TAX FOUNDATION

Promoting Trade, Shackling Our Traders

J.D. FOSTER, PH.D.
EXECUTIVE DIRECTOR AND CHIEF ECONOMIST
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NOVEMBER 1997

BACKGROUND PAPER NO. 21

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Since 1937

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Introduction

The pursuit of free trade has been a bipartisan hallmark of U.S. policy for decades. U.S. negotiators have sought lower trade barriers and open markets through the trade agreement with Canada, the expansion of that agreement to include Mexico, and various multilateral negotiations involving the General Agreement on Tariffs and Trade. Most recently, President Clinton has asked Congress to renew his authority to negotiate additional trade pacts on a "Fast Track" basis.

In Europe, efforts continue to integrate the continent into a single trading block. On the other side of the globe, various countries in Asia are also seeking to establish more effective free trade arrangements. Support for free trade continues worldwide because it is ultimately good for workers and for consumers.

While free trade policies continue to advance into the 21st century, U.S. international tax policy remains in the dark ages. Indeed, the very concerns sometimes raised about free trade arise in tax policy. In this paper, we consider the structure of U.S. international tax policy, its consequences, and its justifications, all in the reflected light of free trade principles.

The Clash of International Tax and Trade Policies

The free market is the superior economic system because natural market forces encourage participants to make the best possible use of the nation's resources. At the same time, it provides the widest possible range of products and services to consumers. The free market is built on a very few simple principles, such as voluntary exchange for mutual benefit, respect for private property rights, the rule of law, and the free establishment of prices by market participants.

The free establishment of prices is particularly important for reaping the gains from international trade and for understanding the economic effects of tax policy. Prices provide the traffic signals that direct the flow of resources, goods, and services. Undistorted, these prices yield the optimal allocation of resources and distribution of output. Whether by trade, tax policies, other policies, or by market anomolies, distorted prices yield distorted allocations and distributions.

The success of U.S. international trade policy, both politically and economically, depends on U.S. companies' ability to compete in global markets. A fundamental synergy exists between trade policy and other policies — trade policy cannot succeed unless U.S. companies succeed; U.S. companies' success depends in part on the appropriate choice of other government policies that can negate or preserve the benefits of international trade. A key factor limiting U.S. companies' success in the international arena is the federal income tax. By its very nature, the income tax distorts the economic decisions businesses and individuals make every day about how to allocate their scarce resources of capital, labor, energy, and time. These distortions arise in the domestic economy and in the international arena.

U.S. international tax policy imposes federal income tax on the worldwide income of U.S. citizens while taking precautions to avoid double taxation, on the one hand, and tax evasion on the other. This simply means that, as far as the federal income tax is concerned, income earned by a U.S. citizen is subject to U.S. tax, and the calculation of the tax is roughly the same, whether the income is earned at home or abroad. This approach, called "worldwide taxation" or "capital-export neutrality,"[1] ensures that the foreign source income of U.S. citizens bears at least as much total income tax as the income would bear if it had been earned at home.

Foreign governments impose various taxes on income earned in their countries, often including an income tax. Both the U.S. and the foreign government have the right and the ability to tax U.S. citizens' foreign source income. If they each exercise that right, double taxation will surely follow, except that the resulting level of tax would probably preclude the income producing activity in the first place. A basic tenet of good tax policy is that all income should be taxed once and only once. Double taxation, whether of saving, corporate income, or foreign source income should be avoided wherever possible. One solution for avoiding double taxation is for the foreign government to decline to tax the foreign income of U.S. citizens, while the U.S. reciprocally declines to tax income earned in the U.S. by the foreign country's citizens. Governments insist on taxing the economic activity and persons within their own borders, however, so this solution is not feasible.

Alternatively, the U.S. could decline to tax the foreign source income of U.S. residents, so that this income would be subject to tax only in the country where the income is earned. This system, known as "territoriality," is practiced to a greater or lesser extent by many of our major trading partners.

A third option, which is the basis of U.S. tax policy and is demonstrated in Example 1 (below), is to avoid double taxation by allowing a foreign tax credit against U.S. income tax liability for foreign income taxes paid.

Properly applied, the foreign tax credit approach prevents double taxation. However, even properly applied, worldwide taxation often places U.S. companies

Example 1

Suppose P, a U.S. parent company, earned $100 million in country M through a foreign branch A, and suppose it paid $25 million in income taxes to M. Company P receives $25 million in U.S. foreign tax credits associated with this income. With a U.S. corporate income tax rate of 35 percent, P would incur a pre-credit U.S. liability of $35 million on the income earned by A. After applying the $25 million tax credit for taxes paid to M, Company P has a residual U.S. income tax liability of $10 million.

