

Taxing Foreign Source Income: The Economic and Equity Issues



TAX FOUNDATION, INC.
50 Rockefeller Plaza
New York, N.Y. 10020

Government Finance Brief No. 25
May 1976
Price \$1.00 Per Copy

★ ★ ★

Copyright 1976
TAX FOUNDATION, INC.

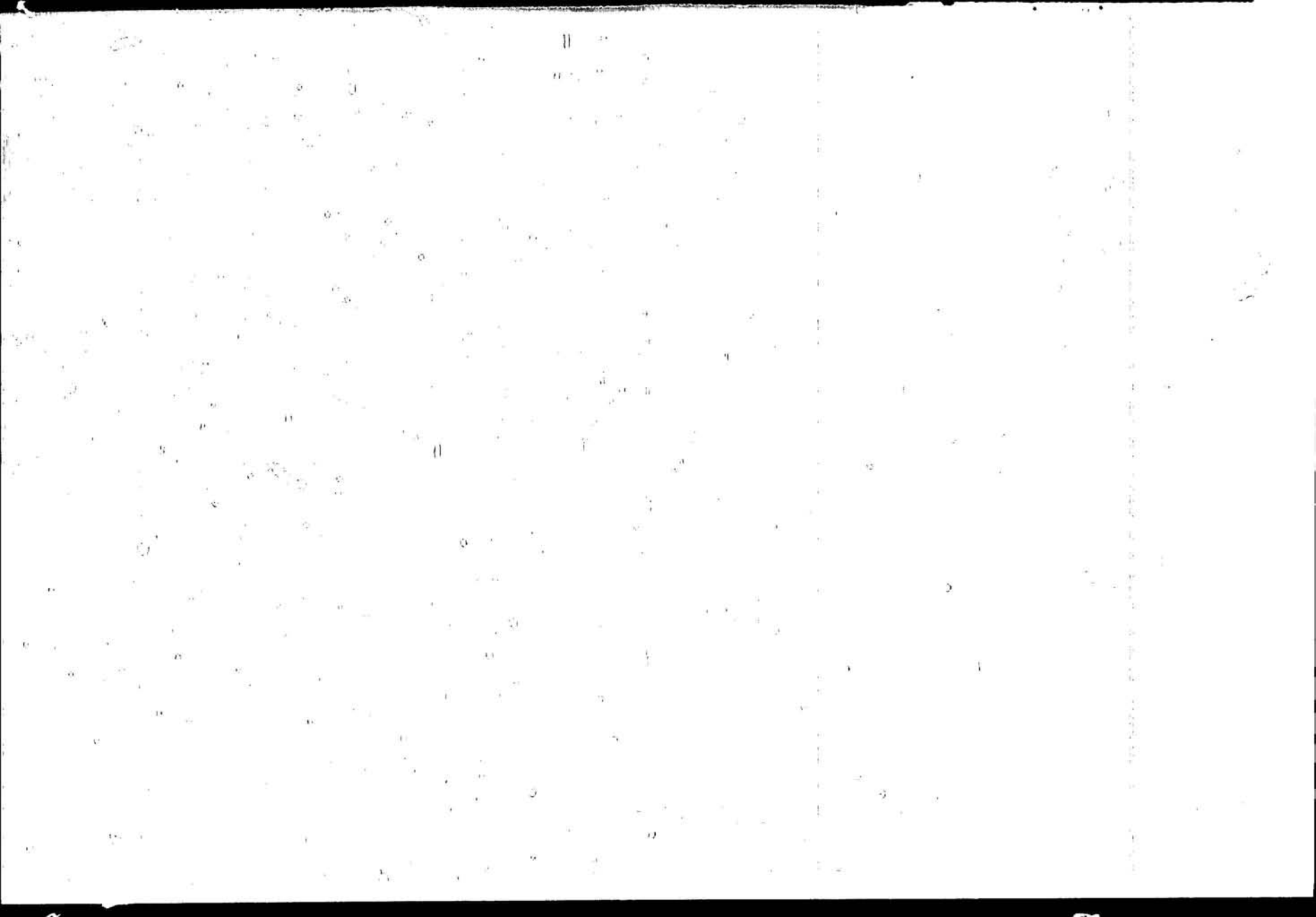
Foreword

Some of the most controversial and complex issues in public discussions of Federal tax revision relate to questions of how foreign-source income of U.S. companies should be taxed. In this *Brief*, prepared by Norman B. Ture, President of Norman B. Ture, Inc., economic consultants, the author deliberately casts the discussion in abstract and hypothetical terms to expose the basic analytical issues involved in determining the "best" tax treatment of foreign-source income.

Earlier this year the Committee on Finance, U.S. Senate, held hearings on tax revision and extension of expiring tax cut provisions. At the invitation of Committee members, the statement in this Brief was submitted for the record by Mr. Ture, on behalf of the Tax Foundation, on April 21.

The Tax Foundation is a publicly supported, non-profit organization, founded in 1937 to engage in non-partisan research and public education on the fiscal and management aspects of government. Its purpose, characterized by the motto "Toward Better Government Through Citizen Understanding," is to aid in the development of more efficient and economical government. It serves as a national information agency for individuals and organizations concerned with problems of government expenditures, taxation, and debt.

Tax Foundation, Inc.
May 1976



Taxing Foreign Source Income: The Economic and Equity Issues

By Norman B. Ture*

With the growth of U.S. private investment abroad over the past decade, the U.S. Federal income tax provisions pertaining to foreign source income have been increasingly targets of tax reform. Those who urge increasing the U.S. tax on foreign source income argue that the present tax treatment (1) is inequitable because it imposes a lower U.S. tax burden on foreign income of U.S. companies than that levied on the income of domestic U.S. corporations, and (2) subsidizes investment abroad by U.S. multinational companies at the expense of domestic U.S. investment, production, and employment.

Neither the equity nor the economic case for increasing the U.S. tax on foreign source income is analytically correct. The basic tax reform proposals—for reducing if not eliminating the foreign tax credit and for requiring current payment of U.S. tax on undistributed foreign earnings—would neither enhance the equity in the taxation of those who bear these

tax burdens nor contribute to greater productivity and efficiency of the U.S. economy. On the contrary, these tax changes would aggravate the inequities in the corporation income tax; they would differentiate corporation income tax liabilities on the basis of the location of the economic activity giving rise to corporations' incomes, without regard to the differing economic situations of those who actually bear the corporation income tax burden. They would, moreover, distort the allocation of capital resources and impair the productivity and efficiency of the U.S. economy.

This statement is addressed to both the equity and economic issues involved in determining the appropriate treatment in the U.S. income tax of the foreign earnings of U.S. companies. My analysis urges that on the score of both equity and economics, not only should the basic reform proposals be rejected, but foreign earnings—or losses—should be completely excluded from the U.S. tax.

The Equity Issue

The standard equity argument against the existing provisions is that they violate the equity requirement that persons with equal incomes should pay equal taxes. This results because the present provisions allow a credit for foreign taxes

against U.S. tax liability but only a deduction from income for taxes paid to a U.S. State or local government. Why, according to this argument, should taxes paid to a foreign government receive better Federal income tax treatment than

*The views expressed in this statement are those of the author and do not necessarily reflect the opinion of the Tax Foundation or any other organization he represents.

taxes paid to a state or local government in the U.S.?

