational's operations. Each of these business decisions is influenced by tax policy, particularly how countries tax income from foreign investment.

The U.S. tax system, in the past, has chosen to tax income from foreign investment at the same rate as it taxes domestic income under a principle called capital-export neutrality. The principle is based on the idea that investment abroad is a substitute for investment (and jobs) at home, and is founded on the assumption that global markets are perfectly competitive. As I describe later, capital-export neutrality was seen as a laudable objective in the 1960s when the United States was the primary source of capital investment, and dominated world markets. Both the global economic setting and the accepted view of global markets have changed dramatically since the 1960s. In the past few decades, other countries have come to challenge the United States' preeminent position in the global market, and the United States has become a net recipient of foreign investment as opposed to the largest source. There is mounting evidence that foreign affiliates are in fact complements to domestic investment and employment, and therefore should, if anything, be encouraged.

The United States' system of taxing income from foreign investment should be reconsidered in the light of the new global setting. The tax system should enhance the competitiveness of the U.S. position in global markets, and ensure that Americans reap the full benefits of increasing trade and investment flows.

The United States in the Global Economy

Over the past few decades, the global economy has become increasingly integrated. For the United States, this integration is reflected by the fact that 10 percent of the U.S. gross domestic product (GDP) in 2001—over $1 trillion—was derived from U.S. exports of goods and services. Roughly eight percent of American workers produce goods and services that will be sold in foreign markets. In addition, imports of foreign raw materials and capital goods help the U.S. economy run smoothly and efficiently.

The importance of global markets has become transparent in many sectors of the American economy. America's farmers, for example, exported almost $55 billion in 2001, with roughly 25 percent of cash sales by farmers and ranchers to foreign consumers. Key manufacturing industries also benefit from access to global markets.

The aerospace industry exports over 40 percent of its output, while the chemical industry exports nearly 20 percent of its output. Even the service sector increasingly looks to foreign markets for its expansion. Service exports, which include sales of insurance, financial, educational and telecommunications services, are among the most rapidly increasing part of U.S. trade, reaching nearly $300 billion in 2001.

The mirror image of increased trade in goods and services is the enormous rise in international capital flows over the past 30 years. These flows represent funds channeled from savers in one country to borrowers in another. The International Monetary Fund estimates that since 1970, gross capital flows—capital flows into and out of a country as a percentage of GDP—have risen almost 10-fold for developed countries and five-fold for developing countries. In the last decade alone, estimated capital flows in developed countries have more than quadrupled.

Americans have benefited from liberalized trade and capital flows. Trade enhances productivity, which is reflected in the fact that workers in exporting firms and industries typically earn about 10 to 15 percent more than the average U.S. worker. More generally, the gain from enhanced global trade by further reducing world barriers to trade by one-third would be equivalent to a $2,500 per-year increase in the annual income of the average family of four. It is in our economic interest to enhance market forces and capture the benefits of international movements of goods and capital.

Multinational Corporations and the U.S. Economy

Multinationals are an intrinsic part of globalization. To begin, they represent a substantial portion of cross-border economic activity. Almost two-thirds of U.S. exports take place through U.S. multinationals. The most recent data show that foreign affiliates of U.S. multinationals purchased $203 billion of goods from the United States in 1999. U.S. multinationals also exported an additional $267 billion of merchandise to unaffiliated foreign customers. In total, U.S. multinationals were responsible for $440 billion of merchandise exports in 1999, representing 63 percent of all U.S. merchandise exports. U.S. multinationals figure equally prominently in imports. The United States imported $377.1 billion of goods that involved multinationals; 37 percent of U.S. total imports (and down from 42 percent in 1989).

The involvement of the United States in global trade has impacts on income and employment in the U.S. economy. In 1999, U.S. multinationals (excluding banks) had a gross product of $2.4 trillion, making up over one quarter of total U.S. GNP. The contribution of multinationals is much higher in manufacturing, where U.S. parent firms produce 54 percent of all U.S. manufactured output. U.S. multinational firms are the source of a large number of jobs; in 1998, parent firms employed over 21 million people in the United States, out of a national workforce of 130 million.

Multinationals are an intrinsic part of global integration because they represent an alternative means by which nations conduct cross-border transactions. That is, the economic costs of production, transportation, distribution and final sale may be lower of conducted within a single firm than *via* a series of market transactions. Accordingly, the rise in global integration carries along with an increased volume of transactions for which multinationals have a particular advantage.