	Income Earned	Income Taxes Owed	Foreign Income Tax Credit
Foreign Source	$ 100 million		
(Paid to M, 25% rate)		$ 25 million	
U.S. Reported Foreign Income	$ 100 million		
(35% rate, pre-foreign tax credit)		$ 35 million	
Available Foreign Tax Credit			$ 25 million
Residual U.S. Tax		$ 10 million	

at a competitive disadvantage. If income earned abroad is subject to a foreign income tax rate that is less than what a foreign-owned company faces, then U.S. tax policy imposes a burden on U.S. companies not borne by their foreign competition. In Example 1, everything else held equal, U.S. company P owes $10 million more in tax than would a foreign-owned company operating in country M engaged in the same activities.

The Foreign Tax Credit Limitation

When the foreign income tax rate exceeds the U.S. rate, then the pure application of worldwide taxation conflicts with another basic proposition of tax policy: the need to protect the domestic tax base. As Example 2 (below) demonstrates, without some form of restriction, worldwide taxation would allow country M effectively to import some of the U.S. tax base at no cost to itself.

To prevent this, the foreign tax credit limitation caps the amount of foreign tax credit available at the U.S. tax liability on foreign source income. In Example 3 (on page 4), after applying the foreign tax credit limitation, U.S. tax on U.S. source income would remain $35 million and the maximum foreign tax credit available would be $35 million, leaving the parent

Example 2

Suppose the same set of facts as in Example 1, except that now the foreign branch A pays $50 million in foreign tax. Under worldwide taxation, P has a $50 million foreign tax credit associated with its foreign income, which more than offsets its $35 million U.S. tax liability on this income. The parent company is therefore in what is called an excess credit position. Under pure worldwide taxation and without any limitation, P *could* use its excess foreign tax credits against its U.S. income tax liability arising out of U.S. activities.

	Income Earned	Income Taxes Owed	Foreign Income Tax Credit
Foreign Source Income (50% rate)	$ 100 million	$ 50 million	
U.S. Reported Foreign Income (35% rate, pre-foreign tax credit)	$ 100 million	$ 35 million	
Available Foreign Tax Credit			$ 50 million
U.S. Domestic Income (35 % rate)	$100 million	$ 35 million	
Total Taxable Income	$ 200 million		
Total U.S. Pre-Credit Tax		$ 70 million	
Total U.S. Tax, After Foreign Tax Credits		$20 million	

company with $15 million in excess foreign tax credits.

Foreign Tax Credit Baskets

The application of foreign tax credits was further limited as part of the 1986 Tax Reform Act. The Act created special limitation rules, or baskets, for various classes of income. Under these rules foreign source income is allocated to one of nine special baskets. Income not allocated to one of the special baskets is allocated to a "general" basket. The nine income baskets relate to:

(1) Passive income (after removing highly taxed passive income);
(2) Interest income subject to a withholding tax rate of 5 percent or greater;
(3) Financial services income;
(4) Shipping income;
(5) Dividends from foreign corporations in which the U.S. shareholder has at least 10 percent, but not more than 50 percent ownership;
(6) Dividends from a Domestic International Sales Corporation;
(7) Taxable income attributable to foreign trade income;
(8) Distributions from a Foreign Sales Corporation; and
(9) Foreign oil and gas extraction income.

Under the new basketing rules, a company earning financial services income, for example, must separate this

Example 3

	Income Earned	Income Taxes Owed	Foreign Income Tax Credit
Foreign Source Income (50% rate)	$ 100 million	$ 50 million	
U.S. Reported Foreign Income (35% rate, pre-foreign tax credit)	$ 100 million	$ 35 million	
Available Foreign Tax Credit			$ 50 million
Excess Foreign Tax Credit			$ 15 million
U.S. Domestic Income (35 % rate)	$100 million	$ 35 million	
Total Taxable Income (35% rate)	$ 200 million	$ 70 million	
Total U.S. Pre-Credit Tax		$ 70 million	
Total U.S. Tax, After Limited Foreign Tax Credits		$ 35 million	

income and its associated foreign tax credits from all other income for purposes of calculating the foreign tax credit limitation. The effects of the multi-basket regime are demonstrated in Example 4.