This equity argument rests on the personification of corporations for purposes of the law, a concept upon which the separate income taxation of corporate business is based. Since it is a widely accepted and intuitively appealing view that persons with equal income should pay equal taxes, corporate persons with equal incomes, presumably, should also pay equal taxes. The identity of the jurisdiction to which the corporation pays taxes, according to this argument, is irrelevant; taxes paid to a foreign government on a given amount of income should be treated as deductions in the same way as taxes paid to a State or municipality and should not be credited against the U.S. tax.

This argument, however, presumes that the income taxes paid by corporations come to rest only on the corporate entity itself. But *things* can't pay taxes; only people do. If we recognize, as we should, that the burden of the corporation income tax falls on individuals as savers and investors and, insofar as the amount of saving and capital is less than it otherwise would be, on workers whose productivity, hence real wages, are less than otherwise, then the argument that corporations with equal income should pay equal taxes is substantively vacuous. The amount of taxes paid by any two corporations with equal incomes has no systematic bearing on the amount of the tax burdens on the individuals who supply the saving and capital generating the corporations' net incomes. Unless one assumes, grossly contrary to fact, that individual shareholders are identical with respect to their marginal tax brackets and portfolio composition, equal corporate income tax liabilities on two corporations almost inevitably mean disparate tax burdens on their respective share-

holders. Applying the conventional equity criterion to corporations, in fact, necessarily involves violating the same equity criterion for *real* persons.

To be useful for purposes of corporate taxation, an equity criterion should be addressed to considerations that are pertinent to corporations in their functions of organizing and undertaking production activities. A logically satisfactory equity criterion would require that equal tax liabilities be levied on businesses imposing equal opportunity costs on the economy, where opportunity costs are deemed, in an efficiently operating market economy, to be adequately measured by the value of the production inputs used by the business, hence denied to alternative production uses. To be completely satisfactory in this respect, the tax should be imposed on the total of such costs a business imposes, that is, on the total payments it makes for all of the production inputs it uses. If only the payment for capital services, i.e., profits, is to be taxed, the basic principle should nevertheless be adapted to that tax.

If this principle were implemented, no U.S. tax would be imposed on the foreign-source income of U.S. business since the production activity generating that income has imposed no cost on the U.S. These costs are imposed solely within the foreign jurisdictions whose real production inputs are used. The mere fact that the foreign operation is undertaken by a U.S. company should have no bearing on the determination of the jurisdiction which should impose taxes; there is no more reason for the U.S. tax to apply to the foreign income produced by a U.S. company's subsidiary, division, branch, what have you, than there is for the U.S. to impose its tax on any company of any other nationality operating in the foreign jurisdiction.

This is not to say that the *investment* by the U.S. company in the foreign

subsidiary is costless to the U.S. In real terms, financing such investment requires an equal amount of U.S. production for exports in excess of imports since, by definition, net foreign investment is equal to the net export of goods and services. The production in the U.S. of the goods for export, of course, imposes real costs, but the income payments made to these production inputs are subject to U.S. income tax (although tax on the payments for capital input—profits—may be partially deferred under the DISC provisions). The costs imposed in the U.S. to finance, in real terms, the foreign investment, therefore, do give rise to U.S. tax liability just as if the exported goods were produced for use in the U.S. Income generated by foreign companies in the U.S. should, for the same reason, be fully subject to U.S. tax, irrespective of the foreign jurisdiction's tax provisions pertaining to its nationals' foreign source income, since this income generation necessarily imposes costs on the U.S. economy.

In the light of this principle, the appropriate tax reform in the interests of greater equity is not to tax the foreign-source income of U.S. companies as if the income had been earned in the U.S. but, on the contrary, to exclude foreign-source income—and losses—entirely from the base of the U.S. corporation income tax. Moreover, the no-U.S.-tax prescription should apply whether or not the foreign earnings are shifted from one foreign jurisdiction to another or returned to the U.S. Should the repatriated earnings be re-invested in the U.S., the domestic income generated by this investment would, as a matter of course, be subject to U.S. tax.

It is difficult to perceive how the tax reform proposal for the elimination of so-called "deferral" squares with the

conventional equity standard that equally situated taxable entities should receive equal tax treatment. In the case of domestic U.S. companies, shareholders are not required to include in their incomes the undistributed profits of the corporations whose shares they own. The tax reform proposal to impose U.S. tax liability on a U.S. company with respect to its share of the earnings of its foreign subsidiaries in the year in which those earnings are realized rather than when they are distributed to the U.S. company clearly would differentiate tax treatment among U.S. corporations solely on the basis of the location of their income-generating activity.

Present law differentiates tax treatment in other respects on the basis of the location of the income. Foreign subsidiaries of U.S. companies cannot claim the investment tax credit nor use the asset depreciation range system in determining their depreciation deductions. Neither can losses of these foreign subsidiaries be offset against the U.S. parent company's income. If it were meaningfully and consistently applied, the equity argument for elimination of the foreign tax credit—the same tax treatment should apply to taxes paid by foreign subsidiaries as to the taxes paid by domestic companies to States and localities—would call for eliminating the other differentials as well, changes which reform advocates oppose on grounds having little to do with their view of equity.

The present foreign tax credit closely approximates the no-U.S. tax prescription when the effective foreign tax rate is the same or greater than the effective U.S. income tax rate. It fails to meet this equity standard when the foreign rate is less than the U.S. rate, since some U.S. tax then is imposed with respect to costs which the U.S. does not sustain.

The Economic Issues

The tax reform argument for increasing U.S. income tax liabilities on foreign source income is that the present tax provisions subsidize investment by U.S. multinational companies in foreign operations. This tax subsidy, it is claimed, shifts investment that otherwise would be undertaken in the United States to foreign sites. As a result, so it is argued, there is less capital in the United States and more capital abroad than would be the case if the U.S. tax fell equally per dollar of return on domestic U.S. and foreign investment. The consequence of this alleged tax-induced shift of U.S. capital to foreign locations is less output, employment, and income at home than otherwise.

Those who view foreign investment by U.S. companies as reducing or "displacing" domestic investment, also argue that such investment (1) shifts production from the United States to foreign sites, therefore directly transferring output and employment from this country to other nations, and (2) transfers U.S. technological advantages to other nations, thereby increasing their productivity relative to that of the United States and weakening the competitive position of U.S. business; the consequent increase in U.S. imports and reduction in its exports, it is argued, necessarily impairs the balance of payments and means a loss of domestic output and employment.

On the basis of these arguments, the present tax treatment presumably should be changed to eliminate the alleged subsidy to investment abroad by taxing foreign source income as if it were earned in the United States. This tax change, so it is argued, would result in a return to the United States of substantial amounts of the capital of U.S. companies now situated abroad. The overall eco-

nomic consequences of this repatriation of U.S. capital would be, ostensibly, the reverse of the effects attributed to the alleged present subsidy of foreign investment, as described above.