To pursue their market opportunities, multinationals must make a number of business decisions. Like all firms, they must determine the scale and character of their capital expenditures, the size and skill composition of their labor force and which technologies are the most promising. However, in each case, multinationals' decisions have a locational dimension as well. That is, they must determine not only the amount of each of these activities, but also where they will take place. Indeed, in the extreme, they must choose where they will call "home."

Why Do Multinationals Invest Abroad?

The starting point for multinationals' investment in foreign countries is the same as domestic investment: profitability. As in other circumstances, firms will seek out profit opportunities as a means to provide firm growth in output, employment, revenues and shareholder returns. Indeed, the economic research suggests that there are significant profit opportunities in this area—an additional dollar of foreign direct investment by U.S. corporations, in present value, leads to 70 percent more interest and dividend receipts and U.S. tax payments than an additional dollar of domestic investment.

What opportunities are provided by foreign investment? Foreign investment by multinationals is often classified into two types, each type associated with a different motivation. In horizontal investment, a firm invests in a similar production process in various countries. Building a facility abroad that is similar to domestic operations is one way to access foreign markets in the face of barriers (tariff or nontariff barriers) to trade in goods. If a market is protected by trade barriers, one way for a firm to get access to the market is to set up a subsidiary in the country and produce the product locally (perhaps with foreign technology, inputs, brand names, *etc.*). Or, it may simply be too expensive to transport domestically-produced goods and remain competitive. Economic research has highlighted that trade and capital movements can be substitutes, and horizontal investment has this character. Alternatively, in vertical investment, a firm invests in different input processes in different countries. This kind of investment is often driven by different costs of operation (including different taxation levels).

Trade flow data generally support the horizontal theory. The Department of Commerce notes that two-thirds of sales from U.S.-owned foreign affiliates were local (that is, 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 plants is their host country.

The distinction between horizontal and vertical incentives for investment informs the concern that multinationals will move production to the location with the lowest cost of production. To the extent that simple versions of vertical investment dominate, this concern has greater significance. However, the vast majority of U.S. multinational foreign investment is in other developed, high-wage countries. In 1999, U.S. majority owned affiliates located 73 percent of assets and employment in OECD countries. This is true for investment from all developed countries. Global investment flows are highly concentrated in the developed world, with 85 percent of outflows originating in and 65 percent of inflows directed at high-income, high-wage OECD countries. More than two-thirds (69 percent) of the total product of U.S. multinational affiliates came from plants located in Europe and Canada. Another 10 percent of total product comes from affiliates located in Japan, Australia, and New Zealand. Thus, close to four-fifths of all U.S. multinational output produced outside of the United States comes from highly industrialized countries.

Empirical research by economists has also concluded that foreign direct investment is more often horizontal than vertical. A number of recent empirical papers support this theory. As noted above, most foreign investment flows from large, rich countries to other large, rich countries. Thus investment is not flowing to the lowest cost (or at least lowest-wage) countries. Second, sales by foreign affiliates of U.S. multinationals are higher in countries with higher tariffs and transport costs on U.S. goods. Third, U.S. firms serve foreign markets more through foreign investment and less through exports; the larger is the scale of corporate operations relative to the scale of production. This fact is consistent with the idea that multinationals arise when there are economies of scale in headquarters (or parent) activities relative to scale economies in production.

Even when foreign investment is vertical, there is little evidence that it affects wages in the home country. For example, a number of empirical studies show that increased capital mobility, including the "outsourcing" of production to low-wage countries, as well as immigration from developing countries to the advanced economies, have only a small effects on wages in OECD countries.

A particularly important version of the location decision is the location of the headquarters of the multinational. Although multinationals, by definition, operate in a number of countries, the Department of Commerce reports that the bulk of the revenue, investment and employment of U.S.-based multinationals are located in the United States, and 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 foreign operations of U.S. multinationals also benefit the U.S. economy because they increase the demands for services from the firm's headquarters. A recent OECD study based on 14 developed countries found that "each dollar of outward foreign investment is associated with $2 of additional exports and with a bilateral trade surplus of $1.70." In addition, U.S. multinationals perform the overwhelming majority of their research and development at home. Physical capital assets often dominate the discussion of multinationals' investment decisions. However, among the assets of U.S. companies are their scientific expertise. Foreign physical capital investments are 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. Nonbank U.S. multinationals performed $142 billion of research and development in 1999 of which $123.5 billion, or 87 percent, was performed in the United States. Thus, the foreign and domestic operations of multinationals appear to be complements, not substitutes.