Aside from raising revenue, the separate basket limitation rules were intended to achieve two policy goals. The first is to move the taxation of foreign source income onto more of a transactional basis, rather than the traditional aggregative basis normally associated with an income

Example 4

Suppose a U.S. automobile company's foreign subsidiary had income from foreign manufacturing and sales of $850 million and paid foreign income tax of $255 million. Suppose the subsidiary financed many of these sales, so that it has financial services income of $100 million on which it paid $45 million in tax. Suppose it also has a fleet of container ships that it uses to transport cars and car parts and that the fleet generated an additional $50 million in income and $20 million in foreign income tax.

Under an overall limitation in which all the company's income falls in a single basket, the subsidiary would have a total of $1 billion in foreign source income, a tentative $350 million U.S. income tax liability, $320 million in available foreign tax credits, and a residual U.S. tax liability of $30 million. The multiple basket approach, however, leaves the company with a net tax increase of $12.5 million and a like amount of excess foreign tax credits.

Overall Limitation

	Income Earned	Income Taxes Owed	Foreign Income Tax Credit
Foreign Source Income (30% rate)	$ 850 million	$ 255 million	
Foreign Financial Services Income (45% foreign tax rate)	$ 100 million	$ 45 million	
Foreign Shipping Income (40% foreign tax rate)	$ 50 million	$ 20 million	
Total U.S. Reported Foreign Income (35% U.S. rate, pre-foreign tax credit)	$ 1 billion	$ 350 million	
Available Foreign Tax Credits			$ 320 million
Residual U.S. Tax After Limited Foreign Tax Credits		$ 30 million	
Excess Foreign Tax Credits			$ 0 million

Continued next page

Example 4 (cont.)
Separate Basket Limitation

	Income Earned	Income Taxes Owed	Foreign Income Tax Credit
General Basket			
Foreign Source Income (30% rate)	$ 850 million	$ 255 million	
U.S. Reported General Foreign Income (35% U.S. rate)	$ 850 million	$ 297.5 million	
Available General Foreign Tax Credits			$ 255 million
Residual U.S. Tax After Limited Foreign Tax Credits		$42.5 million	
Financial Services Basket			
Foreign Financial Services Income (45% foreign tax rate)	$ 100 million	$ 45 million	
U.S. Reported Foreign Financial Services Income (35% U.S. rate)	$ 100 million	$ 35 million	
Available Foreign Financial Services Tax Credits			$ 45 million
Residual U.S. Tax After Limited Foreign Tax Credits		$ 0 million	
Excess Financial Services Foreign Tax Credits			$ 10 million
Shipping Income Basket			
Foreign Shipping Income (40% foreign tax rate)	$ 50 million	$ 20 million	
U.S. Reported Foreign Shipping Income (35% U.S. rate, pre-foreign tax credit)	$ 50 million	$ 17.5 million	
Available Foreign Shipping Income Tax Credit			$ 20 million
U.S. Tax After Limited Foreign Tax Credits		$ 0 million	
Excess Shipping Income Foreign Tax Credits			$ 2.5 million
Total Residual U.S. Tax, All Baskets		$ 42.5 million	
Total Excess Foreign Tax Credits			$ 12.5 million
Net Increase in Residual U.S. Tax on Foreign Income		**$ 12.5 million**	

Example 5

Suppose U.S.-owned foreign subsidiary S invests $10 million in country M to replace machinery about to be retired. Suppose country M allows taxpayers to expense their investments in the year in which they are made, while the U.S. requires depreciation to be taken over four years, starting at 40% of basis and falling 10 percent per year thereafter. Further, suppose subsidiary S makes $15 million in the current year and in the following three years, that the subsidiary has $5 million in other deductible expenses each year, and that the foreign and U.S. income tax rates are 40 percent and 35 percent, respectively.

As Table 1 reveals, under these circumstances, if the U.S. parent must pay U.S. tax on its foreign source income in the period in which the income is earned, it will owe $2.1 million in U.S. tax on its foreign source income in the first year. However, it will pay no foreign tax and therefore accrue no foreign tax credits in that period. In all future periods, a significant foreign tax will be owed. Overall, without deferral the company will face an effective total tax rate in current dollar terms of 47 percent ($14.1 million in tax from $30 million - in net income), exceeding even the higher foreign tax rate.

