BACKGROUND PAPER #12

UNITED STATES INTERNATIONAL TAX POLICY: TAX NEUTRALITY OR INVESTMENT PROTECTIONISM?

November 1994

By J. D. Foster, Ph.D.
Executive Director and Chief Economist
Tax Foundation
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Executive Summary

There has been little debate about international tax policy design since the 1986 Tax Reform Act, in stark contrast to the growing tensions between U.S. international tax policy and the increasingly international economy in which U.S. businesses compete. The debate on international tax policy has historically been couched in terms of two competing theories of tax neutrality. One of these theories, known as territoriality, seeks to prevent domestic tax considerations from diminishing or improving the competitiveness of any domestic taxpayer's foreign investments. Under territoriality, the taxpayer's home country forgoes taxing all foreign source income as long as the income is not afforded special tax treatment in the country in which the investment is made.

The alternative theory, known as capital export neutrality, seeks a domestic tax policy that eliminates tax considerations for investors choosing between domestic and foreign investment opportunities. The measures it suggests are simple: impose domestic tax on foreign source income and allow a tax credit in the amount of foreign taxes paid to be used against domestic tax liability from both foreign and domestic source income.

U.S. policy was founded on the theory of capital export neutrality, but in practice, however, current policy varies significantly from the theory. U.S. policy seeks to ensure that U.S. taxpayers' income from foreign investment is subject to at least as much tax (foreign and U.S.) as domestic investment. This policy is driven by a desire to prevent the U.S. tax code from creating a tax incentive for U.S. businesses to invest abroad. According to proponents of this policy, such an incentive would exist if U.S. citizens' foreign source income, which may be taxed more lightly abroad than it would be if it were earned and taxed in the United States, was exempt from tax at home. This concern is buttressed by the notion that it may be unfair to allow U.S. taxpayers to pay a lower rate of tax on foreign than on domestic income.

Current U.S. policy is not without its consequences. Unquestionably, imposing U.S. tax on foreign source income puts many U.S. businesses at a competitive disadvantage relative to foreign-based businesses. In some cases, this disadvantage can be substantial. For example, according to a recent Tax Foundation study a U.S. investment in Japan must be well over 15 percent more productive than a similar domestic Japanese investment to overcome the extra burden imposed by U.S. taxes.

This paper argues that current U.S. tax policy ultimately aims to preserve the U.S. as a place to invest by creating a tax disincentive to foreign investment. This policy bears a striking resemblance to tariff and nontariff barriers, such as voluntary restraint agreements, which are designed to shield U.S. markets from foreign competition. While trade protectionism is designed to preserve domestic investment and jobs in the face of foreign competition, investment protectionism is designed to preserve domestic investment in the face of more competitive foreign opportunities.
Introduction

International tax policy has received little attention in the United States in recent years. Aside from such developments as the recently released Section 482 transfer-pricing regulations and accompanying penalties, little has been done to alter the basic design of U.S. tax policy since the Tax Reform Act of 1986.

Attention to U.S. international tax policy is long overdue. The current rules raise important questions regarding the competitiveness of U.S. businesses, because the United States collects additional tax on some foreign income of U.S. multinationals, in effect reducing the competitiveness of these businesses relative to their foreign counterparts. Some analysts argue there is no tax policy criterion that can reasonably justify this additional burden and, therefore, support capital import neutrality, or territoriality. Others argue that the current rules are essential to prevent what would otherwise be a tax subsidy for foreign investment at the expense of U.S. domestic investment. Individuals taking this latter view advocate the use of a foreign tax credit approach, or capital export neutrality.

The choice of an international tax policy thus depends on certain key issues of economic policy. U.S. businesses are under increasing pressure in international markets and must constantly strive to raise quality while controlling costs. The beneficiaries of these efforts are U.S. suppliers, U.S. workers, U.S. savers, and U.S. investors. Tax policies that raise costs clearly hamper these efforts. On the other hand, additional domestic investment is crucial to raising the living standards of U.S. workers, and for this reason tax policy should not create special incentives to invest abroad. Only a working definition of tax neutrality can resolve this issue, as it promises the most rapid improvement in both competitiveness and in living standards.