Several basic questions are raised by these tax reform arguments. One of these is whether the present tax provisions do indeed subsidize foreign investment by U.S. companies. Another is whether the consequences of the existing tax provisions for U.S. domestic capital formation, productivity, total output, employment, and income are as claimed by advocates of increasing U.S. taxes on foreign-source income. A corollary question is whether the proposed revisions would produce the favorable economic effects ascribed to them by these advocates, and the implications of these revisions for U.S. international trade.

1. Do the present tax provisions subsidize foreign investment?

The overall thrust of these tax reform proposals is that foreign investment by U.S. companies is excessive. It is axiomatic that trade, freely entered into, increases the economic well being of the participants; it allows them to use the production capability at their disposal to obtain a greater amount of valuable goods and services than if they had to produce themselves all of the goods and services they use. Trade, in short, is a means of increasing productivity. The exchange of production capability, freely entered into, similarly increases productivity. Decisions as to the best place in which to locate production facilities clearly are impelled by determinations of where the use of the facilities will be most productive—where the flow of income they produce will be the greatest. If a given amount of machine tools manufactured in country D, for example, can

be more productively used in country F, that is, if the present value of the increase in income the use of these tools will afford is greater in F than in D, surely it is to the advantage of D to have the machine tools used in F. D will need to use less of its production inputs to produce exports to F to pay for the output of the machine tools than it would need to use to produce the same output in D. The production resources saved in D by this arrangement then may be used in D to produce those goods and services in which D is more efficient. In short, the allocation of the capital represented by the machine tools to F increases D's production capability, as it does F's.

Presumably there should be little argument on this score. The issue should be confined to whether the amount of foreign investment undertaken by U.S. companies is so large that at the margin the present value of the income flow on such investment which the U.S. economy may claim is less than it would be if the marginal investment were made at home. This would result if because of some institutional factors, for example, U.S. tax laws, the foreign investment were subsidized. If it were shown that the present tax provisions do not subsidize such investment, presumably the issue should thereby be resolved; we should conclude that the magnitude of that investment at least roughly approximates the optimum amount, i.e., the amount which maximizes the real income the U.S. economy can obtain from the use of that amount of capital.

The most critical issue, therefore, should be whether the present law tax provisions subsidize foreign investment by U.S. companies.

The validity of the assertion that the present tax provisions subsidize foreign investment clearly depends on what a subsidy is. Subsidies take a multitude of forms but their common characteristic is

that they reduce the costs of—or increase the prices received for—the subsidized activity relative to alternative activities. If the present tax provisions are deemed to subsidize foreign investment by U.S. companies, they must reduce the cost of foreign relative to domestic investment—or equivalently, increase the returns on foreign relative to domestic investment, compared with the relative costs or returns that would prevail in a neutral tax environment.

A neutral tax is one which does not alter the relative prices of goods, services, activities, production inputs, and so forth in the private sector. As a practical matter, of course, perfect tax neutrality is never achieved; as a policy criterion, neutrality calls for taxes with the least possible effect on private sector relative prices. With respect to the tax treatment of foreign-source income, perfect neutrality in the respective tax systems of two countries would mean that relative prices in the private sectors in each country would be unchanged by the taxes, hence would differ from each other in the same way as if no taxes had been imposed in either. If the nationals of either country choose to engage in income-generating activity in the other, such activities should be governed solely by the opportunities and constraints which the other's price structure present. But if one country imposes a tax on its nationals' income produced in the other, it clearly will alter the relative prices its nationals confront compared to the prices they would confront if exposed only to the foreign jurisdiction's taxes. Neutrality, therefore, requires that each country impose no tax whatever on the income its nationals derive abroad, leaving such income fully exposed to the taxation of the country within whose jurisdiction it is generated.

The view of neutrality advanced to support the tax reform proposals is quite different. This tax-reform concept is that

neutrality requires U.S. tax treatment which maximizes U.S. real output and income. According to this so-called national neutrality criterion, the required tax treatment is that which will ensure "... that the total U.S. returns to capital, which are shared between the U.S. government in the form of taxes and the net-of-tax return to American investors ..." is "... the same whether the capital were located at home or abroad. Equality of total returns ... would be achieved if U.S. firms paid the same current rate of tax to the U.S. government no matter where earnings arose."¹ On this view, taxes paid by U.S. companies to a foreign jurisdiction on their income subject to that jurisdiction's tax laws should not be credited against U.S. tax, but merely deducted from the company's foreign income to determine the amount of that income subject to U.S. tax. "For example, if a firm domiciled in the United States earned \$180 in Mexico and if Mexican taxes were \$80, the firm would pay a U.S. tax of \$48 (48 percent of \$100)."² In this case, the company's total tax on the income generated in Mexico would be \$128.

In contrast, under present law (ignoring the foreign tax credit limitation) it would pay a U.S. tax of \$6.40 on the Mexican income (48 percent of \$180 less the foreign tax credit equal to the \$80 paid to the Mexican government); its total tax would be \$86.40, the same as if the \$180 had been earned in the United States; its after-tax earnings would be \$93.60, the same as if earned in the U.S. Under the so-called national neutrality tax rules, in other words, the company would pay an effective tax rate of 71.1 percent, almost half again as high as the rate on the same amount of U.S. income and 60 percent higher a rate than that imposed by Mexico on the income earned

in its jurisdiction. From the company's viewpoint, this type of tax treatment is highly discriminatory against investment in Mexico; it is a substantial *negative* subsidy on foreign investment by U.S. companies. Such investment in Mexico could not be undertaken unless the pretax return were at least \$324, that is, \$144 or 80 percent greater. Clearly there are likely to be far fewer investment opportunities which would afford these greatly enlarged returns. Hence, foreign investment by U.S. companies would be discouraged. Companies of other nationalities, subject to less punitive taxes, then would confront less competition for investment opportunities in Mexico. The proposed change in the U.S. tax treatment of foreign source income, in other words, would subsidize the investment in Mexico by foreign companies.

From the point of view of the U.S. government, according to the advocates of this type of tax treatment, this curtailment of foreign investment is desirable. Limiting investments abroad to those which would afford these much higher returns would ensure that the total of the returns claimed by the U.S. government and the investing company would be the same as if the investment had been made at home. In this example, the Mexican government would receive \$144 of the \$324 of pretax Mexican earnings, leaving \$180 for the U.S. government and the investing company to share.

Hinging this type of tax treatment on how much of the returns to capital *both* the U.S. government and the owners of the capital receive has perverse results. It makes the acceptability of foreign investment depend on how severely the United States taxes capital income, hence on how severely it constrains its growth in capital relative to labor inputs, hence the

¹Gary C. Hufbauer, "A Guide to Law and Policy," *U.S. Taxation of American Business Abroad*, American Enterprise Institute for Public Policy Research, Washington, D.C., Hoover Institution on War, Revolution and Peace, Stanford University, Stanford, California, 1975, pp. 2-3. Emphasis added.

²Ibid, p. 3.

growth in its total output and the productivity, real wage rates, and employment opportunities of its labor force. The higher the effective rate of the U.S. tax, the scarcer capital becomes in the United States, the fewer the acceptable (by this standard) investments abroad and the higher must be their yield. Thus, foreign uses of capital which are far more productive than U.S. domestic uses and which would augment U.S. real income become unacceptable by the national neutrality standard merely by virtue of decisions here and abroad as to the effective capital income tax rates.