Table 1

	Foreign Tax Liability		U.S. Tax Liability	
	Income	Expense	Income	Expense
Year 1				
Gross Income	$ 15 million		$ 15 million	
Depreciation		$ 10 million		$ 4 million
Other Expenses		$ 5 million		$ 5 million
Taxable Income		$ 0		$ 6 million
Pre-Credit Tax Owed				$ 2.1 million
Tax Paid		$ 0		$ 2.1 million
Year 2				
Gross Income	$ 15 million		$ 15 million	
Depreciation		$ 0		$ 3 million
Other Expenses		$ 5 million		$ 5 million
Taxable Income		$ 10 million		$ 7 million
Pre-Credit Tax Owed				$ 2.45 million
Tax Paid		$ 4 million		$ 0
Year 3				
Gross Income	$ 15 million		$ 15 million	
Depreciation		$ 0		$ 2 million
Other Expenses		$ 5 million		$ 5 million
Taxable Income		$ 10 million		$ 8 million
Pre-Credit Tax Owed				$ 2.8 million
Tax Paid		$ 4 million		$ 0
Year 4				
Gross Income	$ 15 million		$ 15 million	
Depreciation		$ 0		$ 1 million
Other Expenses		$ 5 million		$ 5 million
Taxable Income		$ 10 million		$ 9 million
Pre-Credit Tax Owed				$ 3.15 million
Tax Paid		$ 4 million		$ 0

tax. There is a view that, ideally, every transaction would give rise to a separate income, U.S. income tax, and foreign tax credit limitation calculation. This would be similar to a per item tax as arises with a sales tax, for instance. If the U.S. were seeking to move towards a transactional system domestically, such as a traditional value-added tax or national sales tax, then such a move in foreign tax policy would be well motivated. The U.S. domestic income tax, however, is fundamentally a tax on tax payers' incomes, not on their underlying transactions or activities. Thus this shift in foreign tax policy lacks a reasonable motivation.

The second policy goal behind the multi-basket approach is to defend the global economy and the global tax system from undue tax competition. The concern is that foreign countries occasionally opt not to tax some categories of foreign source income, or to tax it at concessional rates, in the hope of creating a more inviting investment climate. To the extent the U.S. imposes a tax on income arising from foreign activities benefitting from unusually low foreign tax rates, the U.S. is able to thwart the foreign government's efforts at least insofar as U.S. taxpayers are concerned.

Under the overall limitation, a U.S. taxpayer with other, highly taxed foreign income, would be able to mix its high- and low-taxed income and foreign tax credits. The result could be little or no residual U.S. tax on the low-foreign-taxed income. By segregating, or basketing, the low-taxed income, the U.S. is able to ensure that the highly taxed income bears the full burden of the higher tax, and that the attempt of the country imposing a low tax to compete for capital resources is defeated.

The problem with this philosophy, at least as it is applied through the multi-basket regime, is that no attempt is made to distinguish between foreign source income that is granted uniquely beneficial treatment and income that is earned in a foreign country that generally imposes a lower tax burden than does the U.S. The implicit notion behind this approach, then, is that countries that impose higher taxes than does the U.S. do so at their own peril, while countries imposing lower taxes, either systematically or specific to particular investments, are somehow competing unfairly. In effect, this is a standard whereby global tax neutrality is defined as whatever U.S. domestic tax policy is at the moment.

U.S. Tax "Deferral"

The worldwide taxation approach clearly expresses the intent of the U.S. government to levy U.S. tax on the foreign source income of U.S. citizens. Worldwide taxation also implies that the tax calculation should parallel the calculation that would be made if the income had been earned in the U.S. Because the U.S. tax calculation for foreign income should be the same as for U.S.-source income under worldwide taxation, it follows that the income of U.S.-owned foreign branches would be taxed in the year in which the income is earned. However, there has been an on-going dispute, regarding the U.S. taxation of income earned by a U.S.-owned foreign-incorporated entity (a "subsidiary").

The U.S. has generally and historically recognized the separate legal status of U.S.-owned foreign subsidiaries. Consequently, U.S. policy has allowed that foreign income earned by U.S.-owned foreign subsidiaries abroad would not be subject to U.S. tax until the income was remitted to the U.S. Four distinct lines of reasoning support such a policy:

1) There is no U.S. taxable event until the subsidiary repatriates the income to

the U.S. A foreign citizen (the foreign incorporated entity) earns the income and the U.S. has no taxing jurisdiction until a U.S. citizen becomes involved, i.e., the parent corporation receives income. Whenever U.S. income tax is due before the subsidiary repatriates the foreign income, some policy rationale must be provided for why the tax should effectively be pre-paid.