Other aspects of the international tax system are also at issue, such as the complexity of the U.S. tax code and the ability of the Internal Revenue Service to administer it. Anyone listening to the men and women of corporate tax departments who wrestle with U.S. international tax law on a regular basis cannot help but be impressed by their repeated and sincere expressions of frustration with the law’s complexity. This complexity, of course, results in higher compliance costs. In a recent Tax Foundation study of corporate tax departments of major U.S. corporations, 93 of 253 respondents with foreign operations listed the foreign tax area to be the primary source of compliance costs, exceeding even the Alternative Minimum Tax.¹

This complexity makes the code difficult to administer. Internal Revenue Service agents must keep abreast of ever-changing tax rules and regulations and know which version of a rule should be applied to which particular tax year. The agents must also be aware of the changing economic environment in which taxpayers operate to understand how to apply the rules. And, when disputes arise between the tax service and the corporate taxpayer, the IRS is increasingly overmatched by corporate tax departments supported by outside legal counsel.

While some important issues are at stake—competitiveness and economic prosperity, for example, as well as the costs of complexity and the difficulty of administering the tax code—neither side in this long-standing debate has been able to make a fully compelling case for its position. Unquestionably, the U.S. tax on foreign source income imposes an additional competitive burden on U.S. busi-
nesses, though the magnitude of the burden can be debated. An important question is whether this competitive burden can be justified by some other tax policy consideration. The presumptions in most matters of law are that (1) the existing rules are correct, and (2) that the burden of proof is on those demanding change. But the current tax code has become so difficult to work with, and its effects on competitiveness are so profound, that the burden of proof may lie with the advocates of the current U.S. international tax provisions. It is necessary to look closely at the theories underlying U.S. policy (and at their alternatives) to determine whether the current policy can be justified.

The Internationalization of Commerce

U.S. international tax policy was established with the income tax itself in 1913 and was significantly refined in 1962, at a time when international trade and investment flows were relatively insignificant and structurally much simpler. Today, the U.S. economy is part of a world in transition to a truly international marketplace. Goods, services, and financial markets are becoming increasingly integrated on a global basis. Multilateral efforts to remove cross-border investment and foreign exchange controls and to expand the global information network, as well as the increasing ease with which people and products move and can be moved have accelerated the trend toward economic integration largely through the activities of multinational corporations.

Numerous barriers to a fully integrated world market still exist, however. As tariffs and quotas to protect home markets become harder to justify, many countries have come to rely more heavily on qualitative and environmental regulations to block imports. Others rely on sophisticated subsidies that give domestic producers a significant cost advantage over foreign competitors. Each of these barriers impedes the free flow of goods and services and discourages businesses from allocating resources in the most efficient manner. Trade and investment barriers necessarily raise the costs of production, creating competitive advantages for some businesses and disadvantages for others.

In the fully integrated world of tomorrow, businesses will face market conditions that are far closer to the economist's paradigm of a perfectly competitive market. Many markets today are far more sensitive to quality and pricing than they were only a few years ago. This sensitivity will continue to grow, expanding to virtually all markets for goods and services. Only cutting-edge technology that raises the quality of goods or reduces the costs of production will produce even temporarily above-average profits.

Businesses will find that in the integrated world of tomorrow, suppliers, customers, employees, and competitors will come from all corners of the globe. Companies will have sales offices and production facilities wherever market conditions dictate and will engage in a wide variety of long- and short-term partnership arrangements and joint ventures to take advantage of temporary market opportunities. The nationalities of shareholders of publicly held corporations will increasingly reflect the distribution of wealth across all nations. For example, if U.S. and Japanese citizens own 15 percent and 10 percent of the world's wealth respectively, then 15 percent of the average U.S. corporation will be owned by U.S. nationals and 10
percent of the average Japanese corporation will be owned by Japanese nationals.

Many U.S. corporations, such as Ford Motor Company, are already approaching this degree of world integration. Ford has assembly plants all over the world, as well as subsidiaries that produce automobile parts. Some of its U.S. auto part subsidiaries sell to U.S. assembly plants and some sell to Ford's foreign assembly plants. Ford probably hires some non-U.S. citizens with specialized abilities for U.S. employment and sends some of its U.S. employees to work overseas. Ford also participates in numerous joint ventures and other types of partnership arrangements around the globe, some with companies that are its competitors in other markets. Finally, a fair amount of Ford's stock is held by foreigners.

Given the internationalization of Ford Motor Company, in what sense is it a U.S. corporation? True, Ford is incorporated in the United States, an important fact for certain domestic tax, accounting, and securities purposes, but this fact hardly stamps Ford as a U.S. entity in the economic sense. And Ford is hardly unique. Many U.S. and foreign companies, from businesses offering financial services to petrochemical concerns, have extensive and growing foreign operations. While many of the conditions of a truly integrated market are still years away for some companies, the movement is inexorable. In terms of international tax policy, then, the question that must be asked is whether U.S. policy as it is currently designed is appropriate to the evolving economic environment.