The "national neutrality criterion" is a highly arbitrary notion. The effects of its practical application—eliminating the foreign tax credit and permitting only a deduction for foreign taxes—depends on the effective U.S. tax rate and those of various foreign jurisdictions in which U.S. companies might wish to invest. For example, if the Mexican government—pursuing the example—were to increase its effective tax rate to 48 percent—the same as assumed for the United States, then an investment by a U.S. company in Mexico would be just as "good," by this neutrality criterion, as the same investment in the U.S. only if its yield rose to \$346. In some other country choosing to tax corporate income at a rate of, say, 24 percent, a U.S. company's investment would be just as "good" if it yielded \$237. By the same token, an investment affording a gross return of \$300 in Mexico is less productive than the same investment providing a gross yield of \$240 in another country and less productive than an equal investment yielding only \$180 in the United States. In other words, the same investment—the same commitment of real capital—is equally productive as in the United States only if it produces widely disparate gross returns, depending on the tax rate, hence on the extent of the tax-induced scarcity of capital in the foreign jurisdiction.

If the U.S. effective rate were 40 percent instead of 48 percent, as in the preceding examples, and if U.S. domestic investment increased so that pretax returns decreased to \$156—the level at which the same after-tax return of \$93.60 would be provided—then the same investment in Mexico would become as productive, by this standard, if it were to yield \$281; in another country with a 24 percent tax rate, a pretax return of \$205 would now make the investment just as productive as the same investment in the U.S.

It is obvious that the implementation of this neutrality criterion would produce a grossly distorted allocation of capital between domestic and foreign jurisdictions—one which would override considerations of the real costs of capital resources and the real returns thereupon by the differences among the jurisdictions' tax rates. Surely it is a peculiar concept of neutrality which holds that a given investment is more valuable if it produces \$180 than if it produces \$360.

The tax reform argument that the present tax treatment of foreign source income subsidizes investment abroad by U.S. companies depends on an arbitrary concept of neutrality which more likely than not would be rejected by the advocates of the proposed tax reforms in other situations. There is a virtually universal consensus that the optimum allocation of any production resource results when the pretax return per unit of that resource is the same (when adjusted for differences in risk) in all alternative uses. One of the principal arguments in the standard tax reform arsenal is that so-called tax "preferences", "loopholes", or what have you result in disparate pretax returns to alternative uses of production resources and that the differences in these pretax returns is one useful measure of the extent of the distortion in the allocation of resources resulting from these tax pref-

erences. Insofar as this reasoning is valid for purposes of tax reform aimed principally at domestic tax situations, it surely should apply with equal force in the tax treatment of foreign-source income.

The present tax provisions provide much more nearly neutral tax treatment of foreign source income than would the proposed revision. Where the tax rate abroad exceeds the U.S. rate, the foreign tax credit, in effect, leaves the income of the U.S. company's foreign subsidiary exposed only to the tax of the foreign jurisdiction in which the income was earned. Where the foreign tax rate is less than that in the U.S., however, the present tax provisions improperly, i.e., non-neutrally, expose the foreign source income to U.S. tax. In the first example above, the U.S. collects a tax of \$6.40 on the \$180 of income earned in Mexico; this additional tax discriminates against the U.S. company in Mexico compared with Mexican companies and compared with companies of other nationalities whose foreign source income is not subject to their country's tax. In other words, in these cases, the present U.S. tax treatment distorts the costs of and returns to investment by U.S. companies compared to other companies in the foreign jurisdiction.

2. Do the present tax provisions adversely affect the U.S. economy?

Based on the assertion that the present tax provisions subsidize foreign investment by U.S. companies, the tax reform proponents assert that the subsidy results in

- a shift of investment from the United States to foreign sites; hence
- a smaller stock of capital in the United States and a larger amount abroad than otherwise;
- less output and income available for use in the U.S. than otherwise;

- a shift in production from the U.S. to foreign sites;
- a transfer of U.S. technological advantages to other nations, increasing their productivity relative to that of the United States and weakening the competitive position of the United States in international trade; hence
- an increase in U.S. imports and a reduction in its exports; hence
- a loss in U.S. production and employment.

At issue are the questions (a) whether foreign investment by U.S. companies occurs at the expense of domestic U.S. investment and (b) whether there are losses in U.S. output, employment, and income, either associated directly with the capital in foreign sites put in place by U.S. investment or indirectly with the alleged adverse balance of trade effects.

The analytical and factual answer to these questions is that the foreign investment undertaken by U.S. companies, given the existing tax provisions, do not entail the adverse economic consequences for the U.S. economy asserted by tax reform proponents; indeed, the U.S. economy would gain from eliminating foreign source income (and losses) entirely from the U.S. tax base; on the other hand, the proposed tax reform would prove injurious to the U.S. economy.

(a) Does foreign investment by U.S. companies reduce investment at home?

The answer to the first of these questions obviously is critical to evaluation of the economic consequences for the U.S. of foreign investment and of the desirability of changes in the tax provisions pertaining thereto. The view that foreign investment displaces domestic investment is based on superficial analysis of

the impetus for and constraints upon private capital formation and on a highly mechanistic treatment of national income account relationships and identities. A more careful and thorough analysis urges that tax provisions may indeed distort the international allocation of capital, as illustrated above; the principal distortion, however, derives from the excessive tax on income that is saved and invested. The severity of this anti-saving, anti-capital tax bias differs from one country to another and is reflected in differences in amounts of capital relative to other production inputs and in the proportions of income saved and invested. The more severely the United States taxes the capital income of its nationals, irrespective of where that income is generated, the less the amount of capital and the slower the rate of its growth will be in the United States. To the extent that the tax law depresses investment in the United States relative to that abroad, it is the set of basic anti-saving tax provisions applicable to domestic income which is responsible, not the provisions pertaining to foreign source income. Increasing the severity of application of the latter provisions will not increase domestic investment, although it certainly will depress foreign investment by U.S. companies.

Basic to the tax reform argument that foreign investment occurs at the expense of domestic investment is the assumption that the total amount of an economy's saving, hence its total domestic and net foreign investment, in a given period of time is completely insensitive to the cost of saving and is otherwise determined, say by current or permanent income. However convenient this assumption may be for some econometric exercises, it is analytically untenable. Since saving and consumption exhaust current income and since an increase in the relative cost of one necessarily means a decrease in the relative cost of the other, if saving

is zero elastic with respect to its cost, so too must be consumption. But suppose that at a given income level, the cost of consumption is increased while that of saving is reduced (for example, by substituting a retail sales tax for an income tax, with no change in total revenue). Then if saving, hence consumption, is completely inelastic with respect to its relative cost, total consumption outlays must increase and total saving must fall by the amount of the increase in the cost of consumption. This result, that consumption increases in response to an increase in its relative cost while saving decreases when its relative cost falls, is absurd in itself; even if it were accepted, it clearly denies the notion that saving is zero elastic with respect to its cost. Indeed, the zero-elasticity assumption is a logical impossibility.