2) A shareholder of a corporation is subject to income tax on dividend income only when the shareholder receives a dividend. Moreover, this treatment applies whether the shareholder is an individual or another business. There is no reason this treatment should vary just because the company generating the dividend is incorporated abroad.

3) Receipts may produce a U.S. tax liability a year or more before they produce a foreign income tax payment, if the U.S. and the foreign government have sufficiently dissimilar definitions of taxable income. For example, suppose the foreign government allows a greater deduction for depreciation than is allowed U.S. taxpayers in calculating their foreign source income. In this case, imposing U.S. tax on such income in the year in which it is earned would mean that there would be no tax credits available to offset U.S. liability in the current year. This is demonstrated in Example 5 (on page 7).

4) Any requirement that a U.S. taxpayer should pre-pay U.S. tax (i.e., be denied "deferral") arising out of unrepatriated foreign earnings exacerbates the anti-competitive effects of U.S. international tax policy. For smaller companies, companies with limited access to capital markets, or for companies that are "cash-strapped", the pre-payment of U.S. tax obviously limits the investments in plant, equipment, and new technologies needed to remain competitive.

Even for larger companies with normal access to capital markets, financing additional investments through internal sources is generally less expensive than relying on external debt and equity markets. Accelerating the payment of the tax raises these companies' financing charges when they finance additional investments, thereby increasing the anti-competitive effects of worldwide taxation.

Clearly, requiring a U.S. parent company to pay income tax on income earned by a foreign subsidiary before the income is repatriated establishes a regime of income tax-prepayment. Requiring a prepayment deviates from normal tax practices. The term "deferral" is a misnomer, therefore, as it erroneously implies the taxpayer is somehow granted special treatment.

Subpart F and "Passive" Foreign Income

Until 1962, all foreign source income was treated as from a single source for U.S. tax purposes. Consequently, taxpayers mixed their income from all foreign sources and averaged their effective foreign income tax rates. For example, suppose a U.S. company earned $100 million each in Germany and Spain in a year, and paid $50 million and $10 million in income taxes to each country, respectively. Then it would be treated as having $200 million in foreign source income and $60 million in foreign tax credits. Its pre-credit U.S. liability would be $70 million at a 35 percent tax rate, and it would owe $10 million in after-credit U.S. tax.

Subpart F of the Internal Revenue Code was enacted in 1962 to establish a distinction between various, specified forms of income of controlled foreign corporations and all other income. Continuing an unfortunate and artificial distinction, the tax code refers to such income as "passive income," and, under the 1962 Act, passive income included such items as foreign source dividend and interest income, annuities, and certain rents and royalties. This list was greatly expanded as part of the 1986 Tax Reform Act to include:

- financial services income,
- shipping income,
- interest income earned in jurisdictions imposing high withholding tax rates, and
- income earned by each foreign corporation in which the U.S. taxpayer owns at least 10 percent, but not more than 50 percent of the voting power.

Income subject to subpart F is treated differently from all other income in two important respects. First, a separate basket is created for subpart F income, thereby preventing the aggregation of foreign tax credits associated with such income with the foreign tax credits arising from other income. Secondly, the U.S. parent may not defer, (must accelerate the payment of) U.S. tax on subpart F income earned by a foreign subsidiary, irrespective of whether or not the income is currently repatriated to the U.S. parent.

The original purpose of subpart F was to impose current tax when the primary purpose of earning income through a foreign corporation was to avoid U.S. tax. A typical example would be dividend income received in a low-tax foreign jurisdiction. If the taxpayer is able to use the income for foreign purchase, then it would never be repatriated to the U.S. and subject to U.S. tax. The expansions in 1986 extended the definition of subpart F to include income that could have been earned through a controlled foreign corporation (CFC) solely to avoid U.S. tax.

There are a great many instances in which a U.S. parent corporation earns income currently subject to subpart F that could not from a practical point of view have been earned through a foreign branch or through a U.S. company. Local content rules, regulations, and business practices may necessitate particular business arrangements having little or nothing to do with the ultimate U.S. tax treatment of any resulting income. For such business arrangements, subpart F eliminates two important factors that otherwise ameliorate the anti-competitive effects of the worldwide tax approach. It directly increases the U.S. company's costs by reducing its ability to finance its operations out of current earnings. And establishing a separate income basket increases the likelihood that a U.S. company will owe residual U.S. tax on its foreign source income. These effects are demonstrated in Example 6 (on page 11).