Tax Neutrality

While tax neutrality has not been the focus of most recent tax legislation, it remains the best starting point in any discussion of international tax policy design. A tax is said to be neutral if it leaves undisturbed the relative prices of goods and services, and of individual activities such as leisure and labor or consumption and saving. These relative prices control the levels of activity in virtually every sphere of the economy. As a rule, the relative prices in a free market allocate the society's resources to those activities and outputs that it most values. And a neutral tax neither diminishes a society's ability to produce goods and services nor affects their type or quality.

Distortions may occur when an anomaly in the market causes too many or too few resources to be used in a particular area—for example, when a natural monopoly develops or a producer is unable to capture all the economic returns of investment. An example of the latter arises when the absence of copyright and patent protection for research and development allows other participants in the market to copy a product or process at a relatively low cost, thereby underpricing the business that made the investment.

Government policies can also distort relative prices through taxation and regulation. A tax on capital purchases raises the return required by investors and reduces the amount and types of investments that individuals are willing to make. Thus, a tax on capital purchases raises the price of capital relative to all other factors of production and shifts the production mix to a less efficient combination of these factors. The net result is a lower level of production, a higher cost of production, or both. When taxes distort relative prices, resources are not employed optimally, output levels are lowered, and standards of living are reduced. In general, every U.S. tax distorts some relative prices. For example, a uniform tax on all final sales of goods and services...
theoretically leaves relative prices of consumer goods unchanged. But such a tax raises the price of consumption goods relative to intermediate goods and reduces the value of labor relative to leisure by reducing workers’ purchasing power.

Neutrality is a standard virtually no tax system that raises revenue can attain. This fact does not vitiate the concept as a guide to tax policy, however, because some taxes are more distortionary to relative prices than others. Often, the relative degree of distortion a tax will produce can be determined beforehand. A federal sales tax on all goods is more distortionary than the consumption tax described above because the sales tax discriminates between goods and services. Such a tax can also be more distortionary because it can have an additive effect if it is imposed at each level of production. In this case, it raises the price of products companies sell to one another during the intermediate stages of production relative to the price of products made from raw material by a single business.

**Tax Neutrality in International Taxation**

Applied to the design of international tax policy, tax neutrality suggests that foreign source income should not be subject to domestic taxes since these taxes raise the cost of foreign production. However, tax neutrality applied to domestic source income will have the same result—business income should not be subject to tax. Since domestic business income is subject to tax, the problem in terms of tax neutrality becomes devising an equitable, effective policy toward foreign source income. Traditionally, two theories have been advanced. Proponents of territoriality, also known as capital import neutrality, compare the tax treatment of a domestic taxpayer’s foreign investment with the same investment made by a foreign taxpayer. According to their argument, the U.S. international tax system is neutral only if it does not impose a higher total tax on a U.S. taxpayer’s foreign investment than the same investment would face if made by a foreign investor. For example, if a French national pays 25 cents on each dollar of investment income earned in France, then a U.S. business making the same investment in France should not see its tax liability rise above 25 cents on the dollar through the imposition of U.S. tax.

Territoriality focuses on the competitiveness of a U.S. taxpayer’s individual foreign investments with the aim of preventing domestic tax considerations from diminishing or improving their competitiveness. For example, suppose Hewlett-Packard Company and the German-based Siemens Corporation invest in identical assembly plants in Germany, where the income from their plants is subject to German tax. Proponents of territoriality argue that U.S. international tax policy should not increase the tax burden on the income from the Hewlett-Packard plant, because doing so would cause the Hewlett-Packard plant’s total tax to exceed the Siemens plant’s total tax. Territoriality is neutral with respect to the competitiveness of the investment.

The alternative theory, capital export neutrality, compares the home country with other countries in terms of its profitability as a place for domestic taxpayers to invest. Thus, proponents of capital export neutrality focus on the location of domestically-owned investment. While territoriality aims to prevent domestic tax considerations from rendering foreign investment by domestic
taxpayers uncompetitive, capital export neutrality aims to eliminate tax considerations from the process of deciding whether to invest at home or abroad.