Paradoxically, the view that an increase in net foreign investment is at the expense of domestic investment because *total saving* is unresponsive to its cost necessarily implies that the *allocation* of saving is responsive to risk-adjusted differentials in these costs (or equivalently, rates of return). In other words, according to this view total saving is insensitive to its cost, but its allocation, in contrast, is responsive to differentials in the cost of saving among alternative uses. Together these propositions hold that households—and businesses acting as their agents—attempt to maximize the amount of future income to be obtained from any given reservation of their current income from consumption, but that no matter how much or how little of their current income must be so reserved to obtain a given amount of future income, they will save the same amount.

Recognizing that the total amount saved and invested out of a given amount of income in fact is responsive to changes in the cost of saving relative to the cost of consumption leads to quite different con-

clusions about whether foreign investment displaces domestic investment. To see this, and in order to keep the analysis no more complicated than it need be, let us begin by assuming a two-country world with no taxes and using the same monetary units. Further, let us assume that there are no nonmarket barriers to intercountry movements of products or production inputs. Finally, let us assume that initially each country's exports and imports are in balance and that there are no capital flows between the two. This implies equilibrium in the sense that capital has been allocated between the two countries, by the nationals of each, in such amounts relative to the other production inputs in each that the rate of return on the capital is the same in each.

Now, let us suppose that a technological innovation in one of the countries, D, results in reducing the real resource cost of producing any given quantity of capital goods. We may simplify the analysis without loss of generality by assuming that capital goods in both countries consist of a single type of facility, say machine tools. Assuming some elasticity of substitution of the machine tools for other production inputs, the immediate consequence of the implementation of this technological innovation is to increase the aggregate real production potential of country D, as well as to reduce the relative price of machine tools. In the ordinary case, investment in the new machine tools by machine tool users in D will displace some investment that otherwise would have been made in older, less advanced tools; total investment, however, is likely to rise, since, by hypothesis, the cost of capital has been reduced.

If production resources in D are "fully" employed, the increase in investment in D must be offset by an equal reduction in some other expenditures on domestically produced goods and services. In all likeli-

hood, domestic consumption would be reduced, since the reduction in the cost of capital is equivalent to a reduction in the cost of saving relative to consumption. In short, the technological innovation results in a shift in the composition of full-employment output—from consumption to capital formation. If resources were less than fully employed, total output would increase *ex ante*; however, the proportion of output allocated to capital formation would rise.

Machine tool users in country F will also want to import some quantity of the new machine tools, and unless the new capital goods are a perfect substitute for other production inputs which F imports from D, F's total imports will increase. Since the balance of payments must balance, F's increase in imports (= D's increase in exports) must be exactly matched by (a) F's increasing its exports (= D's increasing its imports), (b) investment by D's nationals in F in an amount equal to F's trade deficit, or (c) some combination of both.

The increase in D's exports implies either an increase in total production in D, if there are idle production resources, or an equal reduction in some other domestic production if resources are fully employed. In the latter case, according to the tax reform argument, the offsetting reduction in domestic output would be in the form of reduced domestic investment. This assumption derives from the view that the total amount of saving, therefore total domestic and foreign investment, is fixed at any given income level. Then in this view, because resources are fully employed, income is not increased by the increase in exports, neither is saving, and therefore, neither is the total of gross domestic and net foreign investment. If imports are unchanged, an increase in exports is by definition an increase in net foreign investment. Hence, this view argues that the increase

in exports in our example must result in a decrease in domestic investment, under conditions of full employment.

The result, to repeat, depends critically on the assumption that saving is completely inelastic with respect to its cost. But on the contrary assumption, that saving is responsive to changes in its cost, the increase in D's exports equal to its foreign investment in F need not occur at the expense of domestic investment. Indeed, it is not likely to displace domestic investment at all.

The hypothesized reduction in the real resource cost of producing capital goods in our example is equivalent to a reduction in the cost of future income. Even if one assumes that the elasticity of demand for future income is quite low, the effect on the amount of current saving is likely nevertheless to be significant. Total saving, in other words, will increase, and this increase in total saving will result in an increase in domestic and foreign investment in proportions determined by a number of basic economic factors. In our example, it is unlikely that the increase in D's net exports i.e., in its foreign investment will result in any offsetting reduction in domestic investment. On the contrary, domestic production of consumption goods and services is likely to fall while domestic production of capital goods for domestic use and for exports increases.

Consider next an opposite kind of change in D—something which increases rather than reduces the cost of saving. For example, suppose D imposes a capital income tax of, say, 50 percent, limiting the applicability of the tax to domestic income. Obviously, the tax makes it more expensive for those subject to it to save and invest—they must give up a larger amount of consumption uses of current income to obtain any given amount of future income. If it is assumed, as the tax reform argument does, that total saving is

unresponsive to its costs, then the imposition of the tax in D will not affect total saving there nor the sum of D's domestic and foreign investment. But then the net return on saving and investment in D must fall by 50 percent. To pursue the tax-reform view's reasoning, analogous to the preceding case, investment by F in D will decrease. This means that F's exports to D (= D's imports) will decrease in equal amount. Then D realizes an export surplus. This export surplus—necessarily equal to D's net foreign investment—will be balanced, presumably, by a decrease in D's domestic investment.

The tax reform argument produces the paradoxical result that whether the cost of saving in D rises or falls, net foreign investment increases at the expense of domestic investment.

If, more realistically, it is assumed that D's total saving, hence the sum of its domestic and foreign investment, will decrease as the cost of saving is increased by the tax, different results follow. As saving and investing in D decreases, as capital therefore becomes scarcer, the pretax return—and at a constant tax rate, the net return—will increase. By how much will the net return have to rise—how much must the stock of capital decrease?

The decrease in capital in D will halt when the aftertax return has risen to equality with that in F. The critical question then is what happens to saving and investing in F in response to D's imposing its capital income tax. The answer is that unless savers and investors of both D and F are willing to accept lower returns for any given amount of saving or equivalently are willing to save more at any given cost, D's tax will not increase saving and investment in F. Hence, the rate of return in F will not change. Then the reduction in saving and investment in D must be sufficient to raise the after-tax

return there to the unchanged rate in F. The pretax rate of return in D, in other words, will have to double.

When this adjustment is completed, the amount of capital in F will be the same as if D had not imposed its tax, but the amount of capital in D will have fallen. The extent of the reduction in saving and capital formation in D required to attain the new equilibrium will depend on the responsiveness of saving to changes in its relative cost, the conditions of supply of noncapital production inputs, and the substitutability of capital for other inputs.

If fundamental saving proclivities were to change in response to the imposition of the tax in D, so that savers-investors would accept lower returns on any given amount of saving, the decrease in capital in D would be less while the total amount of capital in F would increase.

The change in the percentage allocation of capital between the two countries, it may be seen, results from D's imposing a tax on capital income. To the extent that people increase their saving at any given cost in response to the tax—a peculiar assumption indeed—some shift in investment from D to F will occur. To repeat, it is D's taxing capital income that impels any such shift.

This illustration, it will be readily recognized, involves a tax situation which goes beyond the present U.S. tax provisions pertaining to foreign-source income: D exempts foreign-source income entirely from its tax.