International Tax Policy

Looking Back: Capital-Export Neutrality

The U.S. approach to international taxation dates to the 1960s, a time in which the United States was the source of one half of all multinational investment in the world, produced about 40 percent of the world's output and was the largest capital exporter in the world.

In this circumstance, it was appealing to construct a tax system that was "neutral" with respect to the location of foreign investment by taxing income from all foreign investments at the same overall rate. This approach to taxing income from foreign sources is known as capital-export neutrality. Capital-export neutrality carries with it the appealing notion that taxes will not distort location decisions and that a company will invest wherever the return is greatest, maximizing efficiency. Thus, a firm would be taxed at the same marginal rate on income from foreign or domestic investments. In one example of a fully capital-export-neutral system, domestic corporations have their foreign-source income taxed as if earned in the United States, but with an unlimited credit for foreign income taxes. Under such a system, domestic corporations presumably would locate investments where they are most productive.

As an example of the mechanics of such a system, if the U.S. corporate tax rate is 35 percent, firms earning $100 abroad would owe $35 on the income. To offset foreign taxes, American multinationals can claim foreign tax credits for income taxes (and related taxes) paid to foreign governments. If the U.S.-based firm paid $25 in tax to the foreign government, the firm would be given a tax credit of $25 against its $35 owing to the U.S. government. The United States would receive net taxes of $10 and the overall tax of $35 would be the same for both domestic and any foreign investment.

Capital-export neutrality as a tax policy objective received intellectual support from the "perfect" competition paradigm that dominated economics at the time. In this characterization of market competition, aggressive pricing and ease of entry, and multitudes of competitors yielded no brand-name loyalty, economies of scale or other sources of extra profits.

Capital-Export Neutrality Reconsidered

A variety of considerations suggest a reconsideration of capital export neutrality as a tax policy objective. To begin, it is useful to note that the United States never fully adhered to the principle in practice, suggesting the presence of alternative incentives. Two features of the U.S. system—deferral and incomplete crediting—serve to place an important gap between the principle of CEN and tax practice.

To understand the impact of deferral, consider an example. Assume a foreign subsidiary of a firm makes a profit of $100 which is taxed by the foreign country at a rate of 25 percent. The firm then reinvests $55 of the profit into its operations and pays the other $20 as dividends to its shareholders in the United States. Therefore the firm has to pay U.S. tax on that $20, but gets a credit for the 25-percent tax on the $20 (amounting to $5). If the firm pulls the $55 out of the firm the following year and repatriates it to the United States, it will have to pay U.S. taxes on that profit at that time.

The rules surrounding deferral are the source of considerable complexity. Deferral is only available on the active business profits of American-owned foreign subsidiaries, and the profits of unincorporated foreign businesses such as American-owned branch banks are immediately taxed by the United States. As well, under "subpart F" of U.S. tax law, certain income (called "subpart F income") from foreign investments is "deemed distributed" and is therefore immediately taxable by the United States. Such income includes foreign base company income and funds used offshore to insure risks in the United States. Over the past 30 years, U.S. companies repatriate roughly half of their after-tax income earned by their foreign subsidiaries.

In other ways, the current tax system departs from capital-export neutrality by making foreign investment less attractive than domestic investment. For example, a firm that faces higher taxes in its host country than at home will receive excess foreign tax credits, which it may or may not be able to use. The firm can either apply its excess to foreign tax credits against taxes paid in the previous two years, or in future years. However, if the host country consistently has a higher tax than the United States, it will end up paying the higher of the two tax rates on its foreign income, and pay the lower U.S. tax on its domestic income, counter to the principle of capital export neutrality. A second example in which the tax system acts to discourage foreign investment is one in which activities are carried out in a foreign corporation; the U.S. tax rules will accelerate any income, but defer any losses. If those activities were instead placed in a U.S. corporation, both income and losses would be recognized for U.S. tax purposes. Therefore, given the uncertainty of any initial investment, the current system actually biases investment toward the domestic market and away from foreign ventures.