Under capital export neutrality, all foreign source income is subject to the same domestic tax as income earned at home. The tax code in this case does not make distinctions among different kinds of foreign source income or economic activities. A U.S. taxpayer earning foreign income and paying foreign tax will also incur tax liability on that income in the United States. However, the foreign taxes can be applied as a credit against the U.S. tax liability. If the foreign tax liability is less than the U.S. liability, a residual U.S. tax liability remains. But if the foreign taxes are higher than the U.S. taxes, then the excess foreign tax may be taken as a credit against other foreign or U.S. tax liability.²

In effect, tax policy under capital export neutrality is used as a tool to level the tax playing field across countries. Suppose that Hewlett-Packard's German assembly plant earns $100 million in one year and has a U.S. tax rate of 34 percent and a German tax rate of 40 percent. Hewlett-Packard would owe Germany $40 million in tax and have a tentative U.S. tax liability of $34 million. Under a policy of capital export neutrality, the company could use its $40 million in German taxes as a credit against the U.S. tax liability and therefore would owe no U.S. tax on this income. And after offsetting the $34 million U.S. taxes owed on its foreign income, Hewlett-Packard would still have $6 million in excess credits it could use to reduce the U.S. taxes it owes on its domestic source income.

Suppose, however, that the German tax rate is 25 percent instead of 40 percent. In this case, Hewlett-Packard would owe Germany $25 million in tax on its $100 million in German-source earnings and still have a tentative U.S. tax liability of $34 million. However, with a foreign tax credit of only $25 million, the company would owe the U.S. Treasury $9 million in residual tax on its German income, raising the total tax rate on the income from the German plant to 34 percent. Under capital export neutrality, whether the foreign tax rate is higher or lower than the U.S. rate, a U.S. investor's tax rate on foreign source income equals the U.S. tax rate.

Territoriality and capital export neutrality have sometimes been characterized as outward-looking and inward-looking policies, respectively. These characterizations are not completely accurate, even for the purest applications of the concepts. For companies considering an investment in a country with relatively low taxes, the additional U.S. tax under capital export neutrality is a disincentive; no such disincentive exists under territoriality. Thus, in terms of investment in such low-tax countries, the inward- versus outward-looking characterizations are apt. In a country where the foreign tax on foreign source income exceeds the U.S. tax liability on the same income, however, the situation is reversed. Under capital export neutrality, a U.S. parent company can apply any foreign taxes paid on foreign source income that exceed its U.S. tax liability against U.S. taxes on domestic income. No such equalizing credit is available under territoriality. Thus, for investment in high-tax countries, capital export neutrality is actually more outward-looking than territoriality, because it effectively reduces the rate of foreign tax relative to the U.S. rate. Only in practice does the inward- versus outward-looking characterization become appropriate, because no country currently using the
credit system allows businesses to offset domestic tax liability with excess foreign tax credits.

The major difference between territoriality and capital export neutrality is one of objectives: preserving a level playing field for U.S. investors relative to their foreign competitors versus establishing a level playing field between the U.S. and foreign countries as a place to invest. Another difference between the two theories is that territoriality considers individual foreign investments, whereas the capital export approach considers total foreign investment. The argument for territoriality holds that the income from each foreign investment should face the same tax treatment as an investment made by a foreign national. Under capital export neutrality, the domestic taxpayer aggregates all foreign source income and foreign income tax paid in a given period. Thus, the focus under capital export neutrality is on the sum of the company's foreign income and expenses and the foreign income taxes paid.

No major country applies either theory of tax neutrality in its purest form. However, in general, the United States, the United Kingdom, Australia, and New Zealand use capital export neutrality as their starting point, while the nations of continental Europe start with territoriality. The Netherlands appears to come closest to the pure form of the exemption system prescribed by territoriality.

**Taxes as Fees for Services Rendered**

Another, more philosophic, dimension to the design of international tax policy stems from the view that domestic taxation should be based on the economic relationship between the taxpayer and the state. The government can be viewed as a business providing services, including internal and external security, a judicial system, the regulations necessary to maintain a working marketplace, and so forth. From this perspective, it is reasonable to ask all citizens to pay taxes to cover the legitimate costs of the business of government in their home countries.

The justification for imposing taxes based on services rendered certainly provides reasonable grounds for taxing domestic source income, since government services rendered presumably contribute in some way to creating the environment in which the income has been earned. However, it is extremely difficult to stretch this "state as business" argument to cover foreign source income. It is difficult to identify few significant services rendered by the investor's home government to a domestically owned foreign business that are not paid for in full by the domestic parent. From this point of view, the correct policy would seem to be to forego taxing foreign source income. Further, if this "state as business" argument were valid, it would argue for a simple surcharge on foreign source income irrespective of any foreign taxes paid since any services provided by the home government would not be contingent on the level of foreign tax.

