TAX FOUNDATION
Since 1937

EXTRA POINT

February 1999
No. 11

Hiding Protectionism in the Tax Code

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

Free trade rules. Despite moments of weakness, Americans resist calls for protection against foreign competition. Even facing a large and growing trade deficit, it would be laughable to call for a general increase in tariffs on imported goods. And yet we have had a highly protectionist system in place for decades and the U.S. Treasury in both Republican and Democratic Administrations continue to defend it.

Where is this protectionist scourge? In the federal income tax. Specifically the taxation of U.S. citizens' foreign income. Taxing this income raises a modest amount of revenue, but the real purpose is to use the tax code as a sneaky system of tariffs to discourage U.S. individuals and companies from investing abroad.

Taxing U.S. citizens' foreign income raises a modest amount of revenue, but the real purpose is to use the tax code as a sneaky system of tariffs to discourage U.S. individuals and companies from investing abroad.

Protectionism arises when a government reacts defensively to the threat that lower-cost or higher-quality foreign goods pose to domestic employment. When goods are imported, competitive pressures force domestic suppliers to become more efficient or go out of business. The country overall is better off, because the remaining domestic suppliers are more efficient and because consumers have better choices at lower costs. Nevertheless, the shareholders and employees of the companies that fail clearly suffer.

Because the benefits are diffuse and the pain quite targeted, companies troubled by foreign competition often appeal to the government for protection. When the foreign competition is selling goods below cost, such as has been reported recently with Japanese and Russian steel imports into the United States, the government can and should take action to halt the imports. When foreign companies are just good competitors, the U.S. government must, and usually does, resist calls for protectionist tariffs and quotas.

There are many reasons a foreign supplier might be a winning competitor in fair trade. The classic explanations given in textbooks are that the foreign competitor may have access to lower labor, energy, or raw material costs. For example, ever since World War II the U.S. textile industry has faced stiff competition from companies able to take advantage of low-cost foreign labor.

Japan in the 1970s and 1980s demonstrated three other reasons why some U.S. companies are hard pressed. First, the Japanese developed some superior management techniques, such as just-in-time inventories. They also focused more steadily on superior quality. And they often operated behind high trade barriers that protected their home markets so that their businesses could earn extraordinary profits at home that subsidized their foreign activities.

U.S. companies are also frequently at a competitive disadvantage because of U.S. government-imposed costs that exceed those of our trading partners, such as high taxes and stiff regulations. When a foreign government imposes less tax than does the United States, U.S. companies are disadvantaged at home, but thanks to our protectionist international tax policy U.S. companies are also disadvantaged in the lower-tax foreign country and in all other countries.

To be sure, taxes are rarely a determining factor when a company decides where to establish operations. Issues like proximity to customers and suppliers and local-content rules play a much greater role. But taxes do play a role. When a U.S. company can locate operations in a lower-cost foreign jurisdiction, it becomes more competitive whether the lower costs are due to lower wages or lower taxes.

U.S. tax policy in this regard is to eliminate lower foreign taxes as a reason for establishing foreign operations. How does this work? The U.S. imposes tax on the foreign income of its citizens as though the income were earned at home. To mitigate double taxation, the U.S. taxpayer is allowed to take a limited credit against its U.S. tax liability for foreign income taxes paid. Suppose, for example, General Motors made $100 million in Canada. Suppose it paid $30 million in Canadian income tax. It would then owe on a pre-credit basis $35 million to the U.S. government, but it would get a credit for the $30 million paid to Canada, so it would owe $5 million to Uncle Sam on an after-credit basis.

The concern addressed by U.S. international tax policy is that the U.S.-owned foreign operation could export lower-tax bearing goods to the U.S. or could replace higher-taxed U.S.-source exports. Either way, domestic producers and their employees would come under even stiffer competition. While this rationale is popular in some quarters, it is fundamentally protectionist in nature and indistinguishable in intent from a simple tariff.

Even the language used by proponents of tariffs and the defenders of current tax law is the same. A tariff is defended because foreign plants would otherwise be able to sell lower-cost goods in the U.S. and U.S. jobs would be lost as a result. Defenders of current international tax law argue it is needed to prevent "runaway plants," that is, to discourage U.S. companies from setting up plants abroad instead of in the U.S., thereby costing U.S. jobs.

The defenders of current tax law argue that it comports with tax neutrality and therefore is on a sound theoretical basis. The notion of neutrality they reference, however, is very different from any definition of neutrality used in domestic tax policy. It is, in fact, a counterfeit erected to justify a protectionist policy.

In fairness, many defenders of current tax law are adamant free traders. Many were convinced long ago that current law is essentially correct and so they fail to see its protectionist consequences. However, many of them also know full well how current U.S. international tax law hinders the ability of U.S. companies to compete in international markets. Thus they find themselves in the intellectual box of arguing for a balance between competitiveness and neutrality, as the defenders of current law define neutrality. What these fundamental free traders must realize is that there is no balance between competitiveness and true tax neutrality. They must realize that neutrality properly defined and codified in the tax law allows U.S. companies to be as competitive as they can be without moving into the realm of tax subsidies. A conflict between competitiveness and neutrality only arises when neutrality is improperly defined.

Countries generally protest when one of their trading partners engages in unfair, protectionist practices. A fair question to ask then is, if U.S. tax policy is protectionist, why do our trading partners not protest? The answer is simple. The only parties injured by protectionist U.S. international tax policy are U.S. citizens. Foreign companies and foreign workers actually benefit.

When a U.S. company is deterred from making a competitiveness-enhancing foreign investment due to U.S. international tax policy, in today's world it is highly likely that a foreign company will be ready and willing to take its place. Perhaps the U.S. company saw a cost advantage that will now go to the foreign competition. Perhaps the U.S. company saw a market opportunity that will now go to the foreign competition. It does not matter where the foreign operation's sales take place. Because of U.S. tax policy sales which could have been made by a U.S. company now belong to a foreign company.

Like most forms of protectionism, U.S. international tax policy is a double-edged sword. Usually, however, U.S. consumers suffer to benefit U.S. companies. In the case of U.S. international tax policy, U.S. citizens get cut with both edges since both consumer and producers suffer.

TAX FOUNDATION Since 1937

EXTRA POINT is published by the Tax Foundation, a nonprofit, nonpartisan research and public education organization that has monitored tax and fiscal activities at all levels of government since 1937.

Single copies are free. Permission granted to reprint; credit Tax Foundation and the author.

Editor and Communications Director, Bill Ahern

Tax Foundation
1250 H Street, NW, Suite 750
Washington, DC 20005
(202) 783-2760
(202) 783-6868 fax
www.taxfoundation.org
tf@taxfoundation.org