The effect of the single basket approach is to abate somewhat the anti-competitive effects of worldwide taxation because companies could mix high- and low-foreign-tax-bearing income to reduce their residual U.S. income tax liability. The downside, of course, was that companies were induced to make business decisions to a greater extent on the basis of the U.S. tax consequences. The change in behavior demonstrated the anti-competitive effects of U.S. international tax policy. In effect, whatever efficiencies were foregone by making decisions based on tax consequences were less damaging to a company's competitive position than the U.S. tax burden that would have otherwise been paid. Subpart F reduces U.S. companies' ability to minimize their residual U.S. tax liability, and so reduces their ability to minimize the U.S. tax's anti-competitive effects.

The preceding examples illustrate the

Example 6

Suppose a U.S. company has two foreign subsidiaries, one earning $100 million in financial services income on which it pays $30 million in foreign income tax, the other earning $100 million from manufacturing on which it pays $40 million in foreign tax. Prior to the enactment of subpart F, the company would have $200 million in foreign income on which it would owe $70 million in U.S. tax on a pre-credit basis. The foreign income would carry a combined $70 million in foreign tax credits, so there would be no net U.S. tax liability.

With the advent of subpart F, the financial services and manufacturering operations would each produce $100 million in U.S. taxable income and $35 million in U.S. pre-credit tax liability. However, the financial services income would only generate $30 million in foreign tax credits, leaving a residual U.S. tax liability of $5 million. The manufacturing income, on the other hand, would generate $5 million in excess foreign tax credits, leaving the company with a current net $5 million tax increase.

	Income Earned	Income Taxes Owed	Foreign Income Tax Credit
Foreign Manufacturing Income	$ 100 million		
(40% foreign tax rate)		$ 40 million	
Foreign Financial Services Income	$ 100 million		
(30% foreign tax rate)		$ 30 million	
Total Foreign Source Income	*$200 million*		
(35% U.S. rate, pre-foreign tax credit)		$ 70 million	
Available Foreign Tax Credits		$ 70 million	
Single Basket — Pre Subpart F			
Residual After-Credit U.S. Tax		$ 0	
Excess Foreign Tax Credit			$ 0
Net Residual U.S. Tax on Foreign Source Income		$ 0	
Two Baskets — Subpart F			
Residual U.S. Tax on Financial Services Income		$ 5 million	
Excess Foreign Tax Credit from Manufacturing Income			$ 5 million
Net Residual U.S. Tax on Foreign Source Income		**$ 5 million**	

most important elements in the structure of U.S. international tax policy — the imposition of U.S. tax, the limited foreign tax credit, deferral, and subpart F. There are a vast number of secondary issues, however, which together comprise an amazingly complex body of law. The vast majority of these issues, possibly with only one or two exceptions, stem from the policy decision to tax the foreign source income of U.S. citizens. The balance of this paper considers the theoretical justification, motivation, and implications of this policy.

Tax Neutrality in International Taxation

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 private economy. As a rule, the relative prices in a free market allocate society's resources to those activities and outputs it values most highly. A neutral tax neither diminishes a society's ability to produce goods and services nor affects their type or quality.

When relative prices are distorted, prosperity suffers — resources are misallocated across uses and the satisfaction consumers receive from their purchases declines. Distortions to relative prices 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 monopoly develops or a producer is unable to capture all the economic returns of investment. Government policies can also distort relative prices through taxation and regulation. Protectionist trade policies, for example, distort the pattern of trade and investment, reducing economic growth. Recognition of this fact has led to the worldwide and sustained effort to reverse such policies.

Some taxes are more distortionary to relative prices than others and the difference is often discernable. A general sales tax on all goods and services is generally less distortionary, for example, than a series of selective excises raising the same amount of revenue.

In the absence of U.S. tax on foreign source income, U.S. taxpayers would establish a particular and optimal pattern and level of investment in the U.S. and abroad. Imposing U.S. tax on foreign income distorts the economic incentives facing U.S. investors, thereby reducing the amount of U.S. foreign investment. Therefore, tax neutrality dictates that U.S. foreign source income not be subject to domestic tax since it reduces U.S. foreign investment below its optimal level.