**The Role of Tax Fairness**

Whenever a definition of tax neutrality dictates that a particular economic activity be exempted from paying tax, questions of fairness naturally arise. Thus, the reasons for adopting such a definition of tax neutrality must be compelling. For example, a compelling case based on Federalist principles can be made for not taxing the interest paid to
holders of state and local debt. A similarly compelling argument can be made for taxing savings only once, if at all, and for making charitable contributions fully deductible from taxable income.

The Tax Wedge

Tax fairness is about individuals paying tax. If a country exempts foreign source income from taxes under the principle of territoriality, a reasonable question of fairness arises if tax is imposed on domestic income. However, this state of affairs argues against territoriality only if domestic taxpayers actually pay tax—that is, if they suffer a greater loss of income than they would under the capital export neutrality approach. Bonds are a good example here. Taxable bonds carry a higher rate of interest than tax-exempt bonds from identical issuers because the purchaser of the taxable bond demands a higher interest rate to offset the tax owed on the interest income. This difference is what public finance economists call the tax wedge. The tax wedge associated with a particular investment by a particular taxpayer is the difference between the pre-tax yield of the investment and the after-tax return the investor actually receives.

The market is very efficient in ensuring that the tax wedge is maintained. If something happens that momentarily reduces the size of the wedge, and the interest rate on taxable bonds falls relative to that on the tax-exempt bonds, nobody will buy the taxable bonds until the rate returns to its prior level and the wedge is restored. The opposite is also true. If the wedge suddenly increases because the interest rate on taxable bonds rises, a wave of buyers will flood the market and bid up the price of the taxable bonds by bidding down the rate of return.

What is true of taxable bonds is also true of taxable real investments. Every combination of investment and investor has its own tax wedge relative to the return available on, for example, a tax-exempt Treasury bill. The tax wedge can vary according to the investor’s circumstances. For a domestic investment in new equipment, the tax wedge may depend on whether the taxpayer is currently subject to the alternative minimum tax, for example. The wedge can also vary according to the nature of the investment. An investment that receives relatively favorable depreciation treatment will have a smaller tax wedge than an investment receiving less favorable treatment. For domestic investments, the wedge can also depend on the state or locality where the investment is made. For international investments, the wedge will depend, among other things, on the foreign tax rate. In every case, as the tax wedge increases, the pre-tax return the investment must yield also increases.

Investors facing a relatively high tax wedge will find the range of profitable, taxable investment options limited. However, their after-tax return on acceptable investments will not differ from what they would receive on a tax-exempt investment (except in the case of riskier investments, for which a higher return is required). For both types of investors, the minimum acceptable return is the return available on tax-exempt investments. This situation suggests that high tax burdens limit the amount of investment that will take place, but do not affect the after-tax returns of the investors.

The International Tax Wedge

This lesson applies in full to international investment. If U.S. and foreign tax systems together produce a high level of taxation on foreign investment by U.S. companies, the effect is to increase the
taxpayer’s tax wedge on these investments, just as a high rate of tax on taxable interest raises the interest rate on taxable bonds. The range of the companies’ profitable investments is then limited, since fewer investments yield such high returns. The after-tax return is the same in each case, and the term “tax fairness” loses its meaning with respect to the international investor because the taxation of every investment voluntarily undertaken is neutral with respect to the investor. Neutrality with respect to the investment is another matter entirely.

Consider a U.S. parent company deciding whether to make an investment at home or abroad. Suppose the choice of location is entirely discretionary and the foreign tax rate is lower than the U.S. rate. From the investor’s perspective, as we have learned, there is no question of neutrality. From the perspective of the investment, on the other hand, an investment made abroad faces a lower tax rate, a lower tax wedge, and thus more neutral tax treatment. If, however, the United States taxes the income from the investment under the principle of capital export neutrality, the tax system is less neutral from the perspective of the investment. In reality, however, the tax does not promote neutrality with respect to the investor, because the additional tax burden raises the pre-tax return required from the investment but does not affect the after-tax return to the investor.