Does it make any sense to characterize D's tax as subsidizing foreign investment by its nationals? If D finds the results of its tax distasteful—other countries save and invest more—the remedy is obvious, viz., D should reduce the burden of its tax on capital income. If D deems other tax policy considerations to be determinant and persists in penalizing saving

and investment uses of its income and production capacity in favor of public and private consumption uses, it is difficult to understand why it should seek to extend this punitive effect to other nations whose tax systems more single-mindedly pursue economic progress.

The proposed tax reforms are properly seen as a manifestation of late 20th century mercantilism. As discussed earlier, they would preclude the optimum international allocation of capital on the belief of their proponents that making it more expensive to invest abroad will increase investment at home. As we have seen, this belief is mistaken; it is derived from the misapprehension that an increase in foreign investment displaces domestic investment.

(b) Does foreign investment by U.S. companies reduce the U.S. output employment, and income?

As noted earlier, the tax reform issue should focus on determination of whether foreign investment by U.S. companies is subsidized by present tax provisions. In fact, however, the issue appears to have been enlarged to include the question whether any such foreign investment, subsidized or not, is injurious to the U.S. economy. This latter question, therefore, warrants separate examination.

To address this question, let us return to our case of the two-country world without taxes. Again, assume that technological advances lead to the production in D of less costly, more productive machine tools.

Suppose that companies in D decide to undertake manufacturing operations in F, using the new machine tools which will be imported from D. As in the prior case, their investment in F must be matched initially by an equal increase in D's net exports to F. In this case, of course, their

investment in F is financed, in real terms, by the increase in D's exports to F equal to the value of the new machine tools used in the manufacturing operations in F.

Clearly, the investment by D's companies in F does not result in any immediate loss of domestic production in D, and it may result in an increase if there are idle production inputs in D. To repeat, in real terms the net investment by D in F must be financed by an increase in D's net exports to F. If D had idle production inputs, total domestic output will increase as a consequence of the increase in exports, irrespective of whether the additional exports are matched by additional imports, investment in F, or some combination of the two.

But won't the manufacturing operations undertaken by D's companies in F "displace" similar domestic production in D, either because such output in F substitutes for imports by F or because such output in F is exported to D as substitutes for products otherwise produced and used in D? In other words, doesn't the foreign investment by D's companies result in a subsequent loss of domestic production in D?

The answer, of course, stems from an elementary proposition of international trade. In the first place, companies in D would not undertake the investment and manufacturing operations in F unless they anticipated that the present value of the returns on the use of the machine tools in F would at least equal that in D. If the investment occurs, then, it must be that the real costs of production in F are lower than in D. But if this is so, it is to the advantage of D to have the machine tool's output produced in F, since it will cost less in terms of real input requirements to obtain any given amount of such output; for example, D need use less of its

production inputs to produce exports to F to pay for the output the machine tools produce in F. In short, the foreign production increases D's production capability, which is the fundamental occasion for trade. To be sure, the composition of output in D must change under these circumstances, and it must be recognized that there are some real transitory costs in reallocating production inputs to other uses. But beyond the transition period, the total amount of real output which D can claim clearly will be greater if, under the postulated circumstances, the new machine tools are used in F and the production inputs with which they would otherwise be used in D are reallocated to other more rewarding kinds of production.

The "displacement" of production in D, it is clear, does not depend on D's investing in F but rather on D's exporting the new machine tools to F. If the "displacement" is deemed to be intolerable, accordingly, D must ban the exports; focusing concern on the foreign investment is closing the barn door after the horse has gone.

Moreover, the "displacement" in D resulting from the use of the new machine tools in F is merely a special case of the general rule that trade necessarily involves a different allocation of production inputs from that which would be made in a closed economy. Thus, suppose D's nationals invest in a subsidiary in F which engages in operations requiring no production inputs exported by D. By hypothesis, if the investment is made, it is because the real costs of the particular production activity are lower in F than in D, implying necessarily that some change has occurred in F in the conditions of supply of some production inputs, in the technical conditions of production, and or in the state of the industrial arts, that is, some change in the real terms of trade. Such foreign investment must be ad-

vantageous to both D and F, putting aside the transitional costs of any real resource reallocation which may be required. Various economic entities in D may be temporarily disadvantaged by the displacement resulting from the new or expanded activity in F, but if such disadvantages are to be avoided altogether, D must refuse to import from F, that is, must refuse to engage in trade at all. Moreover, any such temporary disadvantages of trade-caused displacement in D does not depend on whether the particular production activity in F is undertaken by D's nationals or F's. Displacement, therefore, does not depend on D's nationals investing abroad unless it could be shown that they alone could undertake the operations in F, that is, enjoyed some monopoly control over an essential production input or process.

To repeat, the companies in D would not have undertaken the investment in F unless they anticipated that the present value of the returns on the use of the machine tools in F would at least equal that in D. The form of payment for the use of the machine tools, the time pattern of these payments, and the particular place where the payments were made, that is, in D or in F, would be of no consequence so long as the present values (adjusted for such risks as might be involved) were equal.

With respect to any of these alternatives, it is clear that both D and F are advantaged. When adjustment to the implementation of the technological innovation is complete, both D and F will have a larger stock of real capital, hence greater production potential, than they would have had otherwise. In the new equilibrium, moreover, the capital-labor ratios in both countries will be greater and capital formation will be a larger share of total output than otherwise. The marginal product of labor, hence the real wage rate, is likely to be greater than

otherwise. And the rate of return on any given amount of additional capital in D and F will be the same; savers in each country will be indifferent regarding the allocation of their marginal saving between the two countries. Both countries realize an increase in real production potential. From D's point of view, each of the alternative forms of payment for the additional exports must be of equal present value and equal to the present value of the incremental real income which the exported machine tools would produce if instead of being exported they were used in D.

Would anyone insist that D loses by exporting the additional machine tools—real capital—and importing an equally valuable amount of F's output? Would anyone argue that D loses anything if D's machine tool exporters chose, instead, to receive from F's machine tool importers claims on F's future income the present value of which is equal to that of the exported machine tools if used in D? The latter, which is D's incremental investment in F, must be equal in value to the exported machine tools and to the imports from F. It must also be equal to the value of any alternative investment (of equal risk) which might be made in D.

But suppose that the D investors in F choose *never* to repatriate *any* of the earnings on their investments in F; hasn't D then permanently lost an amount equal to the present value of the income stream which the exported machine tools would have produced if they had, instead, been used in D?

In fact, D suffers no loss from failure by its nationals to repatriate earnings on their investment in F. Since the foreign investment, by definition, equals the excess of D's exports over its imports, the *initial* real income produced in D in the production of the new machine tools is the same irrespective of where the tools are sold, in D or to F. They will be sold to

F, clearly, only if the price there is at least equal to their price in D, and the optimum allocations of the sales between D and F, obviously, will be such that the price per machine tool is the same in both D and F. Then irrespective of the form of the payment for the exported machine tools, its present worth to D must equal the price of the machine tools sold in D which in turn must be equal to the present value of the product or income generated by the machine tools in D. Then D must be indifferent whether an additional machine tool is sold domestically or to F and equally indifferent as to the form of payment—that is, imports from F or claims on F's future income—for the machine tool sale. Moreover, D must also be indifferent as to the time pattern of the claims on F's future income or whether F satisfies those claims as they arise by exports to D or by making deposits to D's accounts in banks in D or in F, so long as the present value of the claims is equal to the price of the tools.