Tax neutrality applied to domestic source income reaches the same conclusion, however — business income should not be subject to tax. Such a tax constitutes multiple taxation of capital income, resulting in a smaller stock of capital and less output. Since domestic business income is subject to income tax, the issue becomes whether the justification for a tax on domestic income can be extended to tax on foreign source income.[2]

Taxes are imposed first and foremost to finance government services. One possible justification for taxing business income is that government renders a wide range of services that facilitate or enable the business to operate: National defense protects private property from foreign threats; the judiciary is to preserve a safe society in which markets can flourish and where private property is respected under the law. The argument is that business taxes are a cost of doing business and are justified if some relation exists between the level of tax and the value of the services rendered by government.

The services-rendered argument has been used to justify taxes on domestic businesses because of the association between the ability to operate commercially in the U.S. and the government services received by U.S. businesses.[3] Clearly, however, the services-rendered rationale cannot be used to justify a domestic tax on foreign source income because the government renders little or no services to a U.S. company's foreign operations beyond the services rendered to the U.S. parent.

A second and related rationale based on national resources has sometimes been offered for taxing domestic businesses. The argument runs that a business consumes domestic resources — labor, energy, etc. — in the course of its operations and that a business tax captures the value to society of the resources consumed. This argument obviously cannot be extended to taxing foreign source income because the resources consumed in producing foreign income are foreign in origin.[4]

Justifications for taxing domestic business income cannot be extended to justify taxing foreign source income. We must look elsewhere, therefore, to explain current U.S. policy. Specifically, we must look for justifications that rely on an external perspective. Territoriality focuses on the proper U.S. tax treatment of the income of U.S. citizens operating abroad. The key aspect of neutrality territoriality seeks to preserve is between the U.S. taxpayer and a foreign taxpayer engaged in similar activities. Alternatively, by leaving relative prices undistorted, territoriality seeks to eliminate the U.S. tax on foreign source income as a determinant of whether a U.S. taxpayer makes a foreign investment.

Territoriality, then, naturally preserves the competitiveness of U.S. companies relative to their foreign competitors.

As noted above, the primary alternative theory, known as worldwide taxation, compares the U.S. with other countries in terms of its profitability as a place for U.S. taxpayers to invest. Thus, worldwide taxation emphasizes the relative tax treatment of U.S.-owned investment as between domestic and foreign locations.

In effect, territoriality assures a neutrality between a U.S. investor and a foreign investor considering the same foreign investment. Worldwide taxation seeks a neutrality for a U.S. taxpayer as between the U.S. and a foreign location. The differences are illustrated in Table 2 (below). Without question, the worldwide taxation results in a lower level of foreign investment by U.S. companies than would territoriality.

Justifying Worldwide Taxation

A substantive justification for worldwide taxation can be found in its consequences. These consequences depend on

Table 2

Dimensions of Neutrality

	U.S. Location	Foreign Location
U.S. Investor	Worldwide Taxation	Worldwide Taxation
	Territoriality	
Foreign Investor	Territoriality	

one's assumption regarding the incidence of business taxes. Suppose business taxes are borne by shareholders, for example. As with any tax on capital income, worldwide taxation then results in less foreign investment by U.S. taxpayers. In many instances, U.S. and foreign investment opportunities are complementary. If a company can optimize its operations by siting its plants across multiple jurisdictions, then its overall level of production and investment will be higher. Where U.S. and foreign investment is complementary, the U.S. tax on foreign source income reduces both U.S. and foreign investment. Worldwide taxation is certainly not U.S. policy because of a desire to reduce U.S. domestic investment. Therefore, while this is a possible effect, it is surely not a justification.

Suppose, however, that U.S. and foreign investments are perceived to be substitutes rather than complements. In other words, a U.S. company chooses between a U.S. and a foreign site, and the decision is assumed to have little effect on the rest of the company's investment plans. In this case, imposing a U.S. tax on the income from the foreign site, to "level the playing field," is a tax policy designed to protect the domestic job market from the possibility that U.S. investors will invest abroad to take advantage of lower taxes. It is a form of protectionism advanced through capital flows rather than through trade flows.

Rather than borne by shareholders, suppose business taxes are passed forward to consumers in the form of higher prices. The effect of a U.S. tax on foreign source income then would be to raise the price of the products made by U.S. companies overseas. The U.S. tax is effectively a tariff levied on the product of U.S. international operations. The U.S. company's foreign operations are then less competitive worldwide. They cannot compete as effectively in the country where the production takes place, when they export back to the U.S., or when they export to third countries.