If capital export neutrality is not neutral with respect to the investment, and if the concept of neutrality with respect to the investor is vacuous, in what sense is capital export neutrality neutral? Imposing the U.S. tax in fact creates a new dimension of neutrality that could be labelled nationalist tax neutrality and has nothing to do with either the investment or the investor. Under nationalist tax neutrality, the goal is to eliminate the perceived tax incentives to investment abroad created by relatively lower foreign tax burdens. Such a system is similar to a capital export control mechanism, the purpose of which is to protect domestic production and employment by discouraging foreign investment.

**U.S. International Tax Policy**

U.S. international tax policy is usually described as an attempt to apply capital export neutrality. Indeed, of the two definitions discussed here, U.S. policy lies closer to capital export neutrality than to territoriality. However, in practice, U.S. policy bears little resemblance to either system. The foreign tax credit, which is used to avoid double taxation and to create a more level playing field between the desirability of the United States and foreign countries as places to invest, is the foundation for the claim that U.S. international tax policy is an application of capital export neutrality. However, once this factor is excluded, U.S. policy diverges dramatically from the theory of capital export neutrality. For example, the United States restricts the use of foreign tax credits to offset U.S. tax owed on other foreign source income and prohibits them from being used to offset tax owed on domestic source income. Each of these restrictions violates the principle of capital export neutrality, which permits the unrestricted use of foreign tax credits to offset other tax liabilities and disregards the form of both the taxpayer’s business unit and income.

In effect, then, U.S. policy has created a domestic basket and a foreign basket for aggregating income and associated credits. In the debate on the 1986 Tax Reform Act, the U.S. Treasury proposed a
per-country limitation on the use of the foreign tax credit to disaggregate foreign source income still further. Under this system, taxpayers have as many foreign baskets as they have countries where they earn income. The per-country limitation proposal was eventually abandoned. But the effort to disaggregate foreign source income and foreign tax credits was not. The Treasury and the Congress reacted by creating thirteen "baskets" for foreign source income that classify income by type rather than by country of origin. For example, taxpayers must put all net income from foreign shipping activities into one basket and income from jurisdictions with high withholding taxes into another. Taxpayers may use excess credits from a portion of the income in a given basket to offset residual U.S. tax liability on another portion of the income in that basket but not to offset residual U.S. tax liability arising out of another basket of income.

In this respect, U.S. international tax policy is evolving in a manner that defies the definitions of either territoriality or capital export neutrality. The trend in U.S. international tax policy appears to be toward ever-greater disaggregation of foreign source income and foreign tax credits. The result is increasing complexity and further erosion of the efforts of U.S. multinational corporations to soften the anticompetitive effects of U.S. tax policy. Carried to its extreme, U.S. policy would require international commerce be handled on a transaction-by-transaction basis. That is, each transaction would be subject to U.S. tax using a fully disaggregated foreign tax credit system.

The U.S. generally allows taxpayers to defer recognition of tax liability on foreign source income earned by foreign subsidiaries. However, such deferral is consistent with capital export neutrality only to the extent that the taxpayer is allowed to defer recognition of domestic source income. The Subpart F rules of the tax code, which eliminate deferral for passive income, however, may work against capital export neutrality. Under Subpart F, taxpayers are precluded from deferring the recognition of income from a broad range of income types, primarily financial income such as dividends, interest, and royalties. In those instances when a U.S. parent company is able to defer recognition of income earned by a domestic subsidiary, Subpart F also violates capital export neutrality.

The Competitive Effects of U.S. International Tax Policy

A recent analysis by Yale University Professor Joosung Jun addressed the question of the competitiveness of U.S. businesses relative to their foreign counterparts in light of U.S. and foreign tax practices. Among other things, Jun's analysis compares the cost of capital for U.S. businesses abroad with that for foreign businesses operating in their own countries. In addition, the analysis considers whether U.S. businesses operating at home face lower capital costs than foreign companies operating in the U.S. The study found that the cost of capital for domestic investment can indeed differ from the cost of capital for foreign investment, because either the cost of funds or the taxes on capital income differ across countries. Most prior studies have focused only on the differences in the cost of capital between U.S. businesses and their foreign counterparts that can be attributed to variances in the domestic cost of funds.

While systems of international taxation can significantly complicate compari-
sons of the cost of capital, Jun attempts to focus exclusively on the effects of these systems. He isolated and estimated the effects of various international tax rules on the cost of capital while holding relative financing costs constant. The cost of capital is the pre-tax rate of return that a corporation must earn to pay the rate of return lenders require. The discount rate used in calculating the cost of capital for domestic investment is determined either by the rate of return shareholders require or by the risk-adjusted after-tax rate of return on alternative investment opportunities.

The cost of capital for U.S. businesses and their domestic competitors in major foreign markets is depicted in Table 1. The first column reports the cost of capital for domestic investment—for instance, the cost of capital for a German business investing in Germany. The second column shows the cost of capital facing U.S. businesses in each of the foreign countries represented.

The figures reported in Table 1 show that U.S. international tax policy places U.S. businesses at a significant disadvantage relative to their foreign counterparts. For example, the cost of capital for U.S. businesses in Japan is estimated to be 10.6 percent, compared to 9 percent for their Japanese counterparts. Thus, U.S. capital in Japan must be about 17 percent more profitable than Japanese capital.

Table 1 also demonstrates how far U.S. international tax policy diverges in practice from the theory of capital export neutrality. According to the figures, the cost of capital facing domestic businesses in four countries—France, the Netherlands, Sweden, and Switzerland—is lower than it is in the United States. Under capital export neutrality, U.S. taxes should raise the cost of capital for U.S. businesses in these countries up to, but no higher than, the level facing U.S. domestic businesses—e.g., 7.6 percent. In fact, however, in every country except the Netherlands, the cost of capital facing a U.S. business is significantly higher than it is in the United States.

The cost of capital for U.S. businesses in countries where the cost of capital for foreign businesses is higher than the cost of capital facing U.S. businesses operating at home is even more striking. Under capital export neutrality, if the foreign tax exceeds the U.S. tax on foreign source income, the foreign tax credit should prevent U.S. tax from adding to the total tax liability. In fact, however, in every reported case, U.S. tax raises the cost of capital even further.

Territoriality and Investment

Introducing a territorial system would be a fairly straightforward process, with the exception of the treatment of some types of passive income. Even in those countries that adhere most closely to the principle of territoriality, care has been taken to ensure that various forms of passive income are subject to tax at least once. This practice is deemed necessary because of the ease with which liquid funds can be transferred to low-tax jurisdictions, or tax havens.

The treatment of previously earned foreign income and tax credits could also pose problems when a territorial system is adopted. Some taxpayers would have foreign earnings that would generate U.S. tax liability if they were repatriated immediately. For these taxpayers, applying territoriality retroactively would produce a windfall profit, because the deferred tax liability would be eliminated. Other taxpayers, however, would have accumulated significant foreign tax
# TABLE 1

The Cost of Capital for U.S. and Domestic Firms in Foreign Markets (in percent)

<table>
<thead>
<tr>
<th>Host Country</th>
<th>Domestic Firms</th>
<th>U.S. Firms</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td>7.6</td>
<td></td>
</tr>
<tr>
<td>Japan</td>
<td>9.0</td>
<td>10.6</td>
</tr>
<tr>
<td>Canada</td>
<td>8.1</td>
<td>9.5</td>
</tr>
<tr>
<td>France</td>
<td>7.3</td>
<td>9.7</td>
</tr>
<tr>
<td>Germany</td>
<td>8.3</td>
<td>9.5</td>
</tr>
<tr>
<td>Netherlands</td>
<td>7.1</td>
<td>7.8</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>7.7</td>
<td>8.6</td>
</tr>
<tr>
<td>Italy</td>
<td>9.1</td>
<td>9.9</td>
</tr>
<tr>
<td>Sweden</td>
<td>7.2</td>
<td>8.8</td>
</tr>
<tr>
<td>Switzerland</td>
<td>6.6</td>
<td>8.2</td>
</tr>
<tr>
<td>Australia</td>
<td>9.0</td>
<td>11.5</td>
</tr>
</tbody>
</table>

Average 8.0 9.3

credits that would be lost if the income were repatriated immediately or the credits effectively voided by applying territoriality retroactively. The loss of these credits could have a significant, negative effect on the balance sheets of many U.S. businesses.

There is a further difficulty in introducing territoriality retroactively, given the fungibility of income and capital. If territoriality were adopted prospectively only, those taxpayers desiring to repatriate "old" earnings would doubtlessly find ways to do so through transfer pricing, refinancings, restructurings, and the like without subjecting previously earned foreign income to U.S. tax. These maneuverings, developed entirely to avoid domestic tax on earlier earnings, would serve no economic purpose.

If the United States were to abandon the foreign tax credit system in favor of territoriality, certain consequences for the domestic economy would inevitably follow. First, many foreign investments would face a lower tax rate, encouraging U.S. businesses to increase their foreign investments. This shift would have a temporary dampening effect on U.S. domestic investment. As U.S. foreign investment increased, however, U.S. exports (particularly to the foreign operations of U.S. businesses) would begin to expand, increasing the demand for U.S. goods and encouraging domestic investment.

It is also important to consider the consequences of adopting territoriality for corporate repatriations. All unrepatriated earnings are subject to a foreign tax rate (inclusive of withholdings) that is lower than, equal to, or higher than the U.S. rate. Only earnings bearing a tax rate approximately equal to the U.S. rate would be unaffected by a switch to territoriality. A disincentive (i.e., residual U.S. tax liability) exists to repatriating foreign source earnings that are subject to lower tax rates abroad than at home. And taxpayers are discouraged from repatriating foreign source earnings that are subject to high tax rates unless they can be aggregated with other, low-tax earnings; because otherwise, the U.S. parent loses valuable foreign tax credits.

Over the years, U.S. businesses have accumulated an enormous stock of unrepatriated foreign earnings. With or without a U.S. tax, some of these earnings would have been left abroad to finance further foreign investments. However, a share of these earnings would have been repatriated had the U.S. adopted territoriality and would still be repatriated if the U.S. adopts such a system in the future. By adopting territoriality, therefore, the United States could enjoy a significant, one-time repatriation of accumulated foreign earnings, which would then be available for domestic investment or distribution to shareholders. Any negative, short-term effect on domestic investment should be more than offset by the additional domestic savings and investment from the one-time infusion of repatriated accumulated foreign earnings.

Such developments would have important implications for U.S. international trade flows and exchange rates. For example, the one-time surge of repatriated earnings would tend to move the United States toward a strong capital importing position, and to increase imports and the exchange value of the dollar. Once the repatriation flow ebbed, the long-term effect of increased foreign investment would dominate, the exchange rate would return to more normal levels, and U.S. net exports would increase, particularly to the new, U.S.-owned foreign operations.
Conclusion

Traditional notions of taxing income that rely on legal concepts of domicile or on political concepts of sovereignty may not be suitable for today's complex international commercial transactions. Cross-border international business organizations are not extensions of any particular nation but economic mechanisms that transcend legalistic or political definitions. U.S. tax policy toward foreign source income should reflect these developments and recognize the benefits of encouraging U.S. businesses to make the most economically sound investments.

Capital export neutrality, as it is currently applied in the United States, seeks to preserve the country as a place to invest in the face of opportunities for foreign investment at lower tax rates by creating a tax disincentive to investing overseas. In this sense, current U.S. international tax policy bears a striking resemblance to domestic policies that protect U.S. markets from foreign competition. Just as trade protectionism is designed to preserve domestic investment and jobs in the face of foreign competition, international investment protectionism is designed to preserve domestic investment in the face of more competitive foreign investment opportunities. Theoretical support for U.S. international tax policy is further weakened by its tendency to veer dramatically from capital export neutrality. Its weaknesses come with a high cost: a clear loss of competitiveness for U.S. businesses at home and abroad due to the imposition of U.S. tax on foreign source income. This loss of competitiveness is manifested in foregone investment opportunities, decreased domestic employment, and lower tax revenues.

Territoriality, on the other hand, seeks to preserve the international competitiveness of U.S. businesses both at home and abroad. Territoriality would improve the ability of U.S. businesses to invest overseas, in turn enhancing their ability to export U.S. goods and services. Because of the large pool of unrepatriated foreign earnings of U.S. multinational corporations, the adoption of territoriality would also result in a large influx of earnings, improving prospects for domestic investment while reducing the tax disincentives to foreign investment.
Endnotes


2 As explained in more detail below, U.S. tax policy is based largely on capital export neutrality, but diverges from theory in a number of significant respects, most importantly in that excess foreign tax credits may be used to offset U.S. tax owed on other foreign source income, but may not be used to offset U.S. tax owed on domestic income.


4 To highlight the differential effects of taxes on domestic and foreign investment (given the same cost of funds), this paper assumes that parent corporations use retained earnings as the primary source of funds for both domestic and foreign investment. The paper does not take into account personal taxes in calculating the corporate cost of capital.

5 There are many similarities between the unlocking of foreign earnings that would occur if territoriality were adopted and the unlocking of capital gains that occurs whenever the capital gains tax rate is reduced. In each case, capital is able to flow more easily to its most productive uses, resulting in a net increase in the return to the nation's capital stock.