If D insists on repatriation, or, the mistaken belief that its claims on F's future income are valuable only if the earnings are repatriated, then it must somehow or other prohibit any trade surplus, hence any foreign investment. D cannot have a trade surplus and a full repatriation policy at the same time. All repatriations of earnings on D investment in F require equal trade deficits by D as the repatriations occur. Since by assumption the present value of those claims to F's future trade surpluses (= D's trade deficits) as it repatriates earnings to D must also be equal to D's initial surplus. Insisting on repatriation is equivalent to insisting on a zero trade balance. But if D's initial trade surplus is deemed to have increased D's domestic product, then by the same token D's subsequent trade deficits must reduce D's domestic product. On the other hand, if D's initial trade surplus involved no change in D's total domestic production but merely a change in its composition

(that is, more export goods and less, say, domestically sold consumptions goods), then neither need the subsequent trade deficits, arising as repatriation occurs, affect total domestic output. Neither does failure to repatriate involve any such reduction, but merely differences in the composition of a given volume of output.

Apart from the direct displacement effects, just discussed, indirect displacement effects of foreign investment allegedly result from the resulting transfer abroad of U.S. technological advantages. This view implies that U.S. companies do, indeed, have advantages over those of other nations—that they exercise some monopoly control over the production inputs or processes involved in technological advance and innovation. Were this the case it might be argued that restricting U.S. investment abroad would not simply change the nationality of the foreign investment but also reduce its aggregate volume. In turn, this would ostensibly reduce the rate of growth of foreign production capacity and the alleged adverse impact of that increase in foreign production on U.S. output and employment.

Apart from the fact that both theory and data show that expansion of worldwide production capacity and output enlarges the trade and productivity of all the trading partners and that restricting this expansion adversely affects them all, this argument also reduces to the untenable proposition that trade itself is injurious to the U.S. economy. For unless the technological advantages to which this argument refers are exclusively in intangible form, for example, specialized managerial abilities or technical skills, or unless exports are carefully restricted, the alleged superior technology is conveyed abroad by the very act of exportation. Every 747 aircraft added to a foreign airline, every numerically controlled machine tool sold to a foreign manufacturer,

every advanced-generation computer licensed or leased for use abroad conveys the technological competence which, presumably, is exported by the foreign investment of U.S. multinational companies. The use by foreign producers of technically advanced U.S. exports surely must be just as disadvantageous to U.S. production and employment as the use of the real capital in the same foreign jurisdiction by subsidiaries or branches of U.S. companies. In logic, if the foreign investment by U.S. companies is to be restricted on these grounds, then U.S. exports should be restricted to technologically antique commodities.

Suppose the technological advantage is deemed to be found in the superior executive, management, and technical skills of U.S. company personnel assigned to foreign subsidiaries. Might it then not be argued that restricting the foreign investment which requires these foreign assignments would result in retaining these technological advantages within the U.S.?

The answer is much the same as that already provided. It must be assumed that the use of these personnel abroad is more productive than in the U.S. As a consequence, the U.S. must be advantaged; the present value of its total income claims are greater than if these skills were confined to the United States. Moreover, if this view cannot be accepted, a necessary implication is that the United States must shut off yet another kind of export—that of training and education by barring foreign students from its universities and technical institutes.

As the preceding analysis shows, the arguments that foreign investment by U.S. companies reduces U.S. employment, output, and income basically are objections to the U.S.'s engaging in international trade, rather than objections either to tax provisions which would

neutrally treat foreign income or to the foreign investment generating that income.

Consider, for example, the first of these arguments, that foreign investment shifts production from the United States to some other jurisdiction. To be sure, insofar as trade surpluses are matched by real investment abroad, rather than merely by the accumulation of financial claims, some additional production activity in the foreign jurisdiction is likely to occur. The question, however, is why this real investment is made. Clearly, the reason must be that such investment is more profitable than equal domestic investment. Whether this greater profitability is attributable to lower input costs, more efficient technology, a more genial tax environment, or some other factors is simply not relevant. For unless this greater profitability is available only to the U.S. company or equivalently U.S. companies enjoy some advantage over companies of other nationalities in investing abroad, tax or other restrictions on foreign investment by U.S. companies will not reduce the amount of such investment but merely change the nationality of the investing companies. Irrespective of the nationality of the foreign investing company, the impact on U.S. domestic production and employment is the same.

The type of foreign investment situation which appears particularly offensive to some tax reform proponents is that in which a U.S. company organizes a foreign subsidiary, either investing the retained earnings of other foreign subsidiaries or raising the required capital by foreign issues in foreign currencies, and relying on foreign production inputs, raw materials, and so forth. Insofar as these foreign operations produce products which are also produced in the U.S., it appears that they necessarily involve a reduction in domestic U.S. production, without even the offsetting gain—at least

partial—of requiring an increase in U.S. exports to finance the initial investment in real terms.

This is, however, the very type of foreign investment for which no reasonable case can be made to expose the income it generates to U.S. tax. The foreign subsidiary in this case is a U.S. entity in name only. By hypothesis, no U.S. real resources were required for its organization or its operations; the investment, in this sense, is costless to the U.S., whatever the cost it imposes on the economy of the foreign jurisdiction. The effects of this subsidiary's operations on U.S. output and employment can differ in no material respect from those which would be generated by any other company of any other nationality undertaking the identical investment and production. Applying U.S. taxes to this company's income in order to inhibit the investment, therefore, is merely restricting competition for the real foreign resources required for the investment and production activity, to the obvious benefit of foreign firms free of similar tax burdens.

It is the opportunity for more profitable production in the foreign jurisdiction than in the U.S., not the real foreign investment by U.S. companies, which may affect U.S. output and employment. But these differences in production advantages among countries are the fundamental basis for international trade. The U.S. cannot be sheltered from the output and employment effects of changes in these comparative advantages by inhibiting foreign investment by U.S. business but only by withdrawing from international trade.

3. Would the proposed tax reforms increase U.S. employment, output, and income by repatriating U.S. foreign investment?

To address this question, it is useful to begin by examining the effects of the

existing tax treatment—notably the allowance of a credit against U.S. tax liability on foreign-source income for the taxes paid to the foreign jurisdictions. For this purpose, let us return once again to our two-country world, this time assuming that D imposes the same capital income tax on its nationals' foreign-source income as it imposes on capital income earned at home. Suppose that D allows a foreign tax credit against its tax. If F imposes no tax, then D's tax will apply fully to the income on its nationals' investment in F. Obviously, the amount of such investment will decrease. If initially D's investment in F represented a substantial fraction of the total investment in F, then the decrease in such investment will tend to raise the pretax returns on capital in F. In response, F's nationals will increase their saving and investment in F, partially substituting for the decreasing investment by D's nationals. Total investment in F, however, will decline in the general case. In effect, D's imposing its tax on the foreign source income of its nationals leads to displacement of its nationals' foreign investment by the investment of others. If these adjustments result in a higher equilibrium rate of return in F, as they are likely to do, investment in D will be lower than if D had not imposed its tax on the foreign source income of its nationals.