Under the pass-forward assumption U.S. international tax policy eliminates a great many opportunities for U.S. companies to invest abroad. If U.S. and foreign investment tend to be complimentary, then U.S. international tax policy tends to reduce both foreign and domestic investment. Alternatively, if U.S. and foreign investment by U.S. companies are seen as substitutes, then any policy reducing foreign investment increases U.S. domestic investment. In this case the justification for U.S. international tax policy is to establish a tariff-like protectionist regime by artificially discriminating against foreign investment by U.S. businesses.

The perversity of U.S. policy under a pass-forward assumption is underscored by the fact that, with respect to sales back to the U.S., the U.S. tax is economically equivalent to a highly selective domestic tariff. With respect to U.S. sales, it is tantamount to trade protectionism specifically targeting U.S. companies operating abroad. To the extent protectionism and punitive tariffs are deemed unwise trade policy, U.S. foreign tax policy must be subject to the very same criticisms. Further, these policies suffer from the added perversity with respect to U.S. sales that the protectionism applies only to U.S. companies selling foreign-made goods and services; foreign companies exporting to the U.S. are immune.

The justification for worldwide taxation, and therefore the justification for U.S. international tax policy, is that it is necessary to protect U.S. workers and the owners of other domestic resources from the anti-competitive effects of U.S. domestic tax policies. It is a classic form of protectionism made necessary in the views of its advocates by relatively high U.S. domestic tax policies. As a form of protectionism, however, worldwide taxation remains subject to all the criticisms generally leveled at more overt protectionist measures.

Conclusion

The doctrine of worldwide taxation was developed and adopted long ago, before the principles of free trade were widely accepted, before international trade had become an important dimension of the U.S. economy, and before the development of highly efficient international capital markets. As U.S. companies began increasingly to look abroad for investment opportunities, either to become more efficient producers or as a way of entering foreign markets, a natural reaction was to insure that relatively high U.S. taxes were not an additional motivation for these foreign investments. Hence worldwide taxation was a response to the fear that U.S. companies would flee the U.S. if the tax playing field were tilted in favor of foreign investment.

These thoughts and fears are, of course, the same thoughts and fears that occasionally induce nations to erect various trade barriers against more effective foreign competitors. It is irrelevant whether a foreign location offers a more competitive environment due to lower wages, lower energy costs, lower regulatory costs, or lower taxes. Domestic policies designed to offset these advantages are protectionist in nature and counterproductive to prosperity in practice.

At a time when the clear U.S. policy is to expand international trade by continually working to reduce trade barriers, U.S. international tax policy remains rooted in the very same misplaced fears that produced those trade barriers. Just as expanding international trade opens markets, increases consumer choice, and ultimately contributes to stronger economic growth, moving U.S. tax policy away from worldwide taxation towards territoriality would have those very same consequences. Indeed, it makes little sense to pursue a policy of improving the opportunities for U.S. companies to compete abroad through trade policy, only to shackle them again through tax policy.

Endnotes

[1] The expression "capital-export neutrality" is something of a misnomer in the current environment. The term implies a U.S. company investing abroad raised the financing for the investment in the U.S. Thus, by investing abroad, the company is "exporting" U.S. capital, i.e., U.S.-sourced savings. This model of the economy no longer applies and has not applied for many years. Companies raise capital globally and invest globally. Even investments made in the U.S. may be financed ultimately from foreign saving. And indeed, they are whenever the U.S. is running a trade deficit. A more accurate alternative label for the concepts underlying worldwide taxation might be "investment site neutrality". This term places the emphasis on the central issue of concern to advocates, which is the elimination of foreign tax policies as a determinant of where a U.S. company chooses to invest, rather than on the jurisdiction from which it raises capital.

[2] In pursuing this line of inquiry, we are not asserting that a non-neutral tax on business income is economically justified. Nevertheless, the tax exists and it rests on some policy justification. Assessing the tax on foreign source income requires determining whether the offered justification for the domestic tax can be extended to the foreign arena.

[3] This argument actually fails to justify even a domestic tax on business because business income is taxed repeatedly under the federal income tax. The services-rendered argument cannot explain why businesses depend more on these services, and therefore should bear more tax, than other income earners.

[4] This argument also falls easily as a justification for taxing domestic income. Every resource carries a market price reflective of its value to society. Resources such as energy, labor, and land are traded in well-developed markets and so there is generally no reason to believe their respective prices fail to reflect their value. There is, therefore, no reason to impose a tax even on domestic business to capture these resources' scarcity value.