In addition to some trepidation with fully implementing capital-export neutrality, the underpinnings of the international tax regime have shifted on both the theoretical front and the economic landscape. On the theoretical front, it is now recognized that most multinationals produce differentiated products and compete in industries where there are some economies of scale. Indeed, in the absence of economies of scale, it would not make sense to have the foreign plants affiliated with the parent firm at all. Therefore, the model of perfect competition that drives the principle of capital-export neutrality merits reconsideration.

The traditional theory supporting capital export neutrality is based on a stylized view of multinational companies. Under this view, foreign direct investment is indistinguishable from portfolio investment, and there are no economic rents—that is, there is perfect competition. In a recent paper, Michael Devereux and I reexamined the theory of optimal tax policy taking into account that foreign investment is different from portfolio investment in that the returns that exceed the cost of capital (that is, there are economic rents) due to factors such as intangibles (for example, brands, or patents) and company-specific cost advantages.

As noted above, the returns on foreign investment are higher than those on domestic investment, implying that there are rents. Also noted above, there are economies of scale associated with headquarter activities, further putting the assumption of perfect competition in question. Devereux and I note that research in industrial organization literature on multinational corporations in fact emphasizes the presence of economic rents and that empirical studies of foreign direct investment find that investment location decisions are more closely related to average rather than marginal tax rates. These empirical observations support the view that foreign direct investment differs fundamentally from portfolio investment.

When Devereux and I take into account more realistic assumptions about the economic characteristics of foreign direct investment, we predict that the residence-based tax system fails to achieve domestic welfare maximization. Deferral of taxation of foreign income generally results in higher national welfare than current taxation (ignoring foreign country taxation). At low rates of foreign income tax, a limited foreign tax credit with deferral of foreign income generally dominates current taxation with a deduction for foreign income taxes paid.

In terms of the economic setting, the United States is now the world's largest importer of capital and no longer dominates foreign markets. For example, in 1960, 18 of the 20 of the world's largest companies (ranked by sales) were located in the United States, whereas by the mid-1990s, that number had fallen to eight.

The latter observation highlights the fact that capital export neutrality ignores that the firm can decide where to call "home." Unless the domestic tax rate is the same in both countries, under a scheme of capital-export neutrality, the decision of where to place the firm's headquarters will be affected by the countries' tax systems.

Effects of home-country tax policy on location of economic activity and investment have been investigated by economists, with the basic insight that a move toward a more territorial system will be unlikely to generate a large shift in investment locations. Other analysis has examined positive externalities created for a country by being the home of multinational headquarters, implying that economic activity of foreign affiliates is complementary to the economy of the "home base."

To summarize, 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 wage rates and domestic investments in equipment, technology and research and development. As a result, the United States has a significant interest in ensuring 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. These remarks are not 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.

Revisiting 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.

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 corporation abroad must compete in several ways for capital and customers. It might have to compete with foreign-based companies for a foreign market. It 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.

One concern with moving to a more territorial approach to taxing foreign income is that U.S.-based firms will relocate domestic operations to the country with the lowest taxes. This concern stems from the same assumption noted above that investment abroad and investment domestically is substitutes. Although firms take the cost of production of their affiliates into account, there is little reason to believe that increased investment abroad necessarily implies less economic activity at home.

As noted earlier, the vast majority of U.S. foreign investment is located in other industrialized countries, with taxes not out of line from those in the United States. Because taxes typically are only a small part of total costs of production, the change in taxation level is unlikely to induce a plant to move from the United States. The OECD found that where tax policy is identified as a major issue, transparency in the tax law and administration will often be ranked by investors ahead of special tax relief. Uncertainty over tax consequences of foreign direct investment increases the perception of risk and discourages capital flows, a fact particularly important for long-term, capital-intensive direct investment that most host countries are eager to attract.

A related concern is the loss of the tax base. Some argue that if the United States does not tax income from foreign investment, it will lose substantial revenue. However, this argument presupposes two facts:

1. Foreign tax credits received by foreign subsidiaries are less than the tax owing to the U.S. government.
2. There is not another way to tax that same profit.

Although the U.S. tax rates are one of the highest among industrial economies, a number of firms have excess foreign tax credits. There is also evidence that the United States can capture taxes from foreign subsidiaries from personal income taxation. Because foreign subsidiaries tend to pay out more dividends (due perhaps to the greater need to signal profitability), profits can be taxed. In a recent study, James Hines estimates that, among American firms, one dollar of reported foreign profitability is associated with the same level of dividend payments to common shareholders as is $3

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international race to the bottom in terms of the taxation of income from capital. We do not need cooperation in setting tax rates, but we must have cooperation on information sharing and tax collection. There is considerable pressure internationally on tax rates and within the United States a real effort to move us away from taxing income toward taxing only consumption.

Conclusion

Let me close with this observation. I believe the United States has the wrong mix of taxes. I have written about this at some length. We rely much too heavily on the income tax and not nearly enough on consumption taxes in the United States. I do not believe we should rely entirely on a value-added tax or other consumption tax. Nor am I persuaded that we should eliminate the income tax altogether. Instead, I would enact a 10- to 14-percent value-added tax to finance a $100,000 exemption from the income tax as well as a reduction in the top income tax rate to 25 percent for both individuals and corporations. I have detailed this proposal in a YALE LAW JOURNAL article.[7] The numbers actually work. You don't need sunsets and phase-ins and all the other gimmicks now common in Congress in order to make this proposal work. It would have the great advantage of freeing about 150 million Americans from having to file tax returns. And it would be a much more coherent tax system. It would allow us to collect taxes on sales in the United States through the value added tax even when we are experiencing slippage in our ability to collect the income tax.

There are important reasons to take seriously a fundamental restructuring of the U.S. tax system domestically. We also need a fundamental re-thinking of the international tax regime. This conference has been an excellent opportunity for us to begin to debate these issues. Thank you.

ENDNOTES

* This speech took place on November 14, 2003, and has been edited and annotated.

1 MICHAEL J. GRAETZ, FOUNDATIONS OF INTERNATIONAL INCOME TAXATION (2003); Michael J. Graetz and Itai Grinberg, *Taxing International Portfolio Income*, 56 TAX LAW REV. 537 (2003); Michael J. Graetz and Paul W. Oosterhuis, *Structuring an Exemption System for Foreign Income of U.S. Corporations*, LIV NAT'L TAX J., 4, at 771 (Sept. 2001); Michael J. Graetz, *The David R. Tillinghast Lecture: Taxing International Income—Inadequate Principles, Outdated Concept, and Unsatisfactory Policy*, 54 TAX LAW REV. 261 (2001), *also published at* 26 BROOKLYN J. INT'L LAW 1357 (2001); Michael J. Graetz and Michael O'Hear, *The "Original Intent" of U.S. International Taxation*, 51 DUKE LAW J. 1021(1997).

2 Mihir A. Desai, *New Foundations for Taxing Multinational Corporations*, TAXES, Mar. 2004.

3 See Graetz and Oosterhuis, *supra* note 1.

4 *Id.*

5 *Id.*, at 568–75.

6 H. David Rosenbloom, *Thinking About Subpart F: The Domestic Base Company*, TAXES, Mar. 2004.

7 Michael J. Graetz, *100 Million Unnecessary Returns: A Fresh Start for the U.S. Tax System*, 112 YALE LAW J. 261 (Nov. 2002).

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of reported domestic profitability. In fact, the United States receives greater tax revenue from the foreign operations of American companies by taxing individual dividend income that it does by taxing corporate income. For example, Hines finds that for $100 of after-tax foreign profits generates $50 more dividends to domestic shareholders than does $100 of after-tax domestic profits.

While fears of runaway plants or a runaway tax base are overblown, runaway headquarters is a real concern. Measured by deal value, over the 1998 to 2000 period, 73 to 86 percent of large cross-border mergers and acquisitions involving U.S. companies have been structured so that the merged company has its headquarters abroad. In the case of Daimler-Chrysler, U.S. taxes were specifically identified as a significant factor in determining the location of the new parent firm. U.S.-based multinationals have most of their jobs and funds invested in their parent firms, losing the parents becomes more of a concern than simply increasing the amount of investment in foreign-owned affiliates.

Conclusions

Multinational corporations are an integral part of the U.S. economy, and their foreign activities are part of their domestic success. Accordingly, we must ensure that U.S. tax rules do not impact the ability of U.S. multinationals to compete successfully around the world. Policymakers should continue to review carefully the U.S. international tax system, including fundamental reforms like a territorial system, with a view to removing biases against the ability of U.S. multinationals to compete globally. Such reforms would enhance the well-being of American families and allow the United States to retain its world economic leadership. These gains should contribute to the growing interest in fundamental tax reform.

ENDNOTES

* This speech took place on November 14, 2003, and has been edited, annotated and expanded.