If F were to impose the same tax as D on capital income earned in its jurisdiction, D's nationals would continue to invest the same amount as before F levied its tax, provided D allows a foreign tax credit for F's taxes on the income from such investment. In this case, investment by F's nationals will also decrease, just as investment in D declined in response to D's imposing its tax. The result will be a reduction in total investment in F.

Contrary to the assertion of the tax reform proponents, the present-law treatment of foreign-source income does not

expand foreign investment by U.S. companies at the cost of domestic investment. The culprit responsible for the loss of domestic investment in the United States is the excessive taxation of saving, hence capital formation, compared to consumption uses of income. The application of one of the sources of this excessive tax—the corporation income tax—to foreign-source income, even where foreign taxes may be credited against U.S. tax—in no way reduces this U.S. tax bias against saving and domestic investment. It serves, rather, merely to restrict the bias against foreign investment to about the same degree as that imposed on domestic investment.

Suppose that D permits its nationals only to deduct taxes paid to F on their incomes in F, instead of allowing a credit for such taxes. Would this tax change increase investment in D?

If F has no tax, D's nationals will invest in F only if the return there is equal to the pretax return in D. This means that if the investment is to be made in F, the return on investment in F must increase from 10 percent to 20 percent. But the return on investment in F will double only if total capital in F declines enough relative to other production inputs in F to double the marginal product of capital. More realistically, as D's nationals reduce their investment, F's nationals will increase their investments in F, partially replacing D's investment. Total investment in F will probably decline, however. To the extent that any such decline in F's stock of capital relative to its other inputs occurs, F suffers the consequences of a reduction in production potential, just as if it, too, had imposed a capital income tax.

If F does in fact impose the same tax as D, then D's nationals will further reduce their investment in F, if F's taxes may only be deducted against income instead of being credited against D tax liability.

In our example, the pretax return on D's nationals' investments in F would have to quadruple if the after-tax return in F is to equal that in D. Obviously, far fewer investments in F will prove attractive to D's nationals under these conditions. The effect on total investment in F will depend on how large a proportion of the investment was made by D's nationals: the larger the proportion, the greater the reduction in total investment.

In either case D's extending its tax to its nationals' income on investments in F reduces total investment in F.

In other words by imposing its tax on returns to foreign investment by its nationals, D exports its tax and its adverse effects on production capacity and output to F. In what reasonable sense can neutrality mean that if D chooses to be poorer, F must also be impoverished?

The consequences of D's taxing the foreign-source income of its nationals is to accentuate the sacrifice of production potential and the attendant reduction in labor's productivity, real wage rates, and employment opportunities resulting from its tax on domestic capital income. As a corollary, taxing the foreign source income further distorts the allocation of production resources in D. Output will not only shift away from adding to production capacity, it will also shift from exports to private and public consumption production.

At best, therefore, D's imposition of a tax on returns on investment in F will change the composition of domestic real output from export to private or public consumption goods production. And the total amount of this production, irrespective of the shift in its composition, will be less than it would have been if D had not imposed the capital income tax in the first place. Moreover, both D and F must lose by D's taxing returns on investment in F. F loses the gain in its production capacity

and domestic product which would have resulted from the higher level of investment by D in F. And even if D can uninterruptedly maintain a constant rate of domestic resource utilization, its production inputs will be less productively employed by virtue of the curtailment in trade resulting from D's taxing returns on investment in F.

The argument for D's taxing the foreign source income, in logic, calls for *restricting* its exports. The argument is that lacking these tax provisions, D's nationals may use real resources to finance investment in F where the real marginal return is less than that in D. For example, suppose that without these tax provisions D's nationals would invest \$100,000 in a subsidiary in F. Suppose this investment would yield \$10,000 per year in F, when F imposes no tax, but \$20,000 per year *pretax* in D. According to the tax reform argument, the "correct" tax provisions should inhibit the investment in F unless it, too, yields \$20,000 per year. In real terms, financing this investment requires an equal \$100,000 increase in exports over imports. Suppose these

additional exports are capital goods. On this criterion, why should D allow the export to F of \$100,000 of its capital, irrespective of whether the export finances, in real terms, the investment in F? After all, if the capital is used in D, it will produce \$20,000 per year *pretax*, while in F it produces only \$10,000. Then the export of \$100,000 of capital involves D's foregoing a *pretax* income stream the present value of which is \$200,000 in exchange for either imports or claims on F's future income with a present value of only \$100,000. To be consistent, then, with the "reasoning" upon which it decided to tax the foreign-source income, D should embargo all sales of the capital to F at any price less than \$200,000. Alternatively, D should impose an excise tax of \$100,000 on the export of the capital.

The same line of reasoning that calls for taxing foreign source income, in other words, also calls for control of exports irrespective of their form, to insure that the present value of the payments made for them at least equals the present value of the *pretax* returns on domestic investment in an amount equal to the exports.

Conclusion

This discussion has been cast, deliberately, in abstract and hypothetical terms. The reason for doing so is to try to expose the fundamental analytical issues involved in determining the "best" tax treatment of foreign-source income. I hope that this purpose has been served.

This by no means is intended to deprecate the importance of actual business evidence as it pertains to these issues. Such evidence has been abundantly supplied. It shows that foreign investment by U.S. subsidiaries does not displace the parent companies' investment at home; indeed, U.S. companies whose foreign subsidiaries are most rapidly expanding

the scale of their operations are for the most part, investing domestically at rates exceeding those of purely domestic companies in the same industries. It shows, further, a direct, positive connection between the foreign investment in these subsidiaries and the expansion of parent company exports. It shows a return flow to the United States of earnings on foreign investments which exceeds each year the additions to the stock of capital in the foreign subsidiaries and which, on the average, is over half of the net earnings of the subsidiaries. At the more aggregative level, changes in net foreign investment show no correlation with changes in the unemployment rate. Nor is the strong

growth of such investment in the last decade or so associated with any change in the labor share of national income originating in business or with the growth in the dollar amount of that share.

The data and factual evidence from business, I believe, strongly confirm the arguments I have advanced against the alleged deleterious effects of the existing tax provisions and against the proposed tax reforms. I should like to think that that evidence will be more persuasive if presented in a framework of analysis similar to that in my discussion.

Even more, I hope that my discussion, together with the evidence from business experience, will prove useful in stemming the current thrust toward neomercantilism. One would have thought that the benefits of trade would become in-

creasingly evident as the economies of the world become increasingly "open." By the same token, one would have thought that the benefits of international capital flows, unimpeded by nationalistically-inspired tax obstacles, would be obvious. As this discussion has been at pains to show, however, the thrust of the tax reform proposals is to erect new barriers to the efficient allocation of capital, to the disadvantage of everyone.

Adopting the proposed tax reforms will not expand U.S. domestic investment. It will not increase U.S. employment and output. It will not increase U.S. national income. Indeed, by impairing our trade and distorting the allocation of capital, as it must, it will reduce the efficiency and productivity growth of the U.S